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## World Economy in Low Gear

This year the world economy visibly lacks momentum. Production is increasing much more slowly than forecast in most industrialised countries. This in turn is making it more and more difficult for developing countries to resolve their internal and external economic problems. The flagging of economic activity following a four-year upward trend is not in itself an unusual phenomenon. However, the continued improvement in the overall economic setting in 1986, which resulted from the drastic reduction in the price of oil, the general success in curbing inflation, and the drop in interest rates, pointed towards a more favourable worldwide economic trend. Apparently, economic expansionary forces in Japan and Western Europe were primarily paralysed by the adjustment problems associated with the seemingly unending decline of the US-dollar. The stimulating effects in the primarily domestically oriented US economy, on the other hand, were less rapidly felt.

The influence of the incisive shift in exchange-rate relationships on international flows of goods and services is gradually becoming clearer. In the USA, for example, exports are now increasing due to the renewed improvement in competitiveness, whereas there is hardly any further increase in imports; this year's "external contribution", therefore, again promises to contribute towards economic growth for the first time since 1980. This contrasts with retardant influences in Japan and Western Europe, where suppliers from the dollar area benefit to a disproportionate degree from the increase in domestic demand. In real terms, this means that the reduction of the external economic imbalance between the USA and other industrialised countries has begun. In nominal terms the situation will at first change only slightly, however, despite the influence of the shifts in the terms of trade induced by the development of exchange rates.

Both the USA's deficit on current account – a good \$ 140 billion in 1986 – as well as the surpluses recorded by Japan and the Federal Republic of Germany – \$ 86 and \$ 36 billion respectively – will probably decrease only slightly in 1987.

In view of the extent of the preceding undesirable developments in the USA it comes as no surprise that the rectification of the external disequilibrium will take time. Nevertheless, the continuing deficits repeatedly kindle expectations of a further depreciation of the dollar. Even if model calculations support such prognoses they still have a primarily speculative nature and are based on a whole series of uncertain hypotheses concerning the development of adjustment processes. Who, for example, can predict the extent to which the measures introduced to improve the competitive strength of American firms during the strong dollar phase will become effective? What is more, the general economic policy framework is of central importance for exchange rates, as developments since the beginning of the 1980's underline.

The decline of the dollar exchange rate, which has now continued for over two years, was primarily triggered by the USA's extremely expansionist monetary policy – against the background of a fiscal policy which proved incapable of consolidation. The exchange rate effects were not only part of a strategy to back expansionary economic stimuli in the USA, but at the same time a welcome means of exerting pressure on other industrialised countries to adopt an expansionary economic policy course. This strategy was at least successful in the monetary field in so far as many central banks tried to offset an even greater appreciation of their currencies against the dollar by reducing interest rates. As a result, the increase in the money supply worldwide has, for over two years now, been much greater than an expansion

based on the requirements of the production potential and stability would have been. At the same time, hardly any retardant effects emanated from fiscal policies.

It is all the more astonishing that even last year's oil bonanza was unable to give new momentum to the economic development of industrialised countries. The fact that the adjustment of the exchange rate relationships between the currencies of the industrialised countries, an adjustment which was unavoidable following the preceding dollar "boom" period, has led to noticeable friction, indicates that the fundamental conditions for international economic growth are still marked by substantial faults. A major contributory factor in this respect is the continuing budget deficit in the USA, which causes a constant misallocation of worldwide capital supply towards consumption and has thus produced exaggeratedly high real interest rates. In Western Europe, high public sector shares in GNP together with government regulation of commodity and factor markets continue to considerably limit the scope for market economy dynamics and flexibility. Finally, many developing countries lack the kind of promising growth strategies which would give them a better chance of overcoming their debt crises.

Economic policy, therefore, which has in all major countries since the beginning of the 1980s set out to achieve a lasting improvement in the conditions for growth, still has a long and arduous path ahead despite substantial successes – especially in the fight against inflation. In view of the considerable interdependence of national economies each country is not only confronted by its own problems, but more than ever before by the repercussions of worldwide developments. Under these circumstances, discussion on economic policies and cooperation between governments and central banks can help reduce the risk of incorrect analyses and inappropriate measures. However, despite the Plaza meeting and the Louvre agreement there are limits to effective cooperation, since even a large number of common interests cannot brush aside the considerable differences in the priorities and economic policy concepts of major countries.

The overriding significance of the USA is brought to bear in the economic policy field as a result of the *de facto* coordination via international commodity and financial markets. As demonstrated in particular by monetary developments, other countries can hardly ignore this influence. At the same time, this means that the world's dominant economy has a relatively broad scope for external economic "benign neglect". This is the only reason why the USA has been able to stick to a policy of high budget deficits and excessive monetary growth for so long, even though the growing risk of renewed inflation was not offset by noticeable growth success.

The most significant achievement of economic policy cooperation so far has been the limitation of protectionist intervention. There have at any rate been far fewer protectionist measures than might have been expected in view of the marked slowdown of economic growth and the increase in unemployment since the mid-1970's. Yet even the success in this field is currently jeopardised, since the slack world economy, the essential changes in external economic structures and the current account imbalances increase pressure on governments to protect domestic producers. The draft version of the new trade bill in the USA is a warning, and there is a growing risk of trade wars between the USA, Japan and the European Community. Once doubts about the continued existence of the principle of free trade begin to increase, a principle whose growing acceptance after the Second World War was one of the most important motors of economic growth, this is bound to have particularly adverse effects on the propensity to invest in the export industries so important to growth. And since growing protectionism also reduces the sales opportunities of developing countries the prospects for defusing the debt crisis will also deteriorate.

The risk of a vicious circle of weak growth, which encourages protectionism, and the accompanying further deterioration of growth prospects poses a major challenge to the economic policies of the industrialised countries. Correspondingly pleasant-sounding declarations, therefore, will inevitably be heard during next month's economic summit. Their value will depend on whether, following the disillusioning experiences of recent years, attempts to lend greater credibility to the objectives and economic policy declarations of the summiteers are successful.

Günter Großer