

Großer, Günter; Weinert, Günter

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Günter Großer, Günter Weinert*

No Momentum in the World Economy

The upswing in the world economy has lost momentum surprisingly fast. A slowdown in growth in North America had been expected, but the budding hopes in Japan and Western Europe for a continued recovery in utilisation of capacity and employment were disappointed. Are there grounds for such hopes in 1996 or have the structural constraints on growth now become so powerful as to prevent a more significant economic revival?

Outside the industrial countries forces for growth continued to prevail at an unchanged level in the world economy during 1995, with real gross domestic product in the developing countries likely to record some 6% growth for the fourth year running. Asia continued to spearhead growth with production rising by between 8 and 9%. Even the transforming economies of Eastern Central Europe, where market reforms have made further advances, achieved an average rate of growth of 4%. As compared with these, the industrial countries lagged well behind with an increase in their gross domestic product of little more than two per cent. As they still account for more than half of global production, they colour the generally gloomy economic picture.

Causes of the Flagging Upswing

Monetary factors have been key inhibitors of growth. In countries further advanced on the cyclical curve, such as the USA, Canada and the United Kingdom, tighter monetary policy by the central banks, seeking to forestall the overheating of the economy and the strengthening of inflationary expectations in particular, took its effect. At the same time, the marked rise in world capital market interest rates which followed the upswing in most industrial countries in 1994 – evidently also because this led to the stability risks being gauged to be higher – made itself felt. After a rise in long-term government bond yields, which in most of the major industrial countries

reached about two per cent, interest rates turned around again as early as the beginning of 1995, but due to the usual impact lag, they provided little stimulus to the economy last year.

Also in a number of Western European countries whose currencies came under pressure in spring 1995, the central banks felt obliged to raise interest rates, which countered the impulses stemming from improved competitiveness thanks to depreciation. Conversely, the central banks of the strong currency countries cut interest rates back even more during the year. This was offset, however, by the deterioration of sales and earnings expectations due to their loss of competitiveness. On balance, the turbulence on the currency markets in Western Europe has evidently placed a burden on the economic climate and, not least, damped the propensity to invest. In Japan as well, the appreciation shock in the first months of last year must have been a major reason why the massive monetary and fiscal policy kick-start failed to ignite the economy and stagnation persisted.

Except for Japan in particular, where the government put together a new record spending package last autumn, fiscal policy in most industrial countries was directed at curtailing budget deficits. A major goal was to curb government claims on financial resources – largely for consumption – and hence enhance growth conditions via lower interest rates. Measured by the decrease in structural budget deficits, though, the consolidation both in the USA (after considerable progress in the two previous years) and in most West European economies has been

* Hamburg Institute for Economic Research (HWWA), Hamburg, Germany.

slow. Nevertheless, it has supported the lowering of interest rates world-wide, thus counteracting the short-term constraining effects of fiscal policy on demand.

The flagging of the upswing in the course of last year is evidently the outcome of highly disparate influencing factors stemming not only from the divergent cyclical stages in the industrial countries but also from differences in the magnitude of structural obstacles to growth. The usual cyclical pattern was especially manifest in the USA: considering the high utilisation of production capacity, the aim of dampening demand through monetary policy was to make a "soft landing". In Japan, in contrast, along with the renewed appreciation of the yen it was particularly the structural financial imbalances which had arisen as a result of monetary excesses at the end of the eighties which impeded recovery, so that utilisation of capacity dropped further. In Western Europe in turn, the currency turbulences were obviously partly induced by uncertainty about the future of major economic policy parameters in the run-up to Monetary Union. Because the attendant gloomier economic climate acted as an impediment to the development of the forces for growth, a cyclical slowdown resulted as the stockbuilding stimuli waned.

Continuing Labour Market Problems

With only modest production growth, the grave labour market problems in the industrial countries were hardly alleviated at all. The number of employed persons in Western Europe grew little and, at nearly 11% of the labour force, unemployment was only slightly under its peak reached at the beginning of 1994. In Japan, too, the situation deteriorated further, although the large companies continued to show restraint in laying off workers. In the USA, in contrast, the rate of unemployment, at 5½%, continued to be at a level which is viewed as "normal". The increase in employment there has been helped by continued wage moderations; despite the advanced upswing, hourly earnings rose by just under 3% in 1995, somewhat less even than in Western Europe, with its persistent underemployment.

The cooling down of the world economy affected prices at an early stage. The boom on the raw materials markets, for example, came to a standstill as early as the beginning of last year. The cost of living rose in the industrial countries in 1995 by an average of little more than 2% – an exceptionally small increase. Although this included a broad range from

an unchanged price level in Japan to an inflation rate of over 5% in the "weak currency country" Italy, the success of persistent efforts to contain inflation is unmistakable.

Even though North America has apparently managed to put a break on the upswing without the growth in production falling below the increase in production capacity to any significant degree, there are still major risks and uncertainties ahead for the world economy. In Japan, for example, the effects of structural distortions in the financial sphere and in the real economy still override cyclical developments and this is the reason for considerable uncertainty about the effectiveness of monetary and fiscal policy stimuli. In Western Europe, on the other hand, the question is whether the marked deterioration in the economic climate is a sign of an unusually early waning of the forces for growth or whether it is just a "dent" in the upswing, possibly especially in response to the cyclical euphoria carried along by stockbuilding. In this precarious economic setting, economic policy in the industrial countries is increasingly concerned to bolster confidence in a sustained improvement in the conditions for growth.

Fiscal Policy Constraints

Even in the USA, where fiscal policy has already achieved definite consolidation successes in the last three years, economic policy is dominated by disputes over the measures required for a decisive overhaul of government finances. After halving aggregate structural financial deficit, the government and the opposition now want to achieve a balanced budget within seven years. This concerted action has been conducive to interest rate cuts on the capital market, although the quarrel over the necessary change of course in public expenditure and revenue has delayed the adoption of a federal budget for the current fiscal year which already began in October. The budget can be expected to underpin hopes for a lasting consolidation even though there is little prospect of much progress in lowering the deficit in the short term.

Priority has been accorded to cutting government deficits in the Western European economies, too. The aim of alignment with the Maastricht criteria often just conceals unavoidable fundamental dictates: due to the persistently high deficits, resulting only in small part from cyclical factors, government debt in the Western European economies has risen by almost a third on average in the course of this decade alone to

make up 75% of annual gross domestic product. As taxes and other deductions from earnings are already high, raising taxes has become an increasingly difficult option and spending cuts are now inevitable, not least in welfare benefits. In the face of political opposition the consolidation will continue to proceed only slowly, quite apart from the inhibiting effects of the flagging momentum of the economy. This year too, for example, fiscal policy in Western Europe will act as a direct brake on demand. In Japan, in contrast, the boosting of the economy will be continued, particularly with the aid of government investment programmes. For 1996, it looks as if the overall fiscal deficit is going to be higher than in most other industrial countries, at almost 5% of gross domestic product, despite high surpluses in social insurance.

Supportive Effects of Falling Interest Rates

While this means that altogether general fiscal policy conditions will remain largely similar in 1996 to last year, the monetary policy picture is much brighter. While discount rates in the USA continued to be raised in early 1995, a policy of gradual monetary

relaxation has been pursued since the middle of the year, when the signs increased that an overheating of the economy would be avoided; it will certainly be continued in the course of the year. The Bank of Japan is already well in the lead here – it will presumably hold to its policy of stimulation via a symbolic discount rate of only 0.5% to help overcome borrowing reticence on the part of companies and households. In Germany, where key interest rates are approaching their historical low, and in the other Western European "strong currency" countries interest rate levels and patterns also indicate an expansive monetary policy course; in most cases, the monetary reins will probably be loosened further. As indicated in recent months, the central banks of countries with weak currencies will at the same time use the leeway to cut their interest rates, which are still high.

Of major importance for the world economy is the swing in the development of long-term interest rates. Just as their rapid rise worldwide in the course of 1994 was largely attributable to the robust upswing in the USA and the recovery in Western Europe, faltering growth in 1995 led to a substantial decline in

Economic Indicators

	Real Gross Domestic Product (Year-on-year change in %)				Consumer Prices (Year-on-year change in %)				Exchange Rates ¹ (Changes over 12 mths in %)		Unemployment Rates ² (Annual average)	
	1985 to 1993 ^a	1994	1995 ^b	1996 ^c	1985 to 1993 ^a	1994	1995 ^b	1996 ^c	Dec. 1994	Dec. 1995	1994	1995 ^b
USA	2.4	4.1	3.0	2.0	3.7	2.6	2.8	2.5	-5.1	-2.6	6.0	5.5
Canada	2.2	4.6	2.5	2.0	3.9	0.2	2.0	2.0	-5.9	0.6	10.3	9.5
Japan	3.6	0.5	0.5	2.0	1.7	0.7	0.0	1.0	6.0	-4.8	2.9	3.1
Western Europe ^d	2.3	2.9	2.5	2.0	3.9	3.0	2.7	2.4	-	-	11.1	10.8
Austria	2.5	3.0	3.0	2.0	2.8	3.0	2.3	2.0	0.9	2.2	5.6	-
Belgium	2.0	2.2	2.0	2.0	2.6	2.4	1.5	2.0	3.4	2.9	9.7	9.9
Denmark	1.7	4.5	3.0	2.0	3.3	2.0	2.0	2.0	1.0	3.7	12.2	-
Finland	0.8	4.0	5.0	3.5	4.4	1.1	1.0	2.0	10.6	5.4	18.2	17.0
France	1.9	2.9	2.5	1.5	3.2	1.7	1.8	2.0	1.4	3.7	12.3	11.5
FR Germany ^e	2.8	2.9	2.0	2.0	2.2	2.7	1.8	2.0	2.1	3.9	8.2	8.3
Ireland	4.4	6.7	6.0	5.0	3.3	2.3	2.5	2.5	2.2	0.3	14.3	12.9
Italy	2.1	2.2	3.0	2.5	5.9	4.0	5.2	4.5	-3.6	-3.4	11.1	12.2
Netherlands	2.4	2.7	2.5	2.0	1.6	2.8	2.0	2.0	1.6	3.0	6.8	6.5
Norway	2.4	5.7	4.0	3.5	5.0	1.4	2.5	2.5	0.1	0.9	5.4	5.0
Spain	3.5	2.0	3.0	2.5	6.4	4.7	4.7	3.0	-0.7	2.6	23.8	22.5
Sweden	0.9	2.2	3.5	2.0	6.1	2.2	2.6	3.0	3.7	7.3	9.8	9.1
Switzerland	1.8	1.2	1.0	1.5	3.2	0.9	1.8	1.5	3.1	8.3	-	-
United Kingdom	2.2	3.9	2.5	2.0	5.2	2.5	3.5	2.5	-2.0	-6.5	9.5	8.7
OECD Countries Total ^f	2.6	2.8	2.2	1.9	3.3	2.3	2.6	-	-	-	7.9	7.5

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 1993. ⁴ Gross domestic product and consumer prices until 1993, and unemployment: West Germany. ^a Average year-on-year change. ^b Partly estimated. ^c Forecast; country data rounded to nearest half percentage point.

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

interest rates in most countries. With the usual lags, the supportive effects on demand of this "automatic" stabiliser will now make themselves felt following the inhibiting effects last year.

Gradual Recovery Expected

Under the present general conditions the outlook in the USA is good for continued moderate, smooth economic growth. One positive contributory factor has been continuous wage moderation, which has averted the collision with monetary stabilisation efforts which used to be usual in advanced stages of upswing. The stimulative effects of large interest rate cuts, already evident in the residential building sector, will help keep the cyclical responses of the propensity to invest to less promising sales and earning prospects within relatively narrow bounds. Nevertheless, business investment will now rise much more slowly than in the upswing phase and private consumption will increase more moderately. Growth in real gross domestic product, which attained over 3% in 1995 thanks mainly to the considerable overhang, ought to come to about 2 to 2½% in the current year and thus keep just below the rate of capacity expansion.

The retarding effects of the structural problems in Japan will probably continue to be serious, but with the noticeable wearing off of the appreciation shock as a result of the drop in the exchange rate of the yen since late summer of last year, it has become more probable that the massive monetary and fiscal policy push will no longer be counteracted and that production will pick up. Due to the measures taken, public sector demand will expand at first, particularly in the building sector, but improved competitiveness due to the low yen rate also favours a gradual rise in business investment. Aggregate demand will thus

increase at a moderate pace. After virtual stagnation last year, real gross domestic product in 1996 ought to be 2% higher than in the previous year.

After the cooling down of the economy in Western Europe last year, the more conducive monetary conditions will provide increasing support to demand and ultimately restimulate it, in particular as exports to the rest of the world are continuing to rise at a robust pace. The propensity to invest can be expected to revive, partly since the fall in interest rates in most countries means that fixed asset investments have again become more attractive than financial investments. This will be followed by a gradual cyclical recovery of disposable income and private consumption. The pace of overall production growth will probably be slow at first but will speed up gradually. Due to the low overhang, however, real gross domestic product growth in 1996 will again, at 2%, be somewhat lower than in 1995 on average in the Western European economies.

The improvement in major economic parameters in the leading industrial countries in the course of last year, especially the distinct fall in interest rates, gives ground to expect that the world economy will not cool off any further and gradually pick up. At some 2%, the increase in real gross domestic product in the industrial countries will however remain quite low in 1996. Under these circumstances, improvement cannot be expected to ease government finances. Economic policy in many countries is therefore headed for a "hard stretch" and the pressure to accord precedence to short-term demand stimuli over medium-term goals, such as the Maastricht criteria, will increase, but governments will not be able to relent to such pressure without further delaying a lasting improvement in the conditions for more growth and employment.

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

Raw Materials and Groups of Materials	1994		1995			1996		
	AA ²	December	AA ²	October	November	December	5. 1.	19. 1.
Total index	147.8	155.9	162.7	156.0	160.7	165.4	171.2	159.9
Total, excl. energy raw materials	143.2	159.2	163.3	159.5	162.7	160.6	159.2	156.2
Food, tropical beverages	113.5	118.2	117.4	112.6	114.4	112.5	112.6	113.0
Industrial raw materials	165.9	190.5	198.2	195.2	199.6	197.2	194.7	189.0
Agricultural raw materials	171.8	196.3	213.9	212.0	216.8	214.9	215.1	207.6
Non-ferrous metals	171.2	212.8	209.4	201.4	210.9	207.7	198.4	190.3
Energy raw materials	150.4	153.9	162.3	154.0	159.5	168.2	178.2	162.1

¹ On dollar basis. ² Annual Average.