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Günter Großer and Günter Weinert\*

## Continued Growth in the World Economy

*After the stock market crash in the autumn of 1987 even optimists were predicting a sharp slowdown in the growth of the world economy in 1988. In the event, the GNP of the industrialised countries increased by 4 % in real terms last year. What is the outlook for 1989?*

For the industrialised countries 1988 was a year of agreeable surprises. In the light of the turbulence in the international financial markets in the autumn of 1987 even optimists had forecast a sharp slowdown in the growth in demand and output. In fact, however, growth was substantially stronger than had been predicted even before the stock market crash. The gross national product of the industrialised countries increased by 4 % in real terms, the second highest rate of growth this decade. In many countries capacity utilisation equalled or even exceeded the high levels recorded during the upswing at the end of the seventies. Employment also generally increased appreciably. In most countries this did not lead to a significant reduction in unemployment, however, since the labour force also grew substantially. By the end of the year the unemployment rate was just below 2½ % of the labour force in Japan and around 5½ % in the USA (a level at which full employment is considered to have been achieved there), whereas in Western Europe it averaged around 10 %. Inflation nevertheless remained moderate, although it accelerated slightly in most countries.

There were several reasons for the surprisingly good economic performance of last year, but a particularly important factor was the prudent manner in which economic policymakers reacted to the collapse in share prices. The central banks countered the danger of a liquidity crisis by making plentiful funds available and interest rates were reduced appreciably. The events in

the financial markets therefore led to joint crisis management by the governments and central banks of the leading industrial countries, rapidly restoring confidence in economic policy, which had been waning before the stock market crash. The success of their action can also be judged from the fact that monetary policy in the USA could be brought back onto a less expansionary course and interest rates raised again as early as the spring of 1988 in order to prevent an increase in inflationary expectations. From about mid-year onwards other central banks also began to tighten the monetary reins again, particularly as the money supply was expanding rapidly in many countries, especially Japan, the Federal Republic of Germany and the United Kingdom.

### Restoration of Confidence

In the critical months around the turn of 1987-88 the fiscal policies of the leading industrialised countries were also directed primarily towards improving the climate in the financial markets. Above all, the budget passed in December 1987 in the "deficit country", the USA, averted the threat of a setback after the previous year's notable progress towards reducing the budget deficit, and the automatic cuts in expenditure under the Gramm-Rudman-Hollings Act did not come into play. On the other side of the coin, the fiscal policies of the "surplus countries" – Japan and Germany – had a stimulatory effect, not least because of reductions in income taxes under long-term programmes of tax reform. Both countries nevertheless adhered to their

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medium-term budget consolidation objectives, as did other Western European countries too. The credibility of such a policy was enhanced by the fact that several countries saw their public finances improve as a result of the stronger than expected growth in economic activity.

At the beginning of 1988, after economic policy in the US had succeeded in restoring confidence, the depreciation of the dollar came to a halt, aided by massive co-ordinated exchange market intervention by the leading central banks. The initial signs of a turn for the better in the US trade balance undoubtedly also played a part in this. Later in the year US interest rates rose as a result of cyclical factors and the return to a monetary policy orientated more towards price stability; in the late summer this caused the dollar to appreciate so strongly that the central banks again intervened, although this time in the opposite direction. Whereas in earlier years exchange rate fluctuations had been extreme, in 1988 they remained within bounds, thereby helping to stabilise expectations within the economy. A reduction in the US current account deficit from \$154 billion in 1987 to over \$130 billion in 1988 also contributed in this respect. At the same time Japan's surplus contracted from \$87 billion to probably just under \$80 billion, while in Germany the reduction in the surplus vis-à-vis the dollar area was outweighed by an increase vis-à-vis Western Europe.

### **Moderate Inflation**

Inflation remained moderate almost everywhere last year. The further fall in oil prices from \$18 a barrel at the end of 1987 to sometimes only \$11-12 in the autumn of 1988 was undoubtedly a contributory factor and it largely offset the steep rise in the prices of other raw materials. Import prices rose somewhat in most Western European economies, however, primarily owing to the slight depreciation of their currencies against the dollar; after the appreciable fall in import costs in the two preceding years this constituted the loss of an important factor in holding down prices. On the other hand, increases in domestic costs remained moderate in most countries. Wage increases accelerated only slightly, even in countries with low unemployment such as Japan and the USA. Since productivity gains were also tending to accelerate during the rapid expansion in production, unit labour costs generally continued to rise only moderately; in Japan they actually declined slightly. Hence there was little additional inflationary pressure from the costs side. The twelve-month rate of increase in consumer prices averaged around 3½ % in the last few months of 1988, only slightly higher than a year earlier.

### **Growth in Investment**

By early 1988 the economic climate in the industrialised countries was again one of expansion after the brief and slight dampening caused by the turmoil in the financial markets. Above all private non-residential investment, which had begun to increase rapidly in 1987, continued to grow, probably rising by almost 10 % in the USA and Western Europe and by as much as 16 % in Japan last year.

The strength of the pick-up in investment, which was grossly underestimated a year ago and which has been crucial to the intensity of the upswing, is due to a whole range of factors. The basis was laid by the progress almost all countries have made in improving supply-side conditions since the beginning of the eighties. An important aspect in this regard is the containment of inflation and the substantial rise in corporate profits; the sharp fall in oil prices in 1986 reinforced these trends, especially by remarkable terms-of-trade gains redistribution in oil-importing countries. Another factor was the impetus from the expansionary monetary policies pursued by the principal industrialised countries under the leadership of the USA for several years from 1984-85 onwards. The combination of all these factors overcame the wait-and-see attitude that investors in Japan and Western Europe had adopted in reaction to the seemingly endless depreciation of the dollar. In the United States, by contrast, it was the improvement in competitiveness induced by exchange rate movements that contributed to a rise in the propensity to invest.

The behaviour of private households – like that of the corporate sector – was not affected for long by the stock market crash; the propensity to save barely increased in most countries. With economic activity continuing to rise, incomes were in fact boosted substantially by the expansion in employment. In several countries they also benefited from tax reductions, so that real disposable incomes rose at an appreciable rate in 1988 and private consumption increased by almost 3 % in the USA, despite a slight increase in the savings ratio, by an average of 3.5 % in the Western European economies and by over 5 % in Japan. In Western Europe and Japan the substantial increase in incomes and the favourable economic expectations also fuelled a pick-up in the demand for residential construction.

### **Slower Adjustment of External Imbalances**

All things considered, in 1988 the strongest economic stimuli emanated from Japan and Western Europe, where total domestic demand increased by 7½ and 4 % respectively, whereas in the USA it rose by only around

3%. In conjunction with the change in competitiveness due to the dollar depreciation that began in 1985, this differential of demand growth produced a permanent shift in foreign trade flows. In Japan and Western Europe, imports from the rest of the world increased much faster than exports, while in the USA the reverse was the case. This development essentially redirected the cyclical stimuli to the advantage of the USA. However, the adjustment of trade imbalance appears to have slowed down in the course of last year.

The upswing in the world economy has proceeded very smoothly so far; signs of overheating, such as have appeared in the United Kingdom in particular, have been the exception rather than the rule. With capacity utilisation approaching its previous peaks, supply is now

less flexible than before. Even the higher level of investment can steepen the slope of the growth path only very gradually. In this situation there is increasing concern that the effects of many years of excessive monetary expansion will not be confined to the real economy but will also germinate the seeds of inflation that have already been sown. This is particularly worrying if one assumes that oil prices, rather than declining further, will be kept at around \$ 15 a barrel in 1989 through the exercise of greater discipline on the part of OPEC producers.

The economic policy of the USA is a key issue. With production steadily approaching capacity, there is a danger of not only an intensification of wage and price pressures but also of a shortage of resources for further

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Kay-Michael Schanz

# **AUSLANDSVERSCHULDUNG UND DIE ROLLE VON IMF, BIZ UND PARISER CLUB**

**Inhalt und Grenzen der Verpflichtungen des Internationalen Währungsfonds sowie der Bank für Internationalen Zahlungsausgleich und der Teilnehmer des Pariser Clubs**

# **FOREIGN DEBTS AND THE ROLE OF IMF, BIS AND PARIS CLUB**

**Extent and Limits of the Obligations of the International Monetary Fund, the Bank for International Settlements and the Members of the Paris Club**

The discussion on foreign debts often neglects or ignores the legal aspects of the participation of the IMF, the Paris Club and the BIS in the solving of debt problems, in particular the question to what extent these institutions are legally obliged to support debtors and creditors. These problems are dealt with in this study by Kay-Michael Schanz, written as his doctoral thesis for the faculty of law of the Johann Wolfgang Goethe University, Frankfurt. The method of procedure of the Paris Club in particular is closely connected with the question of the necessity of an international law on debt rescheduling. The author develops various approaches to an international arbitration procedure which raises the hope that rescheduling can be speeded up.

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reducing the current account deficit. The Federal Reserve should therefore continue to pursue its moderate stabilisation policy for both domestic and external reasons. Further increases in interest rates are likely, but the more monetary policy is bolstered by corresponding signals from fiscal policy, the smaller they will be. The need for action in this regard is particularly great, since the Government and Congress avoided unpopular decisions before the elections, with the result that efforts to reduce the budget deficit have become bogged down. If the budget deficit were to remain at its present high level, however, it would increasingly restrict the fiscal policy options. It is therefore likely that agreement will be reached on a further, albeit gradual reduction.

### Slight Adjustment of Economic Policy Course

The scope for smooth growth will also narrow in the Western European economies and Japan, so that their central banks will probably also seek to pursue a tighter monetary policy. However, only small increases in

interest rates are to be expected, given the prevailing exchange rate considerations, the likelihood of a moderate stabilisation policy in the USA and the, in general, only slight acceleration in inflation. This forecast applies in particular to Japan, whereas in Western Europe there is likely to be some differentiation from one country to another, depending on differences in their trade and economic situations. Fiscal policy will mostly continue to be orientated towards the medium-term objective of improving supply conditions, primarily by means of appropriate tax reforms. The overall fiscal stance will be neutral in 1989, though with differences between countries. The tendency for budget deficits to contract slightly can be attributed mainly to a growth-induced increase in government revenue.

The main reason for expecting an only mild adjustment of the economic policy course in 1989 is the relatively quiet situation on the price front in most industrialised countries at present. However, the climate would undoubtedly soon deteriorate if the rise in demand and output were to continue unabated and there would

**Table 1**  
**Economic Indicators**

	Real Gross National Product (Year-on-year change in %)				Consumer Prices (Year-on-year change in %)				Exchange Rates <sup>1</sup> (Change over 12 mths in %)		Unemployment Rate <sup>2</sup>	
	1978-86 <sup>a</sup>	1987	1988 <sup>b</sup>	1989 <sup>c</sup>	1977-86 <sup>a</sup>	1987	1988 <sup>b</sup>	1989 <sup>c</sup>	Dec. 1987	Dec. 1988	1987	1988 <sup>d</sup>
USA	2.8	3.4	4.0	3.0	6.8	3.7	4.0	5.5	-16.0	0.0	6.2	5.5
Canada	3.0	4.0	4.0	3.0	7.7	4.4	4.0	4.5	0.1	10.1	8.9	8.0
Japan	4.1	4.5	6.0	4.5	3.3	-0.2	0.7	2.5	14.1	6.8	2.8	2.5
Western Europe <sup>3</sup>	2.0	2.7	3.5	2.7	9.0	2.9	3.3	4.2	.	.	10.6	10.1
Austria	1.9	1.5	3.5	2.5	4.4	1.4	2.0	2.5	1.6	-1.4	5.6 <sup>f</sup>	5.4 <sup>f</sup>
Belgium	1.7	2.1	3.0	2.5	5.8	1.6	1.0	2.0	2.1	-2.2	10.6	9.8
Denmark	2.2	-1.0	0.0	1.0	8.3	4.0	4.5	4.5	0.5	3.2	7.7	8.3
Finland	3.6	3.8	4.0	2.5	8.1	4.1	3.0	5.5	6.4	-0.7 <sup>g</sup>	5.0	4.6
France	2.0	2.3	3.5	3.0	9.3	3.1	2.7	3.5	-0.3	-3.4	11.2	10.9
FR Germany	1.9	1.8	3.4	2.3	3.5	0.2	1.2	2.5	3.6	-2.9	7.9	7.8
Great Britain	1.7	4.3	4.0	2.5	9.7	4.2	5.0	6.5	9.6	4.1	10.4	8.5
Ireland	2.5	4.1	3.0	3.0	1.5	3.2	2.0	3.0	-1.0	-4.0	19.1	18.8
Italy	2.5	3.1	3.5	3.0	3.6	4.7	5.0	6.0	-3.3	-2.6	12.1	12.1
Netherlands	1.4	1.5	2.5	2.5	4.0	-0.5	1.0	1.5	3.1	-2.7	11.9	11.7
Norway	3.9	0.9	1.0	2.0	8.4	8.7	6.5	5.5	-0.6	1.5	2.1	3.2
Spain	1.5	5.5	5.0	4.0	13.4	5.3	5.0	5.5	6.7	-2.2 <sup>g</sup>	20.5	19.7
Sweden	1.9	2.4	2.5	2.0	8.9	4.2	5.5	6.5	-1.9	1.7	1.9	1.7
Switzerland	1.9	2.3	2.5	2.0	3.4	1.5	2.0	2.5	5.9	-6.0	0.7	0.6
OECD Countries Total <sup>3</sup>	2.8	3.3	4.0	3.0	7.5	2.9	3.3	4.5	.	.	7.6	7.0

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

Sources: OECD, IMF, Deutsche Bundesbank, other national statistics, own estimates and forecasts.

be a danger of a switch to a restrictive economic policy that would lead to a decline in economic activity. Such fears are an important factor in the USA, although partly with an eye to developments in 1990. There are now signs that the higher priority monetary policy in the USA is again giving to stability, and the increases in interest rates this entails, is already having a dampening effect on domestic demand. Corporate plans indicate that investment will rise less rapidly. Private consumption would then not be boosted to the same extent as in the past by an increase in employment. Since the external stimuli will probably also weaken somewhat, output in the USA will increase more slowly, leaving aside the recovery in agricultural production after the losses sustained during last year's drought. The increase in real gross national product will probably slow down from 4 % in 1988 to between 2½ and 3 % in 1989.

Economic policy in most other industrialised countries is likely to have but a slightly restraining effect; only in the United Kingdom and Germany will the expansion in demand be noticeably dampened, in the former by the policy of high interest rates and in the latter by the remarkable increase in indirect taxation. Private non-residential investment will generally continue to increase substantially, although the pace will probably slacken somewhat since presumably some of the first projects carried out were ones that had been postponed during the exchange rate shock in 1985-86. On the other hand, the dampening effects of external adjustment will ease. Real GNP is expected to rise by 4½ in Japan in 1989, following an increase of almost 6 % last year, and by an average of between 2½ and 3 % in the Western European economies, compared with around 3½ % in 1988.

### Continuing Stimuli to Growth

The continuing rise in economic activity in the industrialised countries will also give further stimuli to world trade, which is expected to increase by 6 % in volume terms in 1989, after growing by around 8 % last year. The predominant factor will be the expansion in the industrialised countries. The impetus being imparted to the rest of the world is now clearly discernible. In many newly industrialising countries production and imports will show a further substantial increase. Primary producing countries, most of which have seen their export position improve markedly, will also be able to increase their imports considerably, but the oil-exporting countries will have little scope to do so. The overall effect of the upswing in the industrialised countries will be to ease external constraints in the rest of the world. Nevertheless, the creditworthiness of many developing countries has barely improved so far, so that the debt crisis will continue to pose a threat.

The prospect of the expansion in the world economy continuing into its seventh year is based primarily on the fact that conditions in most industrialised countries can be expected to remain favourable to a relatively high propensity to invest. Developments in this key area since the middle of 1987 show unquestionably that earlier estimates were generally far too pessimistic. On the other hand, the outlook is not only clouded by the danger of intensified cost and price pressures; another serious warning sign is the early slowdown in external adjustment since current account imbalances between major industrialised countries are still so large that the danger of abrupt exchange market reactions remains high. Were that danger to materialise, the task of economic policy would become even harder.

**HWWA Index of World Market Prices of Raw Materials<sup>1</sup>**  
(1975=100)

Raw Materials and Groups of Materials	1987		1988				1989	
	AA <sup>2</sup>	December	AA <sup>2</sup>	October	November	December	6. 1.	20. 1.
Total index <sup>P</sup> . . . . .	149.2	153.8	143.4	130.5	133.9	145.9	154.1	157.3
Total, excl. energy raw materials . . . . .	123.8	141.2	150.2	150.7	156.1	160.6	163.9	158.6
Food, tropical beverages . . . . .	91.2	98.6	108.6	110.6	110.0	113.6	119.2	112.0
Industrial raw materials . . . . .	148.6	173.7	181.8	181.2	191.1	196.4	197.9	194.1
Agricultural raw materials . . . . .	167.1	182.7	191.6	185.0	190.7	194.3	193.9	191.0
Non-ferrous metals . . . . .	150.3	201.9	216.4	226.5	246.8	258.2	265.3	257.8
Energy raw materials <sup>P</sup> . . . . .	164.0	161.2	139.5	118.7	120.9	137.3	148.4	156.6

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