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Continuing Risks for the World Economy

World economic trends are presently showing a more clearly upwards direction than the majority of observers had foreseen at the beginning of the year. At that time their judgement was influenced by the recent stock-market crash and the recurring weakness of the dollar. In view of the strain on the business climate which this meant it appeared only right to assign great importance to retarding influences. This estimation has been continually corrected in recent months, however, and for 1988 there are now signs of an increase in the real gross national product of the industrialised countries, which at almost 3 % is hardly lower than last year. This is all the more remarkable as it means that the upward trend of the world economy is continuing for the sixth year running.

Even after a certain time has passed the question cannot be answered with certainty as to how far the shock emanating from the financial markets was at first overestimated and how far, independent of that, the strength of the upward forces in the industrialised countries was underestimated. It must still be assumed, however, that the fall in share prices had certain negative effects on demand and production. Based on previous experience it can be expected that the losses in the value of assets will cause private households – particularly in the USA and Britain – to increase their expenditure less pronouncedly this year. The International Monetary Fund, however, estimates the retarding effects, including repercussions on other areas, for the industrialised countries altogether at only a quarter of one percentage point of the gross national product for each of 1988 and 1989. The effects were above all also kept within narrow limits by the cautious crisis management exercised via the economic policies of the leading industrialised countries last autumn. In particular the prompt increasing of the money supply was instrumental here; it prevented the formation of liquidity bottlenecks. The rapid stabilisation of confidence was shown in the fact that additional drawings on the central banks were made only very briefly and that at the same time there was a rapid reduction of interest rates on financial markets, which had previously risen considerably, especially in the USA.

Apart from the discreet reaction of economic policy, it subsequently became more and more clear that the stock exchange crash had hit the industrialised countries in a phase of increased economic expansion. This was true, firstly, for the USA, where the improvement in competitiveness caused by the depreciation of the dollar had a stimulating effect on exports and investment. Secondly, in many Western European economies and particularly in Japan the dampening effects of the dollar shock on the business climate gradually slackened off as enterprises progressively adjusted their operations. An especially important role was generally played, however, by the impulses emanating in recent years from the usually strong monetary expansion, all the more since the oil price collapse of 1986 had dampened inflationary expectations for some time. As against that, fiscal policy last year in the majority of leading industrialised countries was marked by a reduction in budget deficits, but this did not hinder the relatively brisk increase in total demand and production.

The brightening up of world economic trends in the course of this year so far has certainly given economic policy in the industrialised countries a breathing-space. Nevertheless, the robustness which has come to light of the development of the real economy in the face of shocks from the financial sphere must not now mislead us into paying less attention to the continuation of tensions such as those which erupted last autumn in the collapse of stock and

dollar exchange rates. In particular, the continuing balance of payments disequilibria are prominent here. Although the real import surplus in the USA and the real export surpluses in Japan and the Federal Republic of Germany have already been noticeably reduced the nominal current account balances remain at a high level. The USA's deficit in 1988, at \$ 140 to 150 billion, will be only marginally lower than last year. It thus continues to be so high that it is unlikely in the prevalent economic policy situation and with the present exchange rate to be financed by inflows of private capital.

The absence of more distinct progress in the reduction of the high current account balances continually causes doubt to arise as to the effectiveness of the depreciation of the dollar to date. It is often overlooked here that an increasing share of the American deficit is that of the Southeast Asian newly industrialised countries, which up to now have been very hesitant in the upward revaluation of their currencies. In the USA's trade with Japan and Western Europe, on the other hand, the shift in the terms of trade triggered off by the changes in exchange rates tended at first – as always in such cases – to increase these countries' net surpluses. The real processes, however, through which the necessary adjustment of foreign trade and payments takes place, got under way only hesitantly, one important reason for this being that at first only the overshooting of the dollar exchange rate was corrected which had in any case scarcely played a role in firms' long-term calculations. The adjustment of sales and production patterns, which did not begin until later, requires time, however, and there are many indications that this process will continue for longer even if there are no further changes in exchange rates.

Under these circumstances the question as to the "correct" dollar exchange rate still cannot be answered. Even governments and central banks do not claim to know the answer. The announcement which was first made in the Louvre Agreement of February 1987 and has been repeated since, that the stabilisation of exchange rates "around current levels" is to be aimed at, is obviously only to be understood as an attempt to win time for adjustment following the considerable depreciation of the dollar in recent years and to avoid an overshooting – downwards this time. It is probable that economic policy in the USA will continue to show this orientation despite the dominance of domestic considerations as the fear of stronger inflationary pressures works in the same direction. The monetary policy reins will therefore probably be pulled somewhat tighter in the course of the year. The central banks of the surplus countries, too, will then presumably, without a change in exchange rate targets, again strive more for better conditions for the preservation of price stability. Although such a correction of the monetary policy course of the leading industrialised countries will in the short term tend to have a dampening effect on world economic trends, it could prevent the upsurge of inflationary expectations, which would finally have to end in restriction and recession.

The prospective slackening-off of monetary stimuli to demand and production will presumably be accompanied by a fiscal policy which – following a certain pause in the current year – in major countries will probably be directed again more towards the reduction of deficits. There are indications of this at least for the USA, after the presidential elections, and for the Federal Republic of Germany. Attention is therefore being paid all the more to the improvement of structural conditions, as the latest meeting of the OECD Council of Ministers showed. Particularly in many Western European economies a reduction in the barriers to increased flexibility in the goods and factor markets, not least due to the removal of state regulations and subsidies, promises to strengthen the forces of growth. The pushing through and coming into effect of such reforms is, however, a time-consuming process, which in the short term can only have a marginally strengthening effect on expansive forces.

The economic policy of the major industrialised countries in its attempts to improve structural conditions for growth, to foster the adjustment process of foreign trade and payments, to avoid the incidence of inflationary expectations and at the same time as all of that to guarantee the continuation of the upward economic trend, is walking a tightrope. That it has not yet lost its footing is doubtless a success. But even after the shock which emanated from the financial markets last autumn has been overcome, the risks remain great.

Günter Großer