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Article — Digitized Version

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Intereconomics

Suggested Citation: Weinert, Günter (1997) : Higher risks for the world economy, Intereconomics, ISSN 0020-5346, Nomos Verlagsgesellschaft, Baden-Baden, Vol. 32, Iss. 6, pp. 257-258, <https://doi.org/10.1007/BF02928257>

This Version is available at:

<https://hdl.handle.net/10419/140608>

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Higher Risks for the World Economy

Business forecasts are always in danger of being quickly outdated, as the forecasts published at the beginning of the autumn have shown once more. Despite the “healthy”, tension-free upward trend in the industrialized countries, do they not need revising in the face of the turbulence on the international financial markets, especially the crashes on the stock exchanges? Seen from our present vantage point, is the current widespread expectation that overall production in the industrialized countries will again increase next year by 2½% – with a slowing down of expansion in the USA, a further consolidation in Western Europe and a renewed recovery in Japan – overoptimistic?

Until autumn, there were good reasons to presume that the repercussions of the crashes in Bangkok and Kuala Lumpur, Singapore, Jakarta and Manila, which had already started in late summer, and the turbulence on the related currency markets would keep within regional limits, similarly to the Mexican peso crisis at the end of 1994. The Mexico crisis tangibly dampened growth only in North America, and there are numerous parallels. The experience in Asia reconfirmed the basic rule that an exchange rate pegged to a “leading currency” can only survive in the long term if monetary policy is in line with the exchange rate. This means above all that monetary policy must be consistent with that of the anchor currency country. Otherwise a higher increase in prices than in the leading currency country results in real appreciation and in mounting balance of payments deficits. Confidence in the stability of currency relations is undermined if economic policymakers fail to correct the course of economic policy. Interventions on the currency market in favour of national currencies can only fend this off for a time. As currency reserves diminish a sizable devaluation looms closer. The attendant implosion is the more violent the greater the disruption of basic security principles in financial relations in the private sector in general and the banking system in particular.

The confinement of the turbulence to Southeast Asia over a period of several weeks appeared to vindicate the argument that the problem was a regional one. The “overhauling” of the finances of these countries will greatly slow down the high growth rates seen over past years. Only Japan has been tangibly affected, via its foreign trade connections, by this and by the considerable improvement in the international competitiveness of suppliers in these countries due to devaluation. Of Japan's exports in 1996 about 13% went to the “problem countries”; the USA's share came to just about 7%, and the figure for Western Europe is a mere 2½%.

The crash did not “go global” until the end of October. Since then, hardly any stock exchange has been spared heavy losses. Could the spread of stock exchange turbulence not have been predicted and taken into account? This question takes us to the limits of what

forecasting can do. We cannot forecast "chaotic developments". For this reason, above all, cyclical forecasts, like economic forecasts in general, are always contingent. Assumptions and postulates are made for variables the development of which can only be foreseen with great uncertainty. This holds not only for variables that are heavily responsive to economic policy, but also for those that are primarily determined by the market but also prone to sizable fluctuations, such as prices on the financial markets and especially exchange rates. No assumptions are usually made regarding share price trends, because their short-term vacillations do not normally have any bearing on economic cycles.

Even large falls in prices need not have a serious effect on real trends. Of particular importance, though, is the response of economic policymakers. We still associate the stock exchange crash of 1929 and the persistent decline in share values over the subsequent years with lasting economic depression, with a protracted downward spiral in demand and production, employment, goods and factor prices and the value of assets. As is now generally accepted, however, a cardinal economic policy error in this phase was the failure of the central banks to counter deflation and the crisis in the financial sector by expanding liquidity.

This insight was applied in the stock exchange crash of 1987. In response to a fall of over 20% in share prices the central banks promptly lowered their previously raised key interest rates to supply more liquidity; this was a decisive factor in averting a deeper downward spiral. Worse asset losses and the spread of liquidity problems in the financial sector were thus avoided. At the same time, a steeper drop in demand was also staved off.

The crash ten years ago also showed that plummeting share prices need not indicate or cause an economic downswing. This is probably why the latest crashes on the stock exchanges in North America and Western Europe were mostly greeted with equanimity. Also, the percentage drop was much smaller than before. The fall in share prices is also often gauged as a correction of previous overpricing; central banks had long voiced concern in public about the growing danger of a rebound. On top of this, confidence is evidently high that economic policy measures can keep damage under tight control. The Fed for example has already signalled that it will not be raising key rates; in view of the very low unemployment and accelerating pay rises in the USA, rates would probably otherwise have been raised, albeit cautiously. All this indicates that the latest crash will have virtually no significant adverse cyclical repercussions.

Nevertheless, the risks for the ongoing upward trend in the world economy have increased. There is a greater threat that the persistent turbulence on East Asian financial markets will spill over onto the rest of the world. It is difficult, for example, to predict whether and how far share prices will continue to fall outside Asia. Japan is a major uncertainty factor due, among other things, to its special role as a capital exporter with the highest level of foreign receivables. Its fundamental economic weakness, which is also an expression of massive structural problems, will take more time to remedy and the reorganization of the financial sector, which has been in a fragile state for a number of years, will suffer another setback due to the probably substantial rise in write-offs of credits given to Southeast Asian borrowers. This exacerbates the risk of large shifts in international financial relations.

As risks grow so does uncertainty. This can easily further deter consumers and investors. In order to stabilise expectations, then, economic policy needs to be all the more convincing. Beyond an adequate monetary policy, it is therefore especially important to uphold the degree of liberalisation of international trade, despite sizable shifts in competitiveness due to exchange rate changes and despite an often high rate of unemployment, to prevent a devaluation race. Under these circumstances world trade will also continue to expand rapidly next year – both a condition and a result of strong ongoing growth in world economic activity.

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