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Article — Digitized Version

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Intereconomics

Suggested Citation: Großer, Günter; Weinert, Günter (1991) : World economic slowdown, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 26, Iss. 1, pp. 45-48, <https://doi.org/10.1007/BF02928895>

This Version is available at:

<https://hdl.handle.net/10419/140282>

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World Economic Slowdown

In the course of last year, the economic climate cooled down world-wide; it was placed under additional strain in late summer by the Gulf crisis. In some industrialized countries, especially the USA, recessive trends have recently gained prevalence. Do indications for 1991 therefore point to a downturn in the world economy?

Annual growth performance for 1990 is by no means unfavourable: the aggregate gross national product of the industrialized countries rose by some 2³/₄ %. This increase, however, is the outcome of highly varying developments. On the one hand, growing signs of recession were not confined to the USA; they were also discernible in Canada, Great Britain, Sweden and Finland. On the other, particularly Japan and western Germany recorded robust growth trends. In a number of small West European economies, closely linked to the Federal Republic of Germany, demand and production also rose rapidly, while economic growth in France, Italy and Spain slowed down.

The weakening of growth forces was mainly due to the more stringent monetary policy in response to high capacity utilization adopted in the USA in 1987 and in other industrialized countries in 1988. Central banks thus aimed at curbing the cost and price upswell and forestalling fears of inflation. Evidently thanks to this policy, in 1989 expansion in demand was successfully brought into line with the narrowing scope for increases in production. Therefore even during the upswing the strains on the economy could be kept within relatively limited bounds. During 1990, however, demand was predominantly curbed more strongly, the utilization of capacity ultimately declined in an increasing number of countries, employment grew more slowly or in some cases even declined, as in the USA. The downward trend in unemployment as a whole thus came to a stop; in some cases, such as the USA and Great Britain, unemployment began to increase again.

Even in the final phase of the unusually long eight-year upswing in the world economy the 6% unemployment rate in the industrialized countries as a whole was noticeably higher than in the previous growth phase at the end of the seventies. The rate in Japan, 2%, remained at its previous

low level and in the USA it attained by mid-1990 at little more than 5% – a level which is rated in America as full employment – the lowest figure since 1973. The economies of Western Europe, though, averaged 8% unemployment last year, a decline of merely one half of the rise from the end of the seventies to the mid-eighties. High unemployment continued to be attended here by higher wage increases than in the non-European industrialized countries.

The rise in consumer prices has once again been strengthened world-wide with the sudden leap of world prices for oil triggered by the outbreak of the Gulf crisis. In all, though, the central banks of most countries have succeeded in keeping the inevitable acceleration of cost and price increases accompanying an upturn within narrow margins by means of their stabilization policy. At a good 5%, the average rise in the cost of living in the industrialized countries for example was merely some two percentage points higher in 1990 than three years previously. Differentials between countries continued to widen, however.

Differences in Economic Policy

The tighter course of monetary policy was no longer backed by fiscal policy last year as it had been in the past. Budget deficits rose again as a whole. This more adverse development was however partly due to the slowdown in growth, which curbed the increase in tax revenues. The budget deficit in the USA rose again considerably, not only as a result of cyclical factors, but also due to sizable disbursements to bail out savings and loans associations. Finally, in the Federal Republic of Germany, where government suffered substantial losses in revenue due to the tax cuts in effect as of the beginning of the year, public debt expanded rapidly as a result of transfers to eastern Germany.

Differences in monetary policy emerged. The Federal Reserve, which had in fact pursued a restrictive policy up to

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mid-1989, was increasingly concerned after that to counter economic weakening by easing the monetary reins, despite unabated price rises. When last autumn it looked as if agreement had been reached on renewed efforts to consolidate government finances, short-term interest rates were tangibly cut in several phases. In Western Europe in contrast, where monetary policy was tightened in the autumn of 1989 with further increases in interest rates, the foremost goal under the guidance of the Bundesbank clearly remained that of stability. Economic policy planners in other countries, too, were intent on convergence with a view to the planned economic and monetary union. A constraint was the high financial burden incurred by the transfer payments to eastern Germany, which prompted further rises in interest rates as the economic, monetary and social union was announced. Given the close international linkages on the financial markets, this had repercussions on all countries, although it was mitigated by a higher risk premium for the Federal Republic of Germany. It reflected growing uncertainty about future monetary and financial policy. In all, the expansion of the money supply in Western Europe evidently slowed down in the course of last year due to the influence of high interest policies.

Divergent Economic Developments

A relaxation of monetary policy in the USA on the one hand and a tightening in Western Europe and Japan on the other in conjunction with divergent cyclical trends have brought about substantial changes in international interest differentials. Interest for three-month money on the London Euromarket for dollar deposits was, in the third quarter of 1989, still nearly two percentage points higher than for D-mark deposits; by the end of 1990 this differential was almost completely inverted. The same trend manifested itself in relation to other currencies, in particular the yen. This scissor movement in interest rates was the key cause of a sizable shift in exchange rate patterns: in December the dollar was worth 14% less against the D-mark – and had undergone a similar drop against the other EMS currencies – as compared with one year previously, and as much as 25% compared with mid-1989. It was only during the course of last year that a reversal of the trend against the yen took place, when Japan's central bank intensified its high interest rate policy by substantially raising the discount rate.

The differences in the timing of monetary stabilisation policy left their mark on trends in domestic demand in the industrialised countries last year. The growth of total domestic demand was curbed considerably in the USA, Canada and Great Britain in particular; in each of these countries it was lower than that of the gross national

product. In Japan, on the contrary, domestic demand continued to grow quite strongly and in most continental European countries its expansion was reduced only moderately, although the slow-down became more apparent in the course of the year. In western Germany there was even a marked acceleration in the growth of domestic demand under the influence of the tax reductions and the stimuli emanating from the unification of Germany. The growth of demand in this case was, however, not greater than that of the national product – in contrast to the situation in most other West European countries – because in West Germany's national accounts supplies to East Germany count as exports.

The high rise in interest rates as part of stabilization policy dampened the sales and earnings expectations of business and made financial investments more attractive thus impeding the expansion of investment in plant and machinery in many countries. This was true in particular in the USA, Canada, Great Britain and Sweden; but also in a number of other countries such as Italy, Spain and Finland the growth of investment in plant and machinery slackened markedly. In Japan, however, the investment boom went on virtually unabated and in western Germany the inhibiting impacts of monetary policy were overcompensated not least by demand impulses from eastern Germany. There were also quite considerable differences in trends in private consumption, if only because employment and the pace of expansion in disposable income were markedly influenced by the respective economic trends. In late summer the expansion of real income and of private consumption slowed down due to the rapid rise in the price of mineral oil products. Unlike the growth in investments in plant and machinery, though, growth in private consumption as a whole was not lower than in the previous year; only in the USA, Canada, Great Britain and Spain was there a substantial slow-down.

The divergence in growth rates amongst the leading industrialized countries last year contributed to a further decrease in balances on current account: the deficit in the USA and the surpluses in the Federal Republic of Germany and Japan diminished. In autumn, the rapid rise in petroleum prices on the world market triggered a general shift in balances on current account in favour of the oil-exporting countries.

Impacts of the Gulf Crisis

The repercussions of the outbreak of the Gulf crisis in August 1990 on economic developments have kept within bounds largely because of the high elasticity of oil supply outside Iraq and Kuwait which enabled a rapid easing of the market so that oil prices dropped again considerably by

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the end of last year. However, perspectives are now burdened by the war. More than a quarter of the total oil supply of western economies originates in countries around the Gulf. The marked fall of oil prices immediately after the start of the air attacks on Iraq mirrored hopes of a rapid end to the conflict thus avoiding serious detrimental influences on oil supply. But further developments around the Gulf and their impact on the world economy are still highly uncertain. On the one hand, considerable disturbances of oil production and oil transport outside Iraq and Kuwait – if not by military attack, then by sabotage – are still possible. On the other, a rather short war without serious damage inflicted on oil facilities especially in Saudi Arabia would induce consumers to lower oil stocks, and a later recovery of production in Iraq and Kuwait would restore supply pressure. The course of events since mid-January has reduced the probability of a dramatic rise in the oil price discussed before. Notwithstanding, assumptions regarding the future of oil prices continue to be very uncertain. In the following, forecasts are based on the hypothesis that the average oil price in 1991 will amount to US \$ 25 a barrel, close to the level prevailing at the beginning of this year. Indeed, the chances that the outcome will be lower and that the detrimental impact on prices, interest rates and growth will diminish, have improved. On the other hand, the steep increase of military

expenditure connected with the Gulf war will put a heavy burden on fiscal policy in the USA and several other countries.

Prospects as a whole are poor for lower government deficits in 1991. The USA's budget deficit above all will very likely turn out higher than estimated even disregarding the increased military spending caused by the Gulf war. Even if this deterioration remains within cyclical margins and does not signal the failure of consolidation efforts, there is still the danger that confidence in a sounder fiscal policy, already meagre, will wane even further. In most Western European economies the deterioration of government finances ought not to exceed relatively narrow bounds. In the Federal Republic of Germany, spending in connection with unification in 1991 will again place a substantially heavier burden on the government financial deficit.

Doubts as to the soundness of fiscal policies in leading industrialized countries such as the USA and Germany would hamper a monetary policy seeking stability without unduly impeding growth. Faced with the present recessive trends and only weak monetary expansion, the Federal Reserve will probably cut interest rates further. The dollar will probably remain weak, as interest rates will not diminish in the short term in the other major countries. 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 %)		Employment Rates ² (Annual average)	
	1980 to 1988 ^a	1989	1990 ^b	1991 ^c	1980 to 1988 ^a	1989	1990 ^b	1991 ^c	Dec. 1989	Dec. 1990	1989	1990 ^d
USA	2.8	2.5	1.0	0.0	5.6	4.8	5.5	5.0	5.4	-9.0	5.2	5.5
Canada	3.2	3.0	1.0	1.0	6.6	5.0	5.0	6.0	4.9	-2.9	7.5	7.8
Japan	4.0	4.9	5.5	4.0	2.5	2.3	3.0	3.0	-13.3	-0.3	2.3	2.1
Western Europe ³	2.0	3.5	2.9	1.9	7.5	4.7	5.2	5.0	-	-	8.6	8.0
Austria	1.9	4.0	4.5	3.5	4.0	2.5	3.0	3.5	2.5	1.5	4.3	4.0
Belgium	1.8	4.5	3.5	2.0	5.0	3.1	3.5	4.0	2.5	3.6	8.1	7.9
Denmark	1.6	1.3	1.0	1.0	7.1	4.8	2.5	3.5	3.2	3.2	9.4	9.8
Finland	3.5	5.2	2.0	0.0	7.4	6.6	6.0	6.0	3.8	0.7	3.4	3.4
France	1.9	3.7	2.5	2.0	7.7	3.6	3.5	3.5	3.4	3.1	9.4	9.0
F. R. Germany	1.7	3.9	4.5	3.0	2.9	2.8	2.7	3.5	4.1	2.8	7.1	6.5
Great Britain	2.2	2.2	1.5	0.0	7.3	7.8	9.5	6.5	-11.2	7.9	6.9	6.3
Ireland	2.6	5.9	4.0	2.5	9.7	4.1	3.5	4.0	4.6	2.9	15.0	14.5
Italy	2.4	3.2	2.5	1.5	11.6	6.3	6.0	6.5	2.5	-0.8	10.9	9.9
Netherlands	1.3	4.5	3.5	2.5	3.0	1.1	2.5	3.0	3.1	2.0	8.3	7.4
Norway	3.3	1.2	2.0	2.5	8.7	4.6	4.0	4.0	0.1	0.6	4.9	5.4
Spain	2.4	4.9	3.5	2.5	10.6	6.8	7.0	7.0	3.7	3.8	16.9	16.0
Sweden	2.1	2.1	0.5	-0.5	8.1	6.4	11.0	10.0	-0.9	-1.4	1.4	1.4
Switzerland	2.2	3.3	2.5	2.0	3.3	3.2	5.5	4.5	-3.8	8.2	0.6	0.5
OECD Countries												
Total ³	2.6	3.4	2.7	1.5	6.0	4.3	4.9	4.8	-	-	6.2	6.0

¹External value of currencies weighted by share in international trade. ²In % of total number at or available for work. ³Total of listed countries weighted by real gross national product or private consumption in 1987. ^aAverage year-on-year change. ^bPartly estimated and rounded to nearest 0.5%. ^cForecast; country data rounded to nearest 0.5%. ^dEstimated.

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

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volatility of the financial markets in Japan, however, may confront monetary policy with difficult options. In view of the persistent economic tensions and high government debt the German Bundesbank will keep to its course of constricting monetary leeway in the interests of stability. The other Western European countries will presumably adhere to this course, too, for fear of depreciating their currencies against the D-mark and the resultant destabilizing effects.

Mild Recession in the USA

Economic developments in the USA this year will continue for the time being to be affected by the inhibiting impact of monetary restrictions up to mid-1989. Added to this is the drop in income due to higher oil prices and the uncertainty about developments in the Gulf war. Domestic demand will therefore decline at first and this will not be fully offset either by an increase in net exports. In the past upswing excessive price rises could be avoided and the monetary relaxation is gradually taking effect, which would argue for a comparatively mild recession. There should, then, be a resurgence in overall production as early as the second half of the year. As a whole, however, real gross national product in 1991 will not exceed last year's figure. This is based on the assumption that the Gulf war will not trigger a very big increase in the production of military goods.

The downturn in the USA will reverberate throughout the rest of the world. The dampening effects of the monetary stabilization measures and the retarding impacts of the Gulf war will make themselves increasingly felt in any case, so economic growth in most countries will slacken further. In Japan, too, the investment boom will recede and the growth of real gross national product will decline from 5 1/2 % in 1990 to 3 1/2 % to 4% in 1991. In Western Europe forces for growth are also certain to continue to lose momentum. The economic situation will differ greatly from country to country, though, with the expansion in Germany

and Austria still quite robust and with a temporary recession in Great Britain and Sweden. For 1991 as a whole, aggregate real gross national product for Western Europe will probably increase only by some 2% as compared with 3% in 1990.

In all, under these circumstances imports into the industrialized countries will enter a cyclical slowdown. This will curb export revenue for the developing countries, also via lower commodity prices. They will therefore expand their imports less rapidly, especially as for most of them their terms of trade have worsened alone due to the increase in the price of oil. On the other hand probably only the smaller part of the additional revenue earned by the oil-exporting countries will at first be used for additional imports. As a whole, therefore, the increase in real world trade ought to diminish from between 5% and 6% in 1990 to some 4% in 1991.

The development of the world economy in 1991 will be influenced by the course of events around the Gulf. But apart from this factor of uncertainty current trends in the world economy indicate that cyclical fluctuations are again more pronounced. This is hardly surprising considering the effects of changing monetary policy in recent years. The length and strength of the downward phase will – disregarding the uncertainties over developments in the Middle East – only partly be determined by monetary conditions; of equal importance is the health of the major national economies. Here, on the one hand, there are key weakpoints, such as the virtual impotence of fiscal policy in the USA and the volatility of the banking sector there. On the other, however, the fundamental improvement of supply conditions, not least in Western Europe – achieved in the eighties by means of tax reforms and cuts, decontrol and advances towards a single market, as well as the easing of conflicts over the distribution of income – continues to take effect. This is a good indicator that in most industrialized countries 1991 will be confined to a “cyclical dent”.

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

Raw Materials and Groups of Materials	1989		1990				1991	
	AA ²	Dec.	AA ²	Oct.	Nov.	Dec.	4.1.	18.1.
Total index	158.0	163.3	185.7	245.6	228.4	201.2	185.9	157.9
Total, excl. energy raw materials	150.7	142.9	150.8	152.6	150.2	148.6	148.6	146.4
Food, tropical beverages	104.3	94.2	94.7	90.5	89.2	90.1	89.4	89.5
Industrial raw materials	186.0	179.9	193.6	200.0	196.8	193.2	193.7	189.8
Agricultural raw materials	191.3	158.2	210.8	214.5	216.8	214.2	213.7	212.0
Non-ferrous metals	223.5	189.7	201.9	208.6	193.8	187.2	191.7	182.3
Energy raw materials	162.3	175.2	206.0	299.8	274.0	232.0	207.6	164.6

¹ On dollar basis. ² Annual Average.