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Risks Facing the World Economy

Amidst the festivities commemorating the French Revolution in Paris, the heads of the seven major Western nations celebrated a less spectacular anniversary: they met for the fifteenth annual economic summit against the backdrop of a sustained, vigorous global upswing. The success is particularly remarkable considering that the institution was born as a child of necessity in 1975 at a time of inflation and recession. Despite all the efforts to avert it, this horror scenario reared its ugly head again at the start of the eighties. Much has changed since and new topics like the debt crisis, the protection of the environment and the appropriate response to the recent reforms in the Eastern bloc have come onto the agenda. Nonetheless, despite the glowing economic outlook, the two painful stabilization crises that the industrialized nations have undergone in the last ten years are still too vivid to allow them to lose sight of the dangers and pitfalls on the path of further development.

The major plus points in mid-1989 are the continuing vigorous rise in output and employment in nearly all the industrialized nations. For this year, it thus looks as if the over 3 % growth in aggregate gross national product will approximate the average figure for the last six years of economic upswing and now with the full participation of Western Europe, which until recently had lagged some way behind the other industrialized countries. The utilization of capacity is again on a level with that of previous boom periods and the number of employed persons is climbing fast everywhere. The main reason why unemployment in many West European countries is nevertheless stagnant or diminishing only sluggishly is that the demand for jobs resulting from the increase in both the labour force and the labour force participation rate is growing at a far more rapid pace than in the 60s for example. The challenges facing employment policy are clearly much greater today than they were then.

The motor of the upswing in the industrialized countries is the high propensity to invest. Business investment which at first resuscitated most in the USA and Japan is now resurging in Western Europe, too. The optimistic sales and earnings expectations prompting this are based on a number of factors. A major one is the long-standing efforts of governments to better supply conditions by curbing the government's share of the national product, cutting taxes and taking deregulation measures as well as working towards wage restraint to promote a growth-boosting increase in business profits.

Another contributory factor has been the impulses emanating from the very expansionary monetary policy instigated by the USA in the mid-eighties. Although this stimulation of investment helped bolster the foundation for growth, it also introduced a cyclical component

into the development which now raises the question of "hard" or "soft" landing. This question has already become acute for the USA and most of the other industrialized countries will have to face it with the timelag typical of cyclical developments over recent years.

In many cases, monetary policy has generated impulses that have propelled demand to the limits of capacity and beyond, engendering increasing strains on the economy. At the same time the monetary leeway was created for price rises. Thus after its 2 % low in 1986, the average rate of price increase for private consumption in the industrialized countries has gone up appreciably; on an annual average for 1989, it will probably amount to some 4 ½ %. Since the stabilization successes of that time were magnified by the plummeting oil prices due to the lifting of supply restrictions, the acceleration of the price increase so far can mostly be considered not to warrant abrupt counteraction. If a wage-price spiral now came about in the major industrialized nations however, it would be almost impossible to avoid a renewed sequence of inflation, restriction and recession. Arguing against such an adverse development are the apparently moderate inflation expectations hitherto as suggested by the results of business surveys and also the modest rise in long-term interest rates during the upswing.

A key role in all this is being played by the US Federal Reserve. After the expansionary monetary policy up to 1987, it has for the last two years, except for a brief relaxation after the stock exchange crash, been pursuing a stabilization course. Though substantial structural changes in the financial sector of the USA make an assessment difficult, it had to be rated as increasingly restrictive. In view of the economic slowdown, US monetary policy recently signalled an incipient loosening of the reins. If there is no future adverse development in prices, this line ought to be cautiously continued.

Under these circumstances the central banks of the other industrialized nations should not find it necessary any more to raise interest rates for exchange rate reasons, but in view of the momentum of demand growth, the high utilization of capacity and the associated risk of greater price and wage rises they will probably adhere to a moderate course of stabilization. At the same time fiscal policy in most of the industrialized countries will endeavour to further reduce government budget deficits. As this is a slow process however, dampening effects on economic activity will keep within narrow limits.

Crucial to the continuation of the global economic uptrend will be the ability of the economic policymakers in the major industrialized countries to demonstrate their resolve to keep any new surge of inflation like that of the 70s and early 80s in check without having to resort to drastic restrictive action. Even if prospects look good in this direction, a slackening of the expansionary forces seems unavoidable. It will become visible in the USA and Great Britain in the course of this year and subsequently also in most of the other industrialized countries. In 1990, the overall growth rate of the national product of the industrialized countries will thus average under 3 % for the first time in four years. The lower rate of expansion which is to be expected in countries with high current account deficits will work in favour of a reduction of the continuingly very high external imbalances. However, above all the US deficit will remain an element of instability for exchange rates and thus for economic policies of major countries.

Forecasting world economic developments is always beset with major imponderables, and this in both directions. Nevertheless, the summit leaders would have been dangerously misled to simply rely on the experience from the past few years and assume that the optimists would be proved right yet again. The discussion of the problems and risks associated with the development of economic activity was for all the participants part of the search for the "right" policy line in a situation that had become more difficult. However useful a supranational perspective may be in this regard, it cannot save individual governments the work of "keeping their own house in order" and even the oft propagated international economic policy coordination will be of little use unless this job is done. In this respect, summit declarations must be measured primarily against the yardstick of their appropriateness for use at home.

Günter Großer