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Perspectives for the world economy in 1987/88

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ECONOMIC TRENDS

Perspectives for the World Economy in 1987/88

Economic developments in the industrialised countries are marked by adjustments to the drastic decline the dollar exchange rate has undergone during the past two years. Although the trade disequilibria between the USA and the other economies continue to be pronounced, the shift in competitive positions which has occurred as a result of the exchange rate movements is nevertheless having an obvious effect on current developments. An improvement in the external position has now got under way in the United States, which is reinforcing the expansionary trends, whereas the tendency in Japan and in most Western European economies is for real net exports to decline, thus retarding the growth in production. Overall, the economic cycle in the industrial nations is on a modest upward path. Unemployment is falling in the USA, but is rising, if anything, in many other industrialised countries. Now that price reductions in the energy sector have run their course, price rises in other spheres are again becoming more clearly evident.

Effects of the Debt Crisis

World economic activity continues to be subdued by the balance of payments problems facing the developing countries. The oil exporting countries among them were still strongly restricting imports well into the current year in an effort to compensate for the loss of export earnings after the plunge in oil prices in the first

half of 1986. The price of oil has recovered about two-fifths of its earlier losses since that time, however, so that the curtailment of demand on the part of the oil exporting countries ought now to be coming to an end. The other side of the picture, though, is that the relief felt by oil importing economies has also been reduced. This applies equally to many developing countries which were already adversely affected by increasing dollar interest rates in the spring of this year and by the relative sluggishness of the industrial countries' economies. The situation does vary a lot from one country to another, however, depending on their economic structures and the policies they are pursuing. In the South East Asian NICs, for example, where domestic currencies largely moved with the dollar, the balance on current account has continued to strengthen, while tendencies towards a more negative balance have asserted themselves in major highly indebted countries.

Exchange-rate Oriented Monetary Policies

Until the beginning of this year, the decline in the dollar continued to be forced onward by American monetary policy, which was oriented one-sidedly towards stimulating demand. This, however, brought the undesired consequences of increasing inflation risks in the USA and an ever more obvious suppression of stimulatory forces in revaluing countries. In spring this year, therefore, the expansion of the money supply in the

National Product and Prices

(Year-on-year change in %)

	Real Gross National Product				Domestic Demand ¹				Consumer Prices			
	1985	1986	1987 ^a	1988 ^a	1985	1986	1987 ^a	1988 ^a	1985	1986	1987 ^a	1988 ^a
Western Europe ²	2.6	2.5	2.0	2.0	2.2	3.5	2.5	2.5	5.4	3.0	3.0	3.5
USA	2.7	2.5	2.5	2.5	4.8	3.6	2.0	1.5	3.6	1.9	4.0	4.5
Japan	4.7	2.5	3.0	3.0	3.4	4.2	4.0	4.0	2.1	0.6	0.0	1.0
Industrialised Countries												
Total ²	3.0	2.5	2.5	2.5	3.5	3.5	2.5	2.5	4.1	2.2	3.0	3.5

¹ Private consumption, government consumption and investments in fixed assets. ² Weighted by gross national product or domestic demand or private consumption respectively in 1982. ^aForecast; figures rounded to nearest 0.5 %.

Sources: OECD, EC, national statistics, own estimates and forecasts.

USA was returned to a rate compatible with maintaining stability, and interest rates rose once again. At the same time, Japan and most Western European countries intensified their efforts to prevent their own currencies from being revalued any further against the dollar. In many cases, though, the interest rate reductions which were imperative for achieving that goal meant that monetary expansion in excess of existing targets had to be accepted; substantial foreign exchange market intervention reinforced this tendency. Evidently, the central banks have succeeded in lending credibility to their determination to stabilise exchange rates – at a dollar exchange rate which is again roughly equivalent to its level at the beginning of the 1980's.

Different Fiscal Policies

American fiscal policy plays a key role both in the emergence of the disequilibria between the USA and other industrialised countries in the first place and in their eventual correction. Following the failure to "consolidate" the 1981-83 tax reductions by keeping expenditure in check, the rising budget deficits meant recourse to foreign resources on a massive scale. About a year ago, however, the trend began to reverse, and the marked reduction of the budget deficit in the current financial year generates additional confidence in a stabilisation of the dollar exchange rate, even though

any further progress in consolidating the budget does not appear to be guaranteed at the present stage of the debate. Thus, while fiscal policy in the USA now has a tendency to be contractive, in Japan and the Federal Republic of Germany – fiscal deficits having been progressively reduced – the policy is now expansionary again. In the other countries, in contrast to this, efforts to consolidate the budget as a contribution to the medium-term improvement of conditions on the supply side still predominate.

Manifold Risks

The forecast of world economic activity is based on the assumption that economic policies in the major industrialised countries continue in line with their present course, and that the trend towards a more stable dollar will continue. The main source of uncertainty in this respect is how developments will unfold in the USA. Given the substantial monetary scope for passing on price and wage increases, there is a danger that American inflationary expectations could escalate – increasing import prices being one important trigger. This, however, would make restrictive economic policies unavoidable, and the recessionary effects generated would necessarily be felt beyond the shores of the USA. In Japan and Western Europe, too, it is increasingly difficult as time goes on to keep monetary policy on a

PUBLICATIONS OF THE HWWA-INSTITUT FÜR WIRTSCHAFTSFORSCHUNG-HAMBURG

Klaus Fertig

ÖLANGEBOTSMODELLE: ENTSCHEIDUNGSHILFEN FÜR DIE WIRTSCHAFTSPOLITIK? (OIL SUPPLY MODELS: DECISION-MAKING AIDS FOR ECONOMIC POLICY?)

In the years 1973/74 and again in 1979/81 the world economy was shaken by steep increases in the price of oil. Adjustment to high energy prices became a central task for economic policy both in industrialised countries and in the Third World. This book examines the question, whether and in what way the numerous models designed to explain future oil supply are able to provide the oil-importing western industrialised countries with decision-making aids for the evaluation of the supply situation during the critical phase of the next twenty years. The author lays particular emphasis on optimization models, which are based on the theory of exhaustible resources, and which allow the price and quantity decisions of the oil-suppliers to be derived from the model. (In German)

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V E R L A G W E L T A R C H I V G M B H – H A M B U R G

path which has regard both for the exchange rate and for internal stability. On top of this, the burdens placed on the international financial system by the debt crisis persist as strongly as ever, especially because in the face of restrained world economic activity the only way of correcting the major adverse developments of the past would be to make adjustments so incisive as to be politically unenforceable at present. Furthermore, in industrialised and developing countries alike any sustainable improvement in growth conditions is being placed in jeopardy by insidious increases in protectionism.

USA: Further Expansion

Although, in contrast to previous years, the current process of adjustment both within and between the industrialised countries is at last heading in the "right" direction, the risks facing a further upward movement in world economic activity clearly continue to be severe. On the other hand, there are good reasons for assuming that the situation will at least not come to a head within the near future. In the USA, for example, the fact that pay increases have been modest and that increases in interest rates have slackened off in the recent period suggests that inflationary expectations are remaining within relatively narrow bounds despite the noticeable acceleration in price increases. To this extent, the present modest expansion of the money supply can be expected to continue in the USA. Under these circumstances, domestic demand ought to continue rising at a slow pace, particularly as the propensity to invest is again apparently firming up a little. The improvement in net exports, too, will continue to contribute to the increase in production. Real gross national product will probably rise by approximately 2.5% in 1987, followed by a similar rise in 1988, the latter being reinforced by the fact that economic policy-

makers will be at pains to avoid applying the brakes during an election year.

Western Europe and Japan

The stimulus to the US economy from foreign trade is accompanied by depressive effects in the other industrialised countries, whose net exports will decrease further despite an easing in the retarding influences emanating from OPEC and other developing countries. Domestic demand in Japan and Western Europe, on the other hand, is expected to show a noticeable increase. Now that the dollar is tending to stabilise, uncertainty – among investors in particular – will presumably ease off again, allowing the improvements in important growth preconditions achieved during recent years to exert a renewed influence. With the backing of short-term monetary stimuli, business investment therefore ought to increase at a modest pace in most Western European economies. This would mean that the most important condition for a continuation of the economic uptrend would have been met, even though the expansion will probably remain modest in view of the continuing adjustments in the external sector. Both in 1987 and 1988, the real gross national product of the Western European economies is expected to be only 2% higher on average than the level for the preceding year. In Japan, the exchange rate's subduing effect on the propensity to invest appears to be stronger than in Western Europe. The country's reflationary fiscal policy, on the other hand, is temporarily creating powerful stimuli. Both this year and next, the rate of growth in the Japanese economy as a whole is likely to be something approaching 3%.

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	June	March	April	May	June	3.7.	17.7.
Total index	143.2 ^P	129.0 ^P	146.8 ^P	147.8 ^P	148.9 ^P	148.5 ^P	148.5 ^P	148.5 ^P
Total, excl. energy raw materials	116.1	114.2	117.2	119.5	122.4	121.5	121.7	121.8
Food, tropical beverages	107.1	103.1	88.3	89.6	93.6	90.2	88.5	87.6
Industrial raw materials	122.9	122.6	138.8	142.3	144.3	145.3	147.1	147.8
Agricultural raw materials	131.0	131.6	156.4	163.3	167.2	168.4	169.4	171.0
Non-ferrous metals	124.3	124.8	131.9	133.4	139.5	142.1	147.6	147.3
Energy raw materials	159.1 ^P	137.6 ^P	164.1 ^P	164.3 ^P	164.4 ^P	164.2 ^P	164.1 ^P	164.1 ^P

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