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
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