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Article — Digitized Version

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Intereconomics

Suggested Citation: Großer, Günter; Weinert, Günter (1993) : The world economy still at risk, Intereconomics, ISSN 0020-5346, Nomos Verlagsgesellschaft, Baden-Baden, Vol. 28, Iss. 1, pp. 49-52,
<https://doi.org/10.1007/BF02928102>

This Version is available at:

<https://hdl.handle.net/10419/140386>

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The World Economy Still at Risk

Following the prolonged upswing in the world economy during the eighties, the subsequent downturn is proving to be more persistent than expected. It looks as if the USA is now at last on the road to recovery but Japan and Western Europe are still having a tangible dampening effect at the turn of the year. Are there prospects for an improvement in the world economy for 1993?

For the world economy, 1992 was the second year of the downswing: at an average 1.5%, real gross domestic product in the industrial countries grew only slightly faster than the previous year, again remaining well below potential growth. For the most part, the employment situation has deteriorated. In the latter half of 1992, 7.5% of the labour force in the industrial countries were out of work, one and a half percentage points more than at the start of the downswing in mid-1990. Under these conditions, the upward trend in costs and prices has abated noticeably. During the last months the rise in consumer prices in the industrial countries averaged less than 3% compared with the same period one year ago, nearing the record low in the mid-eighties.

Economic trends in major economies diverged markedly. But the attendant hopes that an international economic see-saw movement thus would help to rapidly overcome the inertia in the world economy have been disappointed. Rather, the recovery in the USA to date has been much more moderate than in earlier recovery phases and the downswing in Japan and Western Europe gained further momentum in the course of 1992.

One particularly inhibiting factor in North America, Japan, the United Kingdom and Scandinavia has been the sustained efforts of businesses and private households to consolidate their finances after the prodigious rise in debt during the eighties. In most Western European countries, though, the predominant factor has been the persistent high-interest policy. In the course of the year, however, the economic climate here was increasingly clouded by growing uncertainty as to the further development of

European unification and – triggered by this – the turmoil on the exchange markets. At the same time, the deadlock in the Uruguay Round of GATT fuelled fears of a setback in the liberalization of international trade in goods and services.

Efforts toward Consolidation

In contrast, economic policy stimulus has been particularly notable in the USA, in particular stemming from monetary policy, with fiscal policy's room for manoeuvre heavily confined by the already large national deficit. The lowering of interest rates which began more than two years ago was continued. The fact that demand and production nevertheless rose only little until well into 1992, with increasing signs of a recovery not becoming apparent until recent months, attests to the influence of structural constraints in the financial sphere. Not least in connection with the deregulation of the banking sector, businesses and private households had increased borrowing rapidly in the eighties and reduced savings. The correction of excessive speculation triggered a substantial drop in real estate prices. In the wake of this, not only did debtors' propensity to spend diminish, but so did banks' willingness to lend. This affected the impact of lower interest rates. On top of this, government spending on deposit insurance grew into an almost incalculable risk for the budget.

Under these circumstances, stimuli for the world economy from the USA were not forthcoming. This made itself particularly strongly felt in Japan as the monetary policy efforts to stimulate domestic demand were counteracted by the reactions to the rapid rise in debt in the private sector during the previous boom. In response to the high losses incurred through plummeting real estate and

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share prices, the banks have evidently been reluctant to grant credits, though businesses too, after suffering from shrinking profits, concentrated more on consolidation than on new investments, and private households' propensity to consume flagged. An extensive fiscal programme was therefore launched to support the economy, providing for considerable funds to purchase assets such as real estate and securities as a contribution towards the stabilization of the markets, along with higher public investment and financial assistance for private investment.

Interest Rate Policy in Western Europe

Unlike developments in the USA and Japan, there was no relaxation of the monetary reins in Western Europe last year, either. A decisive factor here was that Germany, the country whose currency plays a key role, especially in the EMS, was faced with grave problems with regard to inflation and to the distribution of national income as a result of reunification, and that the Bundesbank's prime concern was therefore to check inflationary expectations. Given the largely fixed exchange rates, the other central banks were also compelled to keep interest rates high. In many cases rates even had to be raised during the summer, mainly because doubts arose over the maintenance of the current level of exchange rates amidst growing criticism of the Maastricht Treaty and many currencies were expected to be devalued. After the sizable shifts in exchange rates in the autumn, the turbulence abated but the situation on the foreign exchange markets remained precarious and this made interest rate cuts difficult in many cases, although the rates in Germany have now passed their peak. One consideration here was certainly that other countries could follow the British example and abandon the EMS in favour of lower interest rates. This fear is a valid one because up to now the downswing in most of the Western European economies has continued, unemployment has risen and the economic climate has markedly deteriorated.

Over the last two years and more of downswing, the world economy has been spared a general recession, but the economic outlook is still very precarious. Prospects for overcoming the weakness in economic activity have, however, improved: there are signs that the structural constraints on the development of demand have passed the peak of their effectiveness. This applies in particular to the USA, where businesses and private households have made visible progress in consolidating their finances. In Japan the decline of share and real estate prices has at least almost come to a halt. In these countries, where the phenomenon of "debt deflation" has emerged particularly clearly, the danger of a resultant prolonged process of contraction would appear to have been banished. One important contributory factor has no doubt been the relief afforded businesses and private households by tangibly lower interest rates. More important, though, for private sector decisions than the lowering of indebtedness and current liabilities from debt service is the building up of confidence in the future improvement of the economy as a whole and hence also of conditions for the individual.

Little Leeway in Fiscal Policy

Under these circumstances, fiscal policymakers in many countries have little room for manoeuvre. On the one hand they must accept the increased public spending and lower revenue resulting from the downswing if the economy is not to be weakened further. On the other, high, often substantially growing budget deficits cannot be allowed to kindle fears of unsound fiscal conduct on the part of the government, which would in turn push up interest rates, since the future course of monetary policy would be less predictable. Compounding this is that cyclical downswings often coincide with a serious structural financial deficit due to insufficient consolidation of public finance during the upswing as well as the inherent dynamic in social security outlays. Fiscal policy in a number of countries is thus marked by the fact that

PUBLICATIONS OF THE HWWA-INSTITUT FÜR WIRTSCHAFTSFORSCHUNG-HAMBURG

KONJUNKTUR VON MORGEN

Annual subscription rate
DM 135,-
ISSN 0023-3439

The short report on domestic and world business trends and raw materials markets published every fortnight by HWWA-Institut für Wirtschaftsforschung-Hamburg

NOMOS VERLAGSGESELLSCHAFT BADEN-BADEN

ECONOMIC TRENDS

supportive "automatic" stabilizers are attended by consolidation measures that counteract the medium term growth of the deficits.

In this situation, the governments in most countries still see no scope for fiscal policy measures to boost the economy. The new President of the USA also looks set to try and curb the budget deficit. In Japan, in contrast, where the government has achieved a financial surplus over the last six years, social security included, an extensive programme to stimulate the economy is underway. The United Kingdom is the only country in Western Europe pursuing an expansive fiscal policy, which it began last spring, but the stimulus will already be much more restrained this year. Among the continental European economies, Italy and Sweden above all – with their national debt at 11% and 8% of gross domestic product respectively – will be forced to give consolidation precedence by cutting down radically on spending, despite the economic downswing, to restore confidence in economic policy. In most other countries, the drop in revenue and rise in spending will presumably be accepted. Altogether, then, fiscal policy in Western Europe cannot be expected to generate a stimulus to demand.

In most industrial countries, the impulses from monetary policy will remain crucial. In the USA, it looks as if

the present expansive policy will continue, even though no further drops in interest rates are likely. In Japan, however, where there are no signs of a revival of the sluggish economy, central bank discount rates will in all probability be lowered again. Finally, in Western Europe as well, a relaxation in monetary policy can be expected in the course of 1993, with Germany leading the way.

The success achieved in containing inflation in the industrial countries and the anticipated stimulus from monetary policy worldwide are major preconditions for an improvement in the world economy. It is, however, difficult to say how quickly the retarding effects of former adverse developments and monetary restraint, still being felt today, can be overcome. It cannot even be ruled out that impediments to growth in some countries, in particular in Western Europe, will gain greater influence on the economy in the short term, especially as the turbulence on the foreign exchange markets here resulting from the uncertainty as to future developments in European integration and the tension between employment objectives and exchange rate policy goals has continued until very recently. Under such conditions, the forecast of the intensity of economic developments and in particular the turnaround point is beset with far greater uncertainty than usual.

Economic Indicators

	Real Gross Domestic 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)	
	1982 to 1990 ^a	1991	1992 ^b	1993 ^c	1982 to 1990 ^a	1991	1992 ^b	1993 ^c	Dec. 1991	Dec. 1992	1991	1992 ^d
USA	3.0	-1.2	2.0	3.0	4.1	4.2	3.0	3.0	0.8	4.5	6.6	7.3
Canada	2.9	-1.7	1.0	2.5	5.2	5.6	1.5	2.0	1.8	-9.6	10.0	11.0
Japan	4.2	4.4	1.5	1.5	1.7	3.3	2.0	1.0	7.0	7.1	2.1	2.2
Western Europe ³	2.2	1.2	0.9	0.6	5.5	4.8	3.9	3.6	–	–	8.4	9.2
Austria	2.5	3.1	2.0	1.0	3.2	3.3	4.1	3.5	-0.6	3.1	5.1	5.0
Belgium	2.3	2.1	1.5	1.0	4.2	3.2	2.4	2.5	-0.4	3.4	7.1	7.8
Denmark	2.4	1.2	1.0	1.0	5.3	2.4	2.0	1.5	-2.5	5.8	10.5	11.2
Finland	3.4	-6.5	-1.5	2.0	6.2	4.1	2.6	3.0	-12.5	-12.3	7.5	13.0
France	2.3	1.2	2.0	1.5	5.5	3.2	2.7	2.5	-1.8	4.7	9.5	10.3
FR Germany ⁴	2.3	3.7	1.5	-0.5	2.2	3.5	4.0	3.5	-1.2	4.6	5.7	6.0
Ireland	3.5	2.5	2.5	2.0	6.4	3.2	3.0	2.5	-0.9	5.7	15.1	17.0
Italy	2.4	1.4	1.0	0.5	8.7	6.4	5.5	5.5	-1.4	-13.5	9.9	10.0
Netherlands	2.1	2.1	1.5	1.0	2.0	3.9	3.5	3.0	-0.8	3.7	7.0	6.5
Norway	2.6	1.9	2.0	1.5	7.0	3.4	2.3	2.0	-1.4	-1.1	5.5	6.0
Spain	3.3	2.4	1.5	1.0	8.7	5.9	6.0	5.5	-1.1	-7.7	16.0	17.5
Sweden	2.2	-1.8	-1.5	-1.5	7.1	9.3	2.5	3.0	2.3	-12.8	2.7	4.8
Switzerland	2.1	-0.1	0.0	0.5	3.1	5.8	4.0	3.0	-4.7	2.1	1.3	3.0
United Kingdom	3.0	-2.2	-1.0	1.0	6.0	5.9	3.8	3.5	-2.5	-12.1	8.7	10.0
OECD Countries Total ³	3.0	0.8	1.4	1.8	4.2	4.3	3.1	2.8	–	–	6.8	7.4

¹ External value of currencies weighted by share in international trade. ² In % of total number at or available for work; in most cases, OECD standardized figures. ³ Total of listed countries weighted by real gross domestic product or private consumption in 1989. ⁴ Area before unification. ^a Average year-on-year change. ^b Partly estimated and rounded to nearest half percentage point. ^c Forecast; country data rounded to nearest half percentage point. ^d Partly estimated.

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

The conditions for recovery have improved most noticeably in the USA. The structural constraints caused by the high indebtedness in the private sector ought not to inhibit the stimulus emanating from monetary policy as much as in recent years, so that the forces for growth can be expected to make themselves increasingly felt. Above all, lower interest rates and an again higher return on fixed capital will strengthen the propensity to invest while the demand of private households will probably increase only moderately due to slow employment growth and the only gradually slackening efforts to curb personal debt. In all, the recovery will continue, albeit not with a great deal of buoyance. At 3%, the growth in real gross domestic product in 1993 will exceed growth in production capacity for the first time since 1988.

Experience shows that a recovery in the USA quickly spills over into other countries, not least into Japan, and this will enhance the success prospects for an expansive monetary and fiscal policy there. Overall demand ought to increase as a result in the course of the year. As financial problems will continue to act as a brake for some time to come, however, the economy will only recover gradually; at 1.5% to 2% – notwithstanding a considerably higher current rate in the latter part of the year – real gross domestic product growth for 1993 will barely exceed last year's figure.

In Western Europe, the expected drop in interest rates in the course of the year will mitigate the effect of the most important constraint, which will then be superseded by monetary stimulus. This could help the basic growth factors, which gained strength in many countries during the eighties, to retrieve momentum. This will, however, take time. Uncertainties regarding trends on the foreign exchange markets and the medium-term impacts of sharp changes in exchange rates will also subside only gradually. Demand on the part of both investors and consumers will therefore probably not revive until later in

the year. Even assuming that the current downswing remains moderate and that production in most Western European countries finally revives in the latter half of the year, the average rate of growth of gross domestic product for 1993 is likely to remain somewhat below the 1992 rate of 1%.

World trade is presently receiving little impetus from the industrial countries, apart from the USA. On the other hand, many developing countries, unlike in other earlier downswings in the world economy, are increasing their imports considerably. Very disparate trends are emerging in the East European countries. World trade volume in 1993 will again expand more rapidly, although the estimated annual growth rate of 4% excluding trade within Eastern Europe is slightly below that for 1992.

Progress towards Stability

On the whole, the outlook for the world economy at the beginning of 1993 remains clouded, despite the recovery in the USA, in particular in view of the pronounced downswing in Western Europe. The present mood here may well be more pessimistic than warranted by the facts in response to the disappointing developments with regard to European unification, the foreign exchange markets and monetary policy, but the apparent further postponement of the turn for the better to the latter part of the year will also be detrimental to the world economy. The aggregate gross domestic product of the industrial countries based on the individual forecasts, will, in 1993, in spite of a gradually more noticeable upward trend, at 1.5% to 2% hardly increase more strongly than in 1992. At least for most of the year, the average utilization of capacity will continue to diminish and unemployment in most cases to rise. At the same time greater progress will be made in the fight against inflation and the monetary stimulus generally awaited in the industrial countries will lay the foundation for a revitalization of the world economy in the coming years.

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

Raw Materials and Groups of Materials	1991		1992					1993
	AA ²	December	AA ²	October	November	December	18. 12.	22. 1.
Total index	161.8	153.6	160.1	165.5	156.8	151.9	153.0	146.6
Total, excl. energy raw materials	136.4	133.2	132.1	130.3	125.0	124.9	124.9	123.8
Food, tropical beverages	89.0	92.0	88.6	84.7	86.8	88.3	88.3	88.5
Industrial raw materials	172.5	164.5	165.2	165.0	154.1	152.9	152.8	150.7
Agricultural raw materials	182.0	167.6	169.8	170.4	159.4	154.9	155.0	151.4
Non-ferrous metals	174.5	164.9	172.3	167.7	159.8	162.8	162.1	159.9
Energy raw materials	176.6	165.5	176.5	186.1	175.4	167.7	169.4	159.8

¹ On dollar basis. ² Annual Average.