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World Economy Burdened by Imbalances

The development of the world economy is overshadowed by the slump of the dollar and the collapse of international stockmarkets. What are the prospects for the world economy in 1988?

The dramatic crash on international stockmarkets on October 19th and the subsequent further decline of the dollar were, in the final analysis, a reflection of growing doubts about the ability of existing economic policy strategies to reduce serious international economic imbalances. Up until the end of 1987 the governments of the major industrialised countries were unable to achieve a sustainable stabilisation of financial markets. This has an adverse effect on the prospects for the world economy in 1988.

The crisis in October was all the more astonishing in view of the general consolidation of the rising trend in demand and production last year following an unstable phase at the beginning of the year. The increase of 2.75 % in the aggregate real GNP of the industrialised countries in 1987 was no lower than the previous year's figure. The increase in domestic demand was greater in Japan and Western Europe than in the USA. However, in the wake of the process of external economic adjustment brought about by the many years of dollar depreciation a redistribution of economic stimuli took place in favour of the USA. Under the favourable influence of continuingly moderate pay settlements there was a substantial increase in the level of employment in the USA; the rate of unemployment recently fell below the 6 per cent mark. In Western Europe, on the other hand, there was only a slight increase in the number of gainfully employed persons, the unemployment level remaining at a good 10 %. The rate of inflation in the industrialised countries increased at the beginning of 1987 following the abatement of the stabilisation effects emanating from the reduction of oil prices during the previous year; on the whole, however, it remained moderate. The stimuli emanating from the depreciation of the dollar provide one explanation for the higher average annual rate of inflation at consumer level of almost 4 % in the USA as compared with 3 % in

Western Europe – with substantial differences from one country to the next – and virtual stability in Japan.

The development of the world economy was increasingly burdened by the continuation of external economic imbalances. The current account deficit in the USA of almost US \$ 160 billion in 1987 was once again markedly higher than in the previous year. It corresponded to a good 3.5 % of GNP. The current account surpluses in Japan and the Federal Republic of Germany, on the other hand, reached a similar order of magnitude at an estimated US \$ 85 billion and US \$ 45 billion respectively, and were even higher in relation to GNP in a number of newly industrialising Asian countries. One effect of the pronounced depreciation of the dollar since 1985 was the substantial increase in exports from the USA in real terms last year and the tailing off of the increase in imports. On the balance on current account, however, this was above all concealed by the deterioration of the terms of trade.

The serious imbalances are due to economic policy errors which date back to the beginning of the eighties. At that time the USA was unable to "finance" the supply-orientated reduction of taxes by curbing the rise in spending. With a low domestic savings level, a stability-orientated monetary policy and an over four-year period of dollar appreciation, however, the considerable increase in the budget deficit induced a massive recourse to resources from other countries. The worldwide adjustment of production and foreign trade structures to the high valuation of the dollar can, however, even with a substantial depreciation of the kind which has taken place since spring 1985, be corrected only gradually.

At the beginning of 1987 the dollar had already almost again fallen to its pre-boom level. The pace of its decline and the accompanying shift in competitive positions to the detriment of Japanese and European suppliers threatened to overtax their ability to adjust and thus put a considerable strain on the business climate. It was in

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this situation that the so-called Louvre Accord was drawn up between the industrialised countries. According to this agreement, the reduction of external economic imbalances should no longer be spurred on by a further depreciation of the dollar, but via economic policy coordination. One of the main reasons for the willingness of the USA to accept this arrangement was that, in view of the renewed acceleration of the rate of inflation in the USA, priority was already being given there anyway to the goal of stability.

The USA agreed to work towards a substantial cutback of its budget deficit by reducing external economic imbalances. The deficit did, in fact, already decrease appreciably in the 1986/87 fiscal year – even allowing for special influences. At the same time, however, there was also a decrease in domestic capital supply, since the propensity of private households to save was still falling. Above all, however, the paralysing differences of opinion between the US administration and Congress over the 1987/88 draft budget did not allow confidence to develop in a continuation of the consolidation course. Among the countries with high current account surpluses it was mainly Japan which contributed towards the agreed strategy via an extensive economic policy programme. However, this essentially only meant dropping a restrictive fiscal policy in favour of an on the whole cyclically neutral orientation. In the Federal Republic of Germany, where no comparable measures were taken, there was a renewed increase in the government's financing deficit. Consolidation measures continued to predominate in the other industrialised countries.

Following the Louvre Accord the monetary policy of the industrialised countries was marked by a pronounced differentiation. In the USA the expansion of the money supply, which had exceeded target projections by far for over two years, slowed down considerably during the course of 1987. The already increased inflationary expectations and the lack of a convincing consolidation concept for the federal budget led to a substantial increase in long-term interest rates. The central banks of most other industrialised countries tried to support the dollar via high interest rate differentials vis-à-vis American financial markets and accepted the continually rapid expansion of money supply this entailed. As international investors nevertheless steered clear of the American capital market the dollar exchange rate could only be kept stable via the foreign exchange market interventions and the buying of dollars by the Japanese and Western European central banks. The turbulences on the world's financial markets erupted following a renewed

substantial increase in interest rates in the USA in autumn, its effects on other countries and the latter's realisation that there is a limit to a policy of low interest rates. The mid-October stockmarket crash was followed by a renewed dollar slump.

In order to prevent the situation on financial markets from getting worse and to avert the spread of the shock to commodity markets the central banks initially ensured that there was ample liquidity. In countries with strong currencies interest rates were again lowered with the aim of slowing down dollar depreciation. This prompt and resolute action led to a certain settling down of the stockmarkets and the results of business surveys indicated that real economic aggregates were also demonstrating considerable powers of resistance. Apart from this crisis management, however, the further decline of the dollar since these initial steps were taken has shown that the economic policy of the industrialised countries has hardly been able to boost confidence in a reduction of the acute imbalances in the near future. In such an unstable situation the weighing up of the short and long-term effects of economic policy decisions and the forecasting of the nature of future policies have become more difficult.

This forecast assumes that, despite concern that new inflationary potential may arise, the central banks will for some time primarily endeavour to support the economy via an ample supply of money. Fiscal policy, however, will only provide stimuli for the economy in the Federal Republic of Germany and probably Japan; in the USA, on the other hand, consolidation measures will at most be able to prevent an increase in the budget deficit.

In view of the serious conflict of economic policy goals this forecast is marked by an unusually large degree of uncertainty. The economic policy of the USA is likely to remain imbalanced and relatively uninfluenced by external economic considerations. This means that the exchange rate of the dollar can be expected to remain unstable. However, the so-called "fundamental" determinants are at least in all probability unlikely to contradict the assumption of an average DM/dollar annual exchange rate in 1988 of approximately DM 1.60, the level recorded at the end of 1987. The price of oil, a further key international economic parameter, is also currently difficult to forecast. Market trends suggest that the world market price of US \$ 18 per barrel envisaged by the OPEC will tend to be the ceiling price despite recent dollar depreciation. New developments in the Gulf war or in the production policies of major oil producers, however, could fundamentally alter these parameters.

ECONOMIC TRENDS

The process of international economic adjustment will have a retardant effect on economic trends in those countries whose currencies have appreciated substantially during recent years, since the contribution of net exports to GNP will continue to decline due to the deteriorated competitiveness vis-à-vis suppliers from the dollar area. Domestic demand, on the other hand, will probably continue to expand markedly, especially in Japan, where the considerable flexibility of the economy will facilitate the adjustment to the lower dollar exchange rate. Due inter alia to the monetary and fiscal policy stimuli there investments in fixed assets and consumption will also increase at a moderately rapid pace. As in the previous year, real GNP in Japan will probably increase by roughly 3.5 % in 1988.

The continuing appreciation of currencies against the dollar will probably put a greater strain on the business climate in Western Europe. The propensity to invest will probably slow down in important fields of activity whose competitive position has deteriorated further, especially since the uncertainty about the future development of the dollar exchange rate is substantial. There are also signs of a slower increase in private consumption in a number of countries. With a further reduction of net exports the increase in production will be lower than the increase in domestic demand. The average growth rate

of real GNP in the Western European economies in 1988 will probably be just under 2 % following a figure of roughly 2.5 % last year.

The collapse of share prices on international stockmarkets, the continuing depreciation of the dollar, and the associated increase in uncertainty concerning economic policy will exert a retardant influence on the economy. Its exact extent, however, is not clear. So far there have been no signs in the industrialised countries that the uncertainty is so great among consumers and investors to warrant fears of an economic setback. The direct effect of the losses in the value of share assets will probably be most noticeably felt in the USA, where investments of this kind play a much greater role for private households than in other countries. The propensity to consume, which reached an extremely high level last autumn, will therefore probably decline, and private consumption will only increase slightly. Investments are also hardly likely to increase any further. The waning increase in domestic demand will not be offset by the substantial increase in exports and the reduction of imports. Real GNP in the USA will probably increase by 2 % in 1988 following a figure of 2.75 % in 1987.

Even if, on the basis of the afore-mentioned assumptions, it is possible to considerably limit the

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	
	1977- 85 ^a	1986	1987 ^b	1988 ^c	1977- 85 ^a	1986	1987 ^b	1988 ^c	Dec. 1986	Dec. 1987	1986	1987 ^d
USA	2.7	2.9	2.8	2.0	7.3	1.9	3.7	4.5	-13.6	-16.0	7.0	6.2
Canada	2.9	3.3	3.5	3.0	8.1	4.2	4.5	4.5	-3.2	0.1	9.6	9.0
Japan	4.4	2.4	3.5	3.5	4.1	0.6	0.0	1.5	14.4	14.1	2.8	2.9
Western Europe ³	1.9	2.5	2.5	1.8	9.0	2.9	2.9	3.2			10.6	10.6
Austria	2.3	1.7	1.0	1.0	4.8	1.7	1.5	2.0	4.3	1.6	5.2 ^f	5.5 ^f
Belgium	1.4	2.4	1.5	1.5	6.4	1.3	1.6	1.5	5.2	2.1	10.8	10.6
Denmark	1.9	3.4	0.0	0.5	9.2	3.6	4.0	4.0	4.6	0.5	7.8	7.8
Finland	3.2	2.4	3.5	2.0	9.1	3.6	3.5	3.5	-0.5	4.9 ^g	6.4	5.0
France	1.9	2.0	2.0	1.5	10.1	2.7	3.2	3.0	-0.3	-0.3	10.7	11.2
FR Germany	2.0	2.5	1.8	1.5	3.9	-0.2	0.2	1.0	9.0	3.6	7.9	7.9
Great Britain	1.5	3.1	4.0	2.5	10.1	3.4	4.2	4.5	-15.3	9.6	11.6	10.5
Ireland	3.4	-0.3	2.0	1.0	12.7	3.8	3.5	3.5	2.4	-1.0	18.2	19.0
Italy	2.0	2.7	2.5	2.0	14.8	5.8	4.5	5.5	6.5	-3.3	11.0	12.0
Netherlands	1.3	2.4	2.0	1.0	4.7	0.2	-0.5	1.0	7.2	3.1	12.4	11.9
Norway	3.6	4.4	2.0	1.0	8.7	7.2	9.0	6.0	-12.0	-0.6	1.9	2.0
Spain	1.5	3.0	4.0	3.0	15.1	8.8	5.3	4.0	3.1	5.3 ^g	21.5	20.5
Sweden	1.6	1.3	2.5	2.0	9.7	4.2	4.2	5.0	3.7	-1.9	2.7	1.9
Switzerland	1.8	2.7	2.0	1.5	3.5	0.7	1.5	2.0	7.9	5.9	0.8	0.8
OECD Countries Total ³	2.6	2.7	2.8	2.2	7.5	2.2	2.9	3.5			8.0	7.6

¹ External value of currencies weighted by share in international trade. ² In % of total number at or available for work. ³ Total of listed countries weighted by real gross national product or private consumption in 1982 or numbers available for work in 1985. ^a Average year-on-year change. ^b Partially estimated. ^c Forecast; figures rounded to nearest 0.5 %. ^d Rounded up estimate. ^e October. ^f In % of employed persons.

repercussions on demand of the shock of events on financial markets a marked slowdown in the increase in production seems likely in the industrialised countries. The growth rate of aggregate GNP will probably fall from a figure of 2.75 % in 1987 to a good 2 % in 1988. This means a deterioration in conditions for the developing countries, since the sales of their export products will be adversely affected and the prices of these products will tend to come under pressure. The effects of the continued depreciation of the dollar, on the other hand, will vary considerably depending on currency orientation and foreign trade structures. The competitive position of newly industrialising countries in particular, whose currencies are closely pegged to the dollar, will be strengthened even further. In the case of numerous other countries, including OPEC states, a major factor will be the increase in the price of imports from Western Europe and Japan. All in all, the retardant influence of the slowdown of growth in particular will probably exacerbate debt problems.

The tailing off of economic expansion in the industrialised countries will also be accompanied by a renewed slowing down of the expansion of world trade, which accelerated substantially in the second half of 1987. The probable increase of between 3 and 4 % in real terms during 1988 as a whole, however, will not be much lower than during the previous year. Trends in flows of goods will be marked by the adjustment to the exchange-rate-induced shift in competitive positions during recent years. Imports will continue to be stimulated in the "appreciating countries", i.e. in Japan and in the Western European economies, but retarded in the USA. A reverse differentiation results in the case of exports. These real tendencies will probably be concealed to a lesser extent than up to now by shifts in the terms of trade. The USA's current account deficit, therefore, will probably decrease.

The external economic imbalance between the USA and the other industrialised countries has become so great during recent years that a reduction within a short space of time would trigger worldwide economic disruptions. Even a step-by-step rectification will lead to considerable friction, since until spring 1985 the production and foreign trade structures inside and outside of the USA were orientated to a strong dollar. The unavoidable process of adjustment in the surplus countries, therefore, marked by a reduction of exports and a stepping up of imports, cannot make headway without "pain thresholds" being reached by many domestic suppliers. In such a situation the uncertainty about future trends in exchange rates is one main reason for repeated demands for greater economic policy coordination between the industrialised countries.

The considerable discord between major industrialised countries was undoubtedly one of the causes of the turbulences during recent months. Developments following the Louvre Accord, however, showed that even a coordinated course of economic policy action by the major industrialised countries is doomed to failure if it sets out to achieve objectives which are incompatible if coordination takes place via the market since the causes of imbalances are neglected. As always in a deficit country, the current account deficit in the USA will only then be decisively reduced if the restraint of domestic demand permits a sustained increase of net exports, whereas surplus countries must seek an increase in domestic demand which goes beyond the extension of their own production possibilities. This underlines the risks automatically involved for the USA as well as for the surplus countries when efforts are made to reduce the serious international economic imbalances. Even in the case of international cooperation, therefore, the possibilities open to economic policy are very limited.

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

Raw Materials and Groups of Materials	1986		1987				1988	
	AA ²	December	AA ²	October	November	December	15. 1.	22. 1.
Total index	143.2 ^p	130.2 ^p	149.2 ^p	151.6 ^p	154.2 ^p	153.8 ^p	152.3 ^p	152.1 ^p
Total, excl. energy raw materials	116.1	112.7	123.8	129.0	134.9 ^p	141.2	143.4	143.1
Food, tropical beverages	107.1	93.8	91.2	92.8	95.2	98.6	102.1	104.0
Industrial raw materials	122.9	127.0	148.6	156.6	165.1	173.7	174.8	172.9
Agricultural raw materials	131.0	140.3	167.1	174.0	177.2	182.7	188.5	187.3
Non-ferrous metals	124.3	123.0	150.3	163.6	184.6	201.9	198.1	194.5
Energy raw materials	159.1 ^p	140.4 ^p	164.0 ^p	164.8 ^p	165.6 ^p	161.2 ^p	157.5 ^p	157.3 ^p

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