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The World Economy Moves at a Gentler Pace

1989 was another highly satisfactory year for the industrialised countries, with real gross national product growing by an average of around 3½%. Performance differed from one country to another, however, with the USA beginning to lag behind. Is this the harbinger of a general slowdown in growth?

It was inevitable that the further acceleration of one percentage point in the rate of growth in output in 1988 would not be sustained, since capacity constraints were becoming increasingly noticeable in a growing number of industrialised economies. Consequently countries such as the USA, Canada and the United Kingdom, which had long had a cyclical lead, had already moved towards a distinctly restrictive economic policy stance before last year in order to curb the rise in prices and stem current account deficits. As a result of the measures taken, the forces of expansion began to wane in these countries in 1989. In Japan and most continental European countries, where the upturn in the cycle had occurred later, economic activity continued to expand vigorously.

In most countries industrial capacity utilisation rates equalled or exceeded the previous record levels reached at the beginning of the seventies. The elasticity of supply nevertheless remained relatively high, not least as a result of the introduction of new techniques. Employment increased substantially, but since the labour force continued to grow at a rapid rate unemployment remained high in Western Europe. Shortages developed only in certain parts of the labour market. Consequently, there was only a slight acceleration in wage increases until very recently. The fact that monetary policy was directed increasingly towards price stability played some part in this and

countered the emergence of inflationary expectations, despite a slight cyclical acceleration in the rate of price increases.

The cyclical discrepancy between the industrial countries in itself helped reduce the large current account imbalances; the US deficit and the surpluses of Japan and Western Europe as a whole decreased further in 1989, although the process of external adjustment began to falter during the year. In the USA, the increase in exports of goods and services slowed down from its previously very rapid rate while imports continued to rise distinctly, assisted by the appreciation of the dollar until the autumn. Conversely, in Japan the weakness of the yen greatly strengthened the competitiveness of domestic producers, so that the falling tendency of surpluses on the trade account slackened off. Western Europe's real import surplus in trade with the rest of the world at least increased no further during 1989. However, the region's aggregate nominal current account was more or less in balance for the year as a whole, Germany's large surplus being offset by substantial deficits recorded by other countries, primarily the United Kingdom, Spain and Italy.

Dollar under Pressure

The strength of the dollar until last summer, which hampered the adjustment of external imbalances, was a side-effect of a restrictive US monetary policy aimed at limiting the scope for price increases and stifling emerging inflationary expectations. It was clearly

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successful in this respect, as testified by the easing of long-term interest rates. As early as mid-1988 the rising dollar exchange rate had caused the central banks of the other industrial countries to raise interest rates in order to counter a depreciation of their currencies and thereby curb upward pressure on prices and to support their currencies against the dollar in order to encourage the desired correction of current account imbalances. Monetary expansion nevertheless remained rapid in most countries. Since the middle of last year, when the first signs of a slowdown in economic activity and an easing of price pressures appeared in the USA, the US Administration has been slackening the monetary reins somewhat, whereas in the other industrialised countries, most of which are now booming, even more emphasis has been placed on stabilisation and monetary policy has been tightened further. This reversal of the relative stringency of monetary policy brought the dollar under pressure in relation to Western European currencies.

Fiscal Policies of Industrial Countries

Unlike monetary policy, fiscal policy remained virtually unused as an instrument of short-term economic management; in most industrial countries it had no notable impact on economic activity. Public sector borrowing requirements declined further almost everywhere in 1989 and a number of countries, most notably Japan and the United Kingdom, even achieved substantial budget surpluses. In Germany the reduction in the deficit was due partly to "measures of saving" in anticipation of the tax reduction planned for 1990, but in most countries it was due only to rising capacity utilisation, which generated additional government revenue and reduced expenditure on items such as unemployment benefit. Overall, these factors were mirrored only partially by the final budgetary position. The public sector borrowing requirement is still very high in a number of countries, especially Italy, where the 1989 deficit again exceeded 10% of GDP, but also in countries such as Belgium and the Netherlands. On the other hand, the US budget deficit was far smaller, amounting to just under 2% on a comparable basis, but the constant failure to meet the targets for consolidation of the federal budget and the repeated use of window-dressing increasingly clouded the transparency of US fiscal policy and undermined its credibility.

Since the first half of the eighties fiscal policy in the industrial countries has been directed first and foremost towards improving the conditions for growth by cutting budget deficits and reducing the size of the public sector. Public sector borrowing requirements declined from an

average of almost 4½% of GNP in 1983 to just under 1½% in 1989. Disregarding the wide differences between countries, the efforts to restore sound public finances cannot be regarded as having been completed, since this low percentage figure is due partly to high capacity utilisation. The figures on the size of the public sector in relation to national income reinforce this view. Despite the tax reductions enacted in many countries, tax as a proportion of national income has risen further since 1983, while the average ratio of government expenditure to GDP has fallen slightly but, at around 40%, is still considerably higher than before the slowdown in economic growth in the mid-seventies.

Strong Growth in Investment

Apart from the stimuli generated for a time by expansionary monetary policies, the worldwide strengthening of the propensity to invest in recent years testifies to the considerable success in creating an environment favourable to growth. The many facets of this economic policy include not only a fiscal policy aimed at reducing the budget deficit but also measures to limit state activities by means of deregulation and privatisation. Success in curbing inflationary expectations probably also played an important role during the eighties, mainly by encouraging wage moderation and enabling an improvement in corporate profitability that fostered growth. Investment – and especially corporate investment – thus became the main factor stimulating economic activity in the industrialised countries. Last year this was particularly true of Western Europe, where expenditure on plant and equipment probably increased by between 8 and 9%, and Japan, where the growth was more than twice as fast. There was also a substantial, albeit much reduced, increase of 6% in the USA. Private consumption increased much more slowly, by around 3%.

The differences in the rate of growth in investment were partly responsible for the disparities in the behaviour of domestic demand, which increased by 2½% in the USA last year, by around 3½% in Western Europe and by 6% in Japan. These rates of growth were all much lower than those recorded in 1988. In the USA the slowdown in domestic demand coincided with a waning of stimuli from abroad, while in Western Europe and Japan the earlier restraining effects on demand as a result of external adjustment eased markedly. This was the main reason why the cyclical disparity between the USA and the other industrial countries, which had existed since 1986 as far as domestic demand was concerned, led to different rates of growth in GNP last year.

High capacity utilisation rates and the associated decline in competition accentuated the pressure on prices in the industrial countries. The marked acceleration in the first few months of last year was due mainly to the rise in the world market prices of oil and other raw materials, however; inflation slowed down again as this factor abated during the year. Nevertheless, in the last few months of 1989 the twelve-month rate of increase in the cost of living averaged just under 4½% in the industrial countries, around three-quarters of a point higher than a year earlier. This reflects mainly the slight acceleration in the cost of domestic production factors, especially unit labour costs; wage rates increased somewhat faster and labour productivity rather more slowly.

The recognition made in the eighties that the prevention of inflation is an important condition for a sustained strengthening of investment and growth will continue to have significant influence on central bank policy. For this reason the relaxation of monetary policy in the USA will probably be cautious, particularly as the downward pressure on the dollar as a result of lower interest rates is generating renewed inflationary stimuli owing to the rise in the cost of imports. These exchange rate tendencies can be expected to continue, for the central banks of the other industrial countries will

presumably keep a firm grip on the monetary reins for some time to come in view of the continuing overheating of their economies. The duration and severity of monetary stringency will depend to a large extent on whether the slight cyclical acceleration in inflation triggers a price/wage spiral. Inflationary expectations are clearly still moderate, so that developments in this respect should remain fairly mild.

Fiscal policy in the industrial countries will continue to be directed towards reducing budget deficits this year. Progress is likely to be small, however. Even in the USA, the reduction is expected to be far less than announced, but it will probably have some moderating effect on demand. In most other countries fiscal policy is likely to have little impact on economic activity. Only in Germany, where substantial tax reductions will take effect, will it generate substantial stimulus in 1990.

Differences in Economic Trends

The differences in economic trends that began to emerge last year will become more pronounced in 1990. In the USA the dampening effects of the restrictive monetary policy pursued until the middle of last year will lead to a further slowdown in the growth of demand and output. However, since the Federal Reserve Board

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 Rates ² (Annual average) | |
|-----------------------------------|---|------|-------------------|-------------------|---|------|-------------------|-------------------|---|--------------|---|-------------------|
| | 1979 bis 1987 ^a | 1988 | 1989 ^b | 1990 ^c | 1979 bis 1987 ^a | 1988 | 1989 ^b | 1990 ^c | Dec. 1988 | Dec. 1989 | 1988 | 1989 ^d |
| USA | 2.5 | 4.4 | 3.0 | 1.5 | 6.4 | 4.1 | 4.8 | 4.5 | -0.9 | 5.4 | 5.4 | 5.2 |
| Canada | 3.0 | 5.0 | 2.5 | 2.0 | 7.2 | 4.0 | 5.0 | 5.0 | 9.9 | 4.9 | 7.7 | 7.5 |
| Japan | 4.0 | 5.7 | 5.0 | 4.5 | 2.8 | 0.7 | 2.3 | 2.5 | 6.4 | -13.3 | 2.5 | 2.3 |
| Western Europe ³ | 2.0 | 3.6 | 3.4 | 2.4 | 7.6 | 3.3 | 4.7 | 4.5 | - | - | 9.6 | 8.8 |
| Austria | 1.9 | 4.2 | 4.0 | 3.0 | 4.2 | 2.0 | 2.5 | 3.0 | -2.6 | 2.5 | 5.4 ^f | 4.8 ^f |
| Belgium | 1.5 | 4.0 | 4.0 | 3.0 | 5.4 | 1.2 | 3.1 | 3.5 | -2.4 | 2.5 | 9.9 | 9.1 |
| Denmark | 2.0 | -0.2 | 1.0 | 1.5 | 7.7 | 4.6 | 4.8 | 4.5 | -3.3 | 3.2 | 8.8 | 9.4 |
| Finland | 3.7 | 5.2 | 4.0 | 2.5 | 7.6 | 5.1 | 6.5 | 6.5 | 1.4 | 3.8 | 4.5 | 3.5 |
| France | 1.8 | 3.4 | 3.0 | 2.5 | 8.6 | 2.7 | 3.5 | 3.5 | -3.5 | 3.4 | 10.0 | 9.5 |
| FR Germany | 1.7 | 3.6 | 4.0 | 3.0 | 3.2 | 1.3 | 2.8 | 3.0 | -3.1 | 4.1 | 7.7 | 7.2 |
| Great Britain | 1.8 | 4.2 | 2.5 | 1.0 | 8.2 | 4.9 | 7.8 | 6.0 | 4.3 | -11.4 | 8.3 | 6.4 |
| Ireland | 2.3 | 3.7 | 4.0 | 3.0 | 11.0 | 2.1 | 4.0 | 4.0 | -3.7 | 4.1 | 16.7 | 15.5 |
| Italy | 2.6 | 3.9 | 3.0 | 2.5 | 12.7 | 5.0 | 6.5 | 6.5 | -2.7 | 2.5 | 11.3 | 11.2 |
| Netherlands | 1.3 | 3.0 | 4.0 | 3.0 | 3.5 | 0.7 | 1.0 | 1.5 | -2.8 | 3.1 | 9.5 | 9.0 ^g |
| Norway | 3.5 | 1.1 | 2.0 | 2.0 | 8.5 | 6.7 | 5.0 | 4.5 | 1.8 | 0.1 | 3.2 | 4.6 |
| Spain | 1.9 | 5.0 | 5.0 | 3.5 | 11.8 | 4.8 | 6.8 | 6.5 | 2.0 | 3.7 | 19.1 | 16.8 |
| Sweden | 2.0 | 2.5 | 2.5 | 1.5 | 8.2 | 5.8 | 6.5 | 6.5 | 1.7 | -0.9 | 1.6 | 1.4 |
| Switzerland | 2.1 | 3.0 | 3.0 | 2.0 | 3.5 | 1.8 | 3.2 | 4.0 | -5.9 | -3.8 | 0.7 | 0.6 |
| OECD Countries Total ³ | 2.6 | 4.4 | 3.5 | 2.5 | 6.2 | 3.2 | 4.3 | 4.2 | - | - | 6.8 | 6.3 |

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 1987 or numbers at or available for work in 1987.

^a Average year-on-year change. ^b Partly estimated and country data rounded to nearest 0.5%. ^c Forecast; country data rounded to nearest 0.5%.

^d Partly estimated. ^e Estimated. ^f In % of employed persons.

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

avoided sharp braking manoeuvres during that phase and began to ease its monetary policy six months ago, investment should be only moderately impaired. In view of the reduction in interest rates, the decline in residential building will probably come to a halt in the course of the year. On the other hand, the growth in private consumption will slow down markedly as a result of the weakening of the employment-related rise in incomes; export growth will also slacken. The growth in real gross national product will probably be halved to about 1½%. The rate of price increases will probably moderate only slightly.

In the other industrial countries the dampening effects on demand of a tightening of monetary policy will now gradually make themselves felt. Nevertheless, demand will still rise considerably in 1990 owing to the momentum the upswing has developed. In particular, in Japan the investment boom will continue almost undiminished and private consumption will even accelerate. Since Japanese competitiveness has improved considerably owing to the depreciation of the yen, exports will probably also grow at a brisk pace. Real GNP will therefore rise by around 4½% in 1990, almost as fast as last year. Inflation is likely to accelerate slightly, largely owing to the rise in import prices caused by the depreciation of the yen.

In most of the Western European countries the growth in output will slow down slightly, but the only economies to experience a marked cooling will be the United Kingdom and some Scandinavian countries. Corporate investment will remain the principal driving force, even though in almost all of the countries it will increase less rapidly than in the past. Exports will also slow down somewhat. The growth in real GNP in Western Europe as a whole will probably work out at around 2½% in

1990, just under one percentage point less than last year. Inflation is likely to continue at the present rate.

The slowdown in economic growth in the industrialised countries will be reflected in their imports, although these will still expand strongly. At the same time, many developing countries, whose export receipts are being reduced by the levelling-off of growth in the USA and in some cases particularly by a decline in commodity prices, will increase their imports more slowly than in the past. The same is true of newly industrialising countries, for their export-led expansion will lose momentum. The oil-exporting countries, by contrast, will probably increase their imports at a faster rate following a substantial recovery of their export receipts. World trade should grow by between 5 and 6% in real terms, after expanding by almost 8% in 1989.

Seven years of rising activity have brought the world economy out of the trough into which it had sunk during the stabilisation crises at the beginning of the eighties. Despite strong growth in employment, unemployment is still high in many Western European countries. It is therefore all the more important that they be amongst those countries in which economic activity continues to grow markedly in 1990. The emerging pattern of a cyclical growth differential, in which economic interdependence ensures that the downturn in one country and the upswing in another are both attenuated, also provides a good basis for stabilising world economic activity and hence for a "soft landing" after the vigorous upswing of recent years. However, even if it appears that this hope will be fulfilled in 1990, there are still risks for the years beyond. Above all, in many countries it is not yet certain that the central banks have gained sufficient credibility for their stabilisation policies to be able to curb the rise in prices and wages without stifling growth.

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

| Raw Materials and Groups of Materials | 1988 | | 1989 | | | | | 1990 |
|---|-----------------|----------|-----------|---------|----------|----------|---------|-------|
| | AA ² | December | September | October | November | December | 15. 12. | 5. 1. |
| Total index | 158.0 | 145.9 | 155.8 | 159.9 | 158.6 | 153.3 | 153.5 | 175.2 |
| Total, excl. energy raw materials | 150.7 | 160.8 | 145.2 | 145.4 | 144.4 | 142.9 | 143.5 | 145.4 |
| Food, tropical beverages | 104.3 | 113.8 | 96.3 | 95.2 | 96.3 | 94.2 | 94.6 | 96.2 |
| Industrial raw materials | 186.0 | 105.2 | 152.5 | 183.8 | 181.1 | 170.0 | 180.7 | 182.0 |
| Agricultural raw materials | 191.3 | 193.7 | 190.1 | 191.8 | 195.1 | 198.2 | 198.4 | 202.8 |
| Non-ferrous metals | 233.5 | 256.1 | 219.1 | 216.9 | 201.3 | 189.7 | 191.6 | 190.7 |
| Energy raw materials | 162.3 | 144.3 | 162.0 | 168.4 | 166.8 | 175.2 | 175.2 | 194.1 |

¹ On dollar basis. - ² Annual Average.