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Delayed Recovery of the World Economy

The weakness in the world economy, which began in autumn 1990, is lasting longer than expected. While the expansionary forces in Japan and west Germany increasingly lost momentum during the course of last year, the recovery from the recession in North America began to falter again after a short time. Amidst such developments, doubts are being voiced as to whether the global economy is already on the road to recovery. Will 1992 be another weak year?

Last year, the exceptionally prolonged upswing in the industrial countries, which began in 1983, finally came to an end. Aggregate real gross national product, which had still grown at a rate of 2 ½% in 1990, increased by only some 1% in 1991. Japan and west Germany in particular achieved growth rates well above average, while the USA and the United Kingdom, along with some smaller countries, registered a decline, engendering a divergent economic development from autumn 1990 to the early summer of 1991. Since then, the previously forceful expansion in Japan and west Germany has slowed down rapidly, while the recession in the Anglo-Saxon countries came to an end without recovery having started yet. In all, total demand and production in the industrial countries displayed only weak growth, even in the latter part of 1991.

Utilization of capacity in Japan, west Germany and the majority of the other European economies is still considerably higher than in those countries that entered a recession early. There therefore remains a wide gap between these economies. At the different levels, though, capacity utilization has been on the decline almost everywhere recently. At the same time the employment situation has also worsened in most cases; the slight improvement in the USA proved to be short-lived. Measured against the total labour force, the unemployment rates in the industrial countries have risen on average by one percentage point to some 7% since the middle of 1990.

Slowing Down of Price Rises

The weakness of economic activity acted as a brake on prices last year. World market prices for raw materials even declined markedly. The price of oil, which had doubled in autumn 1990 after the outbreak of the Kuwait

conflict, dropped again quickly to its pre-crisis level. In most cases, the home-made cost push diminished little for the time being. Due to growing unemployment, wage rises slowed down in a number of countries, but unit labour costs continued in many cases to go up rapidly as a result of slackening growth in productivity. It was only in part possible to pass on these higher costs, however, as diminishing utilization of capacity meant keener competition. Thanks to lower oil prices, the cost of living in the industrial countries has only risen by less than 4% in the course of the year. Above-average price rises have occurred in a number of West European countries, including Germany and Switzerland, which had shown a particularly high level of stability for decades.

The aftermath of the Gulf War influenced demand, production and prices last year. For one thing, the drop in the price of oil in the industrial countries induced higher real income. For another, the uncertainty amongst consumers and investors prompted by the crisis was dispelled, temporarily stimulating the propensity to invest and consume, particularly in the USA. But this did not bring about a sustained revival. Rather, the prolonged dampening forces have continued to make themselves felt, especially the after-effects of the high interest rates arrived at during the upswing.

Monetary Policy

Current monetary policy in the USA, however, has been characterized by persistent efforts to spur demand by a series of cuts in interest rates. When, nevertheless, the recovery which had begun in early summer began to falter after a short time, the Federal Reserve lowered the discount rate again in December by a full percentage point to 3.5%. Fiscal policy in the USA last year provided the economy with some support, but the budget deficit rose largely as a result of a further increase in expenditure on

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deposit insurance. As economic policy last year failed to stimulate effectively the propensity to consume and invest, partly inhibited no doubt by the heavy indebtedness of both households and enterprises, domestic demand growth in the USA has recently begun to falter again.

In Japan, too, the Bank of Japan, accompanied by a fiscal policy aimed at consolidation, last year aimed increasingly for lower interest rates, as the dampening effects of the restrictive policy followed thus far became apparent: growth in demand and production had flattened out considerably as early as spring; the substantial rise in real gross national product in 1991 is merely a reflection of the robust growth up to that point.

In Western Europe, the Bank of England in particular, departing from its restrictive policy in autumn 1990, further phased down the base rate substantially. The ongoing wage and price pressures in Germany, in contrast, prompted the Bundesbank to raise interest rates. A number of other countries that had loosened the monetary reins a little in the course of the year followed the Bundesbank's example so as to avert a shift in EMS parities. Apart from the marked decrease in the United Kingdom, interest rates on the European capital markets declined slightly over 1991 as a whole. This did not yet, however, trigger any noticeable impulses to demand. In addition, the stimulating impacts of German unification have been on the wane. Aggregate real gross national product in Western Europe hardly rose at all in the course of 1991.

The divergent economic developments since mid-1990 have been conducive to lowering the previously high balances on current account in major industrial countries. Indeed, on the one hand, the German surplus was completely devoured by the boom unleashed by unification and on the other, the deficit in the USA contracted tangibly; the latter's account was even almost balanced owing to the transfer payments received to cover the costs of the Gulf War. In Japan, though, the surplus on

current account continued its steep rise, despite a comparatively high level of capacity utilization.

As a whole, the outlook for the world economy at the beginning of 1992 is less favourable than forecast a year ago – although the constraints caused by the Gulf War have eased faster than expected. The most prominent factor here is the waning recovery in the USA. It is now even feared that the US economy may relapse into a "double dip" recession. Such a development would impair the chances of rapidly overcoming the economic downtrend in the rest of the world as well, particularly as a strengthening of expansionary forces in the United Kingdom and some other countries that had slid into a recession early on is still not discernible.

Limited Scope of Economic Policy

The scope presently available to economic policymakers to stimulate the economy without incurring new risks is very restricted. This holds especially for fiscal policy. Another sizable rise in the USA's budget deficit for 1992 looks likely, partly as a result of the weak economy and partly due to the continuing expansion of government spending on deposit insurance. Considering that the government and the Congress majority are at odds over taxation policy, the tax cuts presently under discussion will probably be kept within narrow bounds.

As in the USA, albeit for different reasons especially due to unification, in Germany, too, there is a need, after the leap in the government deficit over the last two years, for fiscal policy to lay the groundwork for consolidation, at least in the medium term. There are therefore no signs of any new, significant demand stimuli coming from fiscal policy in these two countries in 1992.

Of the remaining industrial countries, the United Kingdom in particular has announced its intention to relax fiscal policy, now that its government deficit has been curbed in recent years. Although in Japan much more is being invested in infrastructure, other government

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ECONOMIC TRENDS

expenditure is being curtailed. In many other economies as well efforts are continuing to dam the increase of budget deficits stemming from diminishing capacity utilization by cutting spending and raising revenue. This may ease the capital markets, but in the short term it impedes demand-side forces for growth.

Monetary policy will probably be marked well into 1992 by the contrary trends between the USA on the one hand and above all Germany on the other, since the diverging business trends over the last two years will temporarily go on affecting wages and prices. The Federal Reserve will wish to counter what it regards as the banks' inordinate reticence to lend by pursuing a policy of "easy money". Evidently, the inflationary dangers entailed medium-term in forcing monetary expansion for a prolonged period have until now been accorded secondary importance. It is, however, unlikely that interest rates will be lowered again to any substantial degree.

Whereas the Bank of Japan will probably ease monetary restraints again this year in view of the successful containment of price rises, the German Bundesbank will in all likelihood stick to its policy of high interest rates until well into the year in order to counter the danger of a persistent surge in costs and prices and prevent greater expectations of inflation from arising,

particularly as the expansion of the money supply is also threatening to overstep the target margin. In this situation, the interest rate differential could be expected to continue to shift in favour of those European countries with less serious stabilization problems than Germany. However, as agents on financial markets obviously do not expect any long-term changes in the "stability hierarchy" among European countries, the leeway here is quite restricted. A substantial drop in interest rates in Western Europe generally, therefore, will not occur for some time.

The continuing wide interest-rate differential between dollar and D-Mark investments will probably keep the exchange rate for the German currency, and hence the closely-linked currencies of the EMS partners, at a high level for a sustained period. This will foster "the import of stability" into Western Europe, but also "the export of demand" as a result of a shift in international competitiveness. The D-Mark rate is, however, to some extent subject to a major uncertainty factor: the virtually unpredictable developments in Eastern Europe.

Difficult Forecast

Altogether, the US economy will continue to be burdened by problems ultimately stemming from the heavy indebtedness of private households and firms and

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)	
	1981 to 1989 ^a	1990	1991 ^b	1992 ^c	1981 to 1989 ^a	1990	1991 ^b	1992 ^c	Dec. 1990	Dec. 1991	1990	1991 ^d
USA	3.1	1.0	-0.5	2.0	4.6	5.4	4.2	3.5	-9.0	0.5	5.4	6.6
Canada	3.2	0.5	-1.5	2.5	6.1	4.8	5.5	3.0	-2.9	1.8	8.1	10.3
Japan	4.1	5.6	4.7	2.5	1.9	3.1	3.2	2.0	-0.3	7.0	2.1	2.2
Western Europe ³	2.2	2.7	1.1	1.7	6.1	5.3	4.7	4.1	-	-	8.1	8.6
Austria	1.9	4.9	3.0	2.5	3.5	3.3	3.3	3.0	1.5	-0.6	4.6	5.0
Belgium	1.8	3.7	1.5	2.0	4.6	3.4	3.2	3.0	3.6	-0.4	7.3	7.7
Denmark	1.9	2.1	2.0	2.5	6.3	2.7	2.5	2.5	3.2	-2.5	9.5	10.4
Finland	3.5	0.4	-5.5	0.0	6.8	6.1	4.0	2.0	0.7	-12.5	3.4	7.5
France	2.1	2.8	1.5	2.0	6.6	3.4	3.0	3.0	3.1	-1.2	8.9	9.3
FR Germany ⁴	1.9	4.5	3.2	1.5	2.6	2.7	3.5	4.0	2.8	-1.2	6.4	5.6
Ireland	2.9	5.7	1.5	2.5	8.2	3.3	3.0	3.5	2.9	-1.5 ^a	17.2	19.5
Italy	2.3	2.0	1.0	1.5	10.1	6.5	6.5	5.5	-0.8	-1.4	9.9	10.0
Netherlands	1.6	3.9	2.0	1.5	2.4	2.5	4.0	3.5	2.0	-0.8	7.5	6.8
Norway	2.7	1.8	2.0	2.5	8.0	4.1	3.5	3.5	0.6	-1.4	5.2	5.3
Spain	2.9	3.7	2.5	3.0	9.6	6.7	6.0	5.5	3.8	-1.1	15.9	15.6
Sweden	2.1	0.3	-1.5	0.0	7.3	10.5	9.5	4.0	-1.4	2.3	1.5	2.6
Switzerland	2.0	2.2	0.0	1.0	3.2	5.4	6.0	4.5	8.2	-4.7	0.6	1.2
United Kingdom	2.8	0.9	-2.0	1.5	6.2	9.5	6.0	4.5	7.9	-2.5	6.9	9.4
OECD Countries Total ⁵	3.0	2.7	1.1	2.0	4.7	4.9	4.3	3.5	-	-	6.1	6.9

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 1988. ⁴Area before unification.

^aAverage year-on-year change. ^bPartly estimated and rounded to nearest 0.5%. ^cForecast; country data rounded to nearest 0.5%. ^dPartly estimated. ^eOctober.

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

the considerable demands placed on the capital markets by the government. The overlapping of these retarding, structural determinants on the one hand and the impulses generated by economic and above all monetary policy on the other make a short-term forecast difficult. Especially the much lower interest rates, however, would indicate that demand in the USA should revive early on in 1992. Investments in residential building will rise; business will be encouraged to invest and the private consumer to buy. In all, though, the upswing will presumably gain momentum comparatively slowly owing to the retarding factors still in force, particularly as exports ought not to revive very quickly. Real gross national product in the USA in 1992 will be some 2% higher than in 1991.

In Japan, too, following the plummeting of share and property prices, there are signs of increased caution on the part of the banks with regard to lending. The economic climate is also burdened by the hesitant recovery in the USA. Thanks, however, to the favourable fundamental conditions for growth and sustained monetary relaxation, the economy should gradually pick up again. While private consumption will be promoted above all by the fact that real disposable income will go on increasing tangibly with prices rising more slowly, lower interest rates will stimulate investments in residential building and in the business sector. Exports will also recover well in the course of the year. The increase of the real gross national product by 2½% for 1992 as a whole, however, will, largely due to the small carry-over, be well under that for 1991.

Grave Uncertainties

The economies of Western Europe are still undergoing diverging developments. In the United Kingdom for example, the question is whether the large cuts in interest rates made last year will bring about a recovery. In west Germany, in contrast, it is still uncertain whether the strict monetary policy will manage in good time to contain

inflationary expectations sown in the boom and thus prevent excessive wage agreements, which would invoke the risk of a recession. The subsiding of the stimulation of demand triggered by unification and the inhibiting effects of high interest rates will also have repercussions on the other economies of Western Europe.

In all, then, any economic forecast for Western Europe is beset with a high degree of uncertainty. A number of factors would, however, indicate that trends will improve in 1992. Probably, moderate cuts in interest rates will make themselves felt in loosening constrictions on demand after monetary policy in most countries has succeeded in avoiding an overheating of their economies without recourse to tight restrictions. This also applies particularly because of the improvement of supply conditions achieved in the 80s – not least as a result of tax cuts and deregulation – which manifested themselves in a steady rise in corporate profits, and in view of the opportunities afforded by the completion of the single European market. Finally, a boost will come from the reviving economy in the USA; there will also be a strong growth of demand from oil-exporting countries, especially the Middle East, and from newly industrializing countries. Altogether, though, real gross national product in Western Europe will achieve only slow growth: for 1992 as a whole the average rate of growth will be about 1½%, little higher than 1991.

The failure so far of the economies in the USA and the UK, which were the first to enter a recession in the world downturn, to recover rapidly, has focused attention on the risks entailed in forecasting. Nevertheless, the conditions would appear to favour the onset of a moderate recovery in the industrial countries this year, though later than originally anticipated. This is supported in particular, however, by monetary impulses in the USA, reminiscent of the "stop-and-go" policy of the seventies, long believed to be a thing of the past. Such a policy threatens to sow the seeds of renewed instability in the world economy.

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

Raw Materials and Groups of Materials	1990		1991					1992
	AA ²	December	AA ²	October	November	December	13. 12.	17. 1.
Total index	185.7	201.2	161.8	171.6	168.0	153.6	156.4	150.7
Total, excl. energy raw materials	150.8	148.6	136.4	133.7	133.5	133.2	132.3	131.8
Food, tropical beverages	94.7	90.1	89.0	90.1	90.6	92.0	91.5	92.6
Industrial raw materials	193.6	193.2	172.5	167.0	166.2	164.5	163.3	161.7
Agricultural raw materials	210.8	214.2	182.0	170.2	167.5	167.6	166.8	164.2
Non-ferrous metals	201.9	187.2	174.5	170.6	171.7	164.9	162.8	163.1
Energy raw materials	206.0	232.0	176.6	193.8	188.2	165.5	170.5	161.8

¹ On dollar basis. ² Annual Average.