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Günter Großer, Günter Weinert\*

## Upswing in the World Economy

*The world economy gained distinct momentum last year. Following North America, the forces for growth have now prevailed in Western Europe and the Japanese economy has also picked up. Real gross domestic product in the industrial countries rose faster than expected at 3%. Will this upward trend keep going, as it must to alleviate unemployment?*

For the first time since the start of the 90s, the economic trends in the industrial countries are moving in the same direction. A forceful expansion of world trade by nearly 9% in 1994 attests to a rapid spread of expansionary impulses via reciprocal demand stimuli. Many developing countries have contributed to this; their real gross domestic product went up again by nearly 6% last year largely thanks to robust economic growth in Southeast Asia. At the same time, some Central and Eastern European countries are evidently emerging from the transformation crisis. Only in the successor states to the Soviet Union has the downward slide persisted.

Although demand and production in all industrial countries are more or less on the rise, the cyclical positions are very disparate due to divergent developments in recent years. Only in the USA has utilization of capacity surpassed a normal level. In Japan and Western Europe in contrast there is still an output gap, although utilization of capacity has picked up again in most countries. There are also differences on the labour market. In the course of the sustained upswing, employment in North America has expanded considerably. In Western Europe there have been definite improvements only in some early recoverers such as the United Kingdom, Denmark and Norway; nevertheless, the fall in employment seems to have flattened out. The latest figure for employment in the USA is 5½% of the labour force, two percentage points below the peak in 1992, while

it has hardly dropped at all in Western Europe, averaging a good 11%.

### Monetary Stimulus

The economic upswing in the industrial countries has mainly been triggered by monetary policy. The key interest rate was lowered continually in the USA up to the end of 1992, in Japan till autumn 1993 and in Germany till mid-1994, and capital market rates were on the decline until about a year ago when they reached quite a low level. Despite a marked resurgence after that, investment in physical assets remained more attractive than that in financial assets, particularly because in many cases profits rose tangibly thanks to rationalization in the recession. In only a few countries has demand also been stimulated by fiscal measures, in particular in Japan, where monetary policy was ineffectual for a long period especially due to overindebtedness stemming from the 80s and where high surpluses in social security made room for the incurring of debt by the government. In most other industrial countries, however, overall public deficits had already reached a point at the beginning of the 90s well beyond that attributable to the downswing, which called for urgent consolidation efforts. In the USA in particular the deficit has been curbed markedly in the last two years. In Western Europe on the other hand success has been meagre so far. At 4% of gross domestic product, aggregate government deficit in the industrial countries in 1994 went down a little for the first time in five years.

Under these general economic policy conditions,

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investment has kept to its steep upward trend in North America, revived in Western Europe and taken a turn for the better in Japan. In most cases stockbuilding has also generated expansive impulses. Private consumption has grown much less than overall demand, however, in particular because the aftermath of the previous downswing has continued to retard development in employment and income and because taxes and social insurance contributions were raised.

On the other hand, exports and imports have undergone unusually forceful growth. The demand differential is reflected in a larger balance of payments deficit in the USA and a growing surplus in Western Europe. In Japan, in contrast, the effect of the pronounced yen appreciation has played a dominant role in stimulating imports and curbing exports.

The rise in consumer prices has slowed down a little again in many countries. In the Western industrial countries as a whole annual average inflation for 1994 only slightly exceeded 2%, less than half of that at the last peak in 1990. A prolonged flattening out of consumer prices is typical for the early phase of an upswing. On top of this, though, stability is now often accorded higher priority as a major condition for growth. This is manifest institutionally in the progress made toward conferring greater autonomy on the central banks in the EU. The containment of inflation expectations as well as high unemployment in most countries has certainly helped keep wage claims moderate almost everywhere, even in countries whose currencies have depreciated considerably since autumn 1992. Thanks to the rapid rise in labour productivity in the course of the upswing, overall unit labour costs only went up a little in the industrial countries in 1994.

The slowdown of the rise in unit labour costs far offset the drastic rise in prices for many raw materials. Beyond the tangible upswing in manufacturing, a major contributory factor to the bull market, apart from speculative transactions, has been the reversal in stockbuilding trends. Measured against the HWWA Index (in dollars), commodities, excluding crude oil, were 31% more expensive on the world market in December than one year before, with the annual average for 1994 at 19%. Crude oil is, however, far more important as a cost factor and in 1994 its average world market price, which often fluctuates in the short term, was 6% below the previous year's figure.

Economic policy in the industrial countries must

now ensure that the upswing attains its full scope and lay the groundwork for sustained growth as a basis for creating many new jobs. The existing differential in utilization of capacity, especially between the USA and most other countries, has been accompanied by differing monetary policy stances since spring 1994. On the capital markets, in contrast, interest rates are now much higher worldwide than one year ago. While this is helping to prevent overheating in the USA, elsewhere it is a risk factor for the upswing in its early phase in two respects: the possible inhibiting effects and the danger of a continued upward trend.

The resurgence in long-term interest rates during last year is primarily attributable to a strengthening world economy causing demand for capital to rise faster than supply. Partly against the backdrop of the steep rise in raw materials prices, another contributory factor has evidently been doubts that the central banks would be ready to tighten their policy of stability. Also, the sluggish progress in curbing government debt has presumably been viewed as a risk. Only a small part of this is the result of underutilization of capacity; the bulk is of a structural nature.

### **Decline in Government Deficits**

In the USA, too, progress in consolidation is already letting up. The obstacles to cutting costs in health that have so far proved insurmountable, the announcement of tax cuts and the simultaneous drive to have a balanced budget laid down in law make reliable assumptions on future fiscal policy difficult. In any case, any such radical change of course will take time. The budget plans so far foresee for 1995 only a slight decline in government deficit based on higher revenue due to the upswing. The structural deficit is unlikely to go down any further; it is still well above the average level usual up to the beginning of the 80s.

In Western Europe, the cyclical improvement of government finances thanks to additional revenue and savings in spending is making itself felt. Partly with a view to meeting the Maastricht criteria, greater efforts are being exerted to lower government deficit in the long term, much of which, however, still centre on higher tax and duties. Despite the prevailing trend toward lower government deficit, this should average about 5% in 1995 as well, with marked divergences amongst different countries, still as high as at the start of the 80s. This was then, too, seen as a grave threat to growth. This applies even more so today as

## ECONOMIC TRENDS

the leeway for market forces with government spending averaging 50% of gross domestic product is even narrower than at the start of the last decade. In Japan, general government deficit will stay relatively low due to the high surplus in social security – about 2% of gross domestic product. Now that the economy has picked up, the government is phasing out its fiscal measures to stimulate growth. Despite the first steps toward consolidation, the government deficit will probably not diminish given the quite modest rise in income and production and the continuing output gap.

### Divergent Monetary Policies

The prospect of a gradual decline in government deficits mitigates the risk of a further rise in interest rates on the capital markets in the industrial countries. A major consideration will however be whether a rise in utilization of capacity does not induce higher inflationary expectations which could impede the upswing's reaching its full potential. For this reason, the Federal Reserve is certain to press on with the course of monetary tightening it began nearly a year ago. As the growth in money supply has

already let up markedly, key interest rates will only be raised a little further. Capital market interest rates are all the more unlikely to rise notably, as the cyclical upswell in wages and prices has stayed within narrow bounds.

Now that the recovery of their economies has gained momentum, the United Kingdom and several other, smaller North European economies are also trying to pre-empt inflationary expectations by raising key interest rates. Most other West European countries follow the lead of the Bundesbank in monetary policy despite the enlargement of exchange rate bands in the EMS. Considering its unchanged goal of keeping money supply growth in line with potential output and stability and the fact that monetary expansion in Germany is on the desired path, there is little likelihood of a change in key interest rates for the time being. The same applies to Japan which has made less progress in recovery than the other industrial countries. Given the persistent weakness of the forces for growth, the large degree of price stability and the high value of the yen, the Bank of Japan will keep short-term interest rates at their current very low level.

### Economic Indicators

	Real Gross Domestic Product (Year-on-year change in %)				Consumer Prices (Year-on-year change in %)				Exchange Rates <sup>1</sup> (Changes over 12 mths in %)		Unemployment Rates <sup>2</sup> (Annual average)	
	1985 to 1992 <sup>a</sup>	1993	1994 <sup>b</sup>	1995 <sup>c</sup>	1985 to 1992 <sup>a</sup>	1993	1994 <sup>b</sup>	1995 <sup>c</sup>	Dec. 1993	Dec. 1994	1993	1994 <sup>b</sup>
USA	2.2	3.1	4.0	3.0	3.8	3.0	2.6	3.5	1.4	-5.1	6.7	6.0
Canada	2.3	2.2	4.0	3.5	4.2	1.8	0.2	1.5	-4.2	-5.9	11.1	10.4
Japan	4.1	-0.2	1.0	2.5	1.7	1.3	0.7	0.5	18.4	6.0	2.5	2.9
Western Europe <sup>3</sup>	2.6	-0.4	2.7	3.0	4.2	3.2	2.8	2.8	-	-	10.7	11.5
Austria	2.7	0.0	2.5	3.0	2.7	3.6	3.0	2.5	-0.6	0.9	5.9	5.6
Belgium	2.4	1.7	1.5	2.5	2.6	2.8	2.4	2.0	-2.6	3.4	9.6	10.3
Denmark	1.8	1.4	4.5	3.5	3.6	1.3	2.0	2.5	-1.6	1.0	12.3	12.2
Finland	1.1	-2.0	4.0	5.0	4.7	2.2	1.1	2.0	-4.3	10.6	17.7	17.2
France	2.4	-1.0	2.4	3.0	3.4	2.0	1.6	1.5	-1.0	1.4	11.7	12.6
FR Germany <sup>4</sup>	3.1	-1.1	2.8	3.0	2.1	4.2	3.0	2.5	-1.5	2.1	7.3	8.2
Ireland	4.3	4.0	5.0	4.5	3.5	1.5	2.5	3.0	-10.3	2.2	15.7	14.8
Italy	2.5	-0.7	2.5	2.5	6.1	4.5	4.0	4.0	-11.7	-3.6	10.2	12.0
Netherlands	2.7	0.4	2.5	3.0	1.7	2.6	2.7	2.5	-0.7	1.6	8.3	9.8
Norway	2.2	2.3	5.0	3.0	5.3	2.3	1.5	2.0	-2.5	0.1	6.0	5.4
Spain	3.5	-1.0	2.0	3.0	6.6	4.6	4.8	4.5	-14.3	-0.7	22.4	24.0
Sweden	1.3	-2.1	2.0	3.0	6.2	4.7	2.2	3.5	-12.5	3.7	8.2	8.0
Switzerland	2.2	-0.9	2.0	2.5	3.2	3.2	0.9	2.5	3.6	3.1	4.5	4.7
United Kingdom	2.1	2.1	3.5	3.0	5.7	1.6	2.5	3.0	2.0	-2.0	10.3	9.5
OECD Countries Total <sup>5</sup>	2.8	0.9	2.8	3.0	3.6	2.7	2.3	2.6	-	-	7.9	7.9

<sup>1</sup> External value of currencies weighted by share in international trade. <sup>2</sup> In % of total number at or available for work; in most cases, OECD standardized figures. <sup>3</sup> Total of listed countries weighted by real gross domestic product or private consumption in 1992. <sup>4</sup> Gross domestic product until 1992, consumer prices and unemployment: West Germany. <sup>5</sup> Average year-on-year change. <sup>b</sup> Partly estimated. <sup>c</sup> Forecast; country data rounded to nearest half percentage point.

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

Under the above assumption, economic policy will only exert a retarding influence in a few countries this year. One of these is the USA, where total demand exceeds potential output after an upswing of nearly four years. A stability-directed monetary policy will dampen the expansion of demand. The higher interest rates primarily affect residential building. Business investment will not grow as fast as it has done. Above all, businesses will be less inclined to build up stocks. As the rise in employment and income declines, private consumption will also let up. Although exports will go on expanding remarkably due to the recovery in the world economy, the upswing will slow down. Due alone to the large overhang at the start of the year, at nearly 3% for 1995, growth in real gross domestic product will still distinctly surpass that of production capacity.

### Sustained Economic Recovery

In Japan in contrast, the effects of monetary and fiscal policy stimuli over the last few years will now make themselves felt more strongly. Owing to tax cuts and a higher inclination of households to spend, private consumption will rise. There are also signs of improvement in business investment. On the other hand, the boom in government investment will draw to a close and there may even be a temporary decline. The external constraints of the pronounced appreciation in the yen – via the stimulation of imports and slower export growth – will only loosen gradually at first, so the recovery will keep within quite modest bounds; real gross domestic product in 1995 ought to be some 2½% higher than last year. Utilization of capacity will keep to its low level throughout the year.

Given the little change in general conditions as anticipated in Western Europe, the upswing will keep up its momentum. After the rapid expansion in exports to the rest of the world over the last two years and the progressive relaxation of the monetary reins by the central banks, business investment has now entered a recovery and – attended by ongoing expansion in exports – is acting as an engine of economic growth. Earnings expectations due in part to a rationalization push triggered during the recession have evidently improved so much that the dampening effect of markedly higher interest rates will be largely offset. Private consumption will also grow faster, in particular as the gradual expansion of employment in many countries will further raise the propensity to consume. Despite gradually abating stockbuilding stimulus, then, growth in domestic demand will tend to step up. On average, gross domestic product in the Western European countries will rise by a good 3% and the utilization of capacity will go up slightly.

For the industrial countries as a whole we can expect growth in real gross domestic product in 1995 of about 3% and world trade should expand powerfully again by about 8%. It will however take time before any marked advances are made in improving employment, especially in Europe. Crucial here is whether the recovery will advance to a phase of sustained rapid growth carried along by dynamic investment, as in the 80s. The high degree of cost and price stability, which looks like continuing this year, is certainly conducive, but essential to a fundamental improvement in growth conditions in the industrial countries is reversing the long-term trend of an increasing government share in GDP.

### HWWA Index of World Market Prices of Raw Materials<sup>1</sup> (1975=100)

Raw Materials and Groups of Materials	1993		1994				1995	
	AA <sup>2</sup>	December	AA <sup>2</sup>	October	November	December	6.1.	20.1
Total index	144.3	126.9	147.8	156.6	159.9	155.9	160.5	163.2
Total, excl. energy raw materials	120.0	121.8	143.2	156.4	158.9	159.2	162.3	165.6
Food, tropical beverages	91.4	99.7	113.5	123.8	121.1	118.2	120.1	119.6
Industrial raw materials	141.7	138.6	165.9	181.2	187.7	190.5	194.5	200.6
Agricultural raw materials	140.9	138.2	171.8	191.5	195.4	196.3	200.9	208.0
Non-ferrous metals	145.0	136.3	171.2	187.3	204.3	212.8	217.2	224.4
Energy raw materials	158.5	129.9	150.4	156.7	160.5	153.9	159.5	161.8

<sup>1</sup> On dollar basis. <sup>2</sup> Annual Average.