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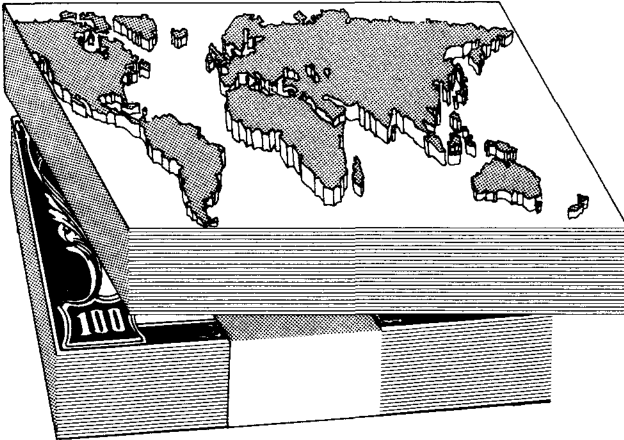
The World Economy



The much predicted upturn in the world economy is proving rather elusive. Many countries are now revising downwards their forecasts for key economic variables for 1982, 1983 and beyond. The OECD has already reduced its July forecasts for growth world-wide to fall from 0.5% to zero. Not only will the start of the upturn be later than expected, but the recovery is also likely to be of a lower magnitude. Indeed whilst inflation is proving reluctant to fall from an average of approximately 8% worldwide there remain doubts about how a recovery can be sustained, given the confidence-sapping effect of high inflationary expectations.

The industrialised countries, notably the UK and USA, where tight monetary policies have been implemented, are beginning to reduce their inflation rates. Whilst a recovery in some of the major industrial countries may be a necessary prerequisite to stimulate a more widespread economic revival it is unlikely to be sufficient unless other countries are able to participate in international markets. The developing countries have an important role but are severely burdened by large international debts which have grown out of their difficulties in financing earlier balance of payments deficits. Between 1975 and 1982 there has been a five-fold increase in developing country debt service payments. Unfortunately, much of this debt is concentrated in short maturity bonds whose interest rates have risen in line with the general domestic rate structures. Compounding their difficulties, the developing countries have had to contend with historically low commodity prices, as a result of the lack of demand from the major manufacturing nations. Some non-oil commodity prices are currently at pre-1970 levels. As a result, the terms of trade of developing countries have worsened, export prices of commodities falling whilst import prices have risen in line with inflation. Developing countries must now sell more in order to protect their purchasing capacity, and hence the standard of living in these countries. Ten years ago five tons of tea would have paid for a tractor, but at current prices thirteen tons of tea are required.

Not surprisingly under these circumstances many countries are unable to meet their debt payments and are requesting 're-scheduling' arrangements from the international banking system. The downward trend in nominal interest rates will, of course, reduce the debt burden but as real interest rates remain at high levels the non-oil, non-NIC developing countries are still unlikely to increase substantially their purchases of manufactured goods.

For many countries, notably Peru, Brazil, Mexico and some Eastern Bloc nations, the ratio of debt to the level of export revenues is well in excess of 30%. The average worldwide is around 19.5%. At these levels the

banking system has itself become vulnerable, with losses already being made by some US and German overseas banks. At a time when the prospects for an upturn might be expected to rely critically on an easing of international credit restrictions, it is likely that the banks and agencies will impose tighter conditions on their loans to developing countries. Yet without the full participation of the Third World in international trade any recovery will be weakened.

Historically, the development process has always generated net borrowing, and as such the present concern over re-scheduling may be excessive. In many ways, the process of "re-scheduling" is no different from the similar technique of "rolling-over" fiscal debts. High interest rates have been largely responsible for most of the financing problems of the developing countries. These high interest rates have originated in the advanced countries, as a result of policies designed to counteract domestic inflation, and to protect the external value of their currencies. But it may be argued that the current signs of recovery in the advanced countries may owe as much to the low level of import prices as it does to the effectiveness of domestic monetary policy. If primary commodity prices rise over the next year, as they are forecast to do, then this will simultaneously have the effect of lightening the debt burden of the developing countries, but at the same time it will add to the inflationary stimulus within the advanced countries. It is clear that the weak recovery anticipated for the next twelve months in the economies of the advanced countries would be jeopardised by any significant further increases in inflationary pressures.

Already some countries are beginning to divorce themselves from the strict confines of monetarism. This will mean that interest rates may soon cease to be the dominant instrument of economic policy. Unfortunately, it is likely that economic policy will increasingly switch to an emphasis on balance of payments problems, in which the main instruments look like being a series of import restrictions designed to protect industrial economies from cheap imports.

Whether the eventual recovery in the world economy will be weak or strong will depend critically on the performance of the **United States** economy. Since October 1979 the level of short term interest rates has been determined by the weekly figures of the M1 definition of money. Last month, Paul Volcker, Chairman of the Federal Reserve Board, promised that for the future direction of monetary policy less emphasis would be attached to the M1 figures. As a result, interest rates are expected to continue falling, helping to ensure that the US economy will grow, probably by around 3%, in 1983, despite recent production figures showing a 0.6% fall in real GDP in September. During 1983 the recovery will be sustained by a further 10% cut in income tax. These clarifications of US policy will have the added benefit of removing some of the uncertainty about future policy which has often been blamed for the high interest rates worldwide.

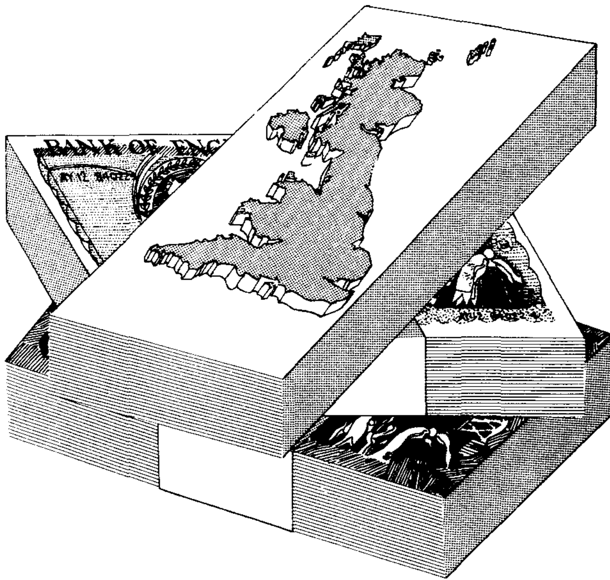
Like other industrial nations, **West Germany** is revising its forecasts for 1983, and it is expected that the 1982 outcome will be for a real drop in output of 1% whilst 1983 should see a 1% real growth - but only if the recovery in international trade actually materialises. Although inflation is expected to fall to around 5% by the end of 1982 and up to 4% next year, an increase in VAT of 1% is expected to come into effect in July 1983.

France also expects a further fall in domestic inflation to around 12% for 1982. In June the franc was devalued in an attempt to reduce the trade deficit. Without devaluation the deficit might have been around £8.9 billion compared with the expected £7.2 billion after devaluation. France operates a minimum wage policy, which has been promoted by the Mitterand government. Minimum wage levels have been increased significantly in relation to both average earnings and domestic prices, effectively threatening the employment prospects of many young people. Further increases in unemployment, and especially youth unemployment are expected as a result.

The performance of the **Japanese** economy never fails to amaze. After a remarkably strong surge in consumer spending between April and June the economy should see 3.4% growth for 1982 as a whole. Even this is a disappointment for such a growth-oriented country. But it is unlikely to encourage a further revaluation of the yen, unless of course such a policy is regarded as expedient to avoid protectionist measures being introduced by export customers. Consequently, exports are not expected to make any contribution to growth next year.

Whilst most countries do indeed expect a recovery next year, it is clear from the major industrial nations that only a weak recovery is anticipated. Despite this pessimism, stock markets throughout the world are pushing up prices to levels which are already discounting a substantial economic recovery for which economists can find no evidence.

The U.K. Economy



In certain respects the outlook for the UK economy is better than for some years. At just over 7%, inflation is at its lowest for over 10 years and is expected to fall further. Prime interest rates have again been cut in recent weeks and at 9% are at their lowest level for nearly 5 years, and further cuts are expected. Mortgage rates will almost certaintly be reduced this month, with beneficial effects on inflation and personal disposable incomes. Productivity improved again this year, albeit at a slower rate than in 1981, the public sector borrowing requirements is less than anticipated, and there is still a healthy balance of payments surplus. Finally, the average increase in the level of annual pay settlements has been reduced to 10% in line with Government aspirations.

In spite of these favourable indications, and the existence of substantial excess capacity, there is no sign of any recovery in output and forecasts of movements in output are pessimistic. Industrial production is static and little or no growth in gross domestic product is expected this year. Moreover, although most forecasters were predicting growth of 2%-3% in output in 1983, similar forecasts were being made this time last year with respect to 1982, and short-term forecasts are already being revised downwards.

As in previous years, the lack of growth cannot be attributed solely to the lack of effective demand. In the first three quarters of 1982, the volume of domestic demand is estimated to have increased by about 3% over the corresponding period in 1981. Over the same period, the volume of imports has increased by over 12%. To put it in a different way, for every 1% increase in the volume of expenditure, roughly 0.8% is met by imports. On this kind of arithmetic, double-digit growth in demand would be needed to generate a rate of output growth sufficient to sustain, let alone increase the present depressed level of employment.

The natural response to this has been a growing demand for a reduction in the sterling exchange rate, or for protection. If it is thought that price competitiveness is the major problem, then a depreciation of the exchange rate is greatly preferable to protection as a means of resotring competitiveness, for a variety of reasons including the risk of retaliation, international obligations under GATT and other trade agreements, and the fact that **selective** import controls would have highly undesirable effects on resource allocation. Indeed, there is a certain irony in the whole debate on import controls in circumstances of floating exchange rates, since a

strong argument in favour of floating rates was alleged to be automatic adjustment to relative changes in international competitiveness. This however failed to anticipate the impact of North Sea Oil on the sterling exchange rate. Despite the serious economic and political implications. however. protective measures are on the increase in many countries including the UK and more trade restrictions are probable.

While there may be reason to query the assumption that uncompetitive prices are the only or even the main cause of the lack of growth in the UK economy, a reduction in the sterling exchange rate is probably desirable and the most appealing policy option for a government reluctant to boost effective demand more directly. To achieve this reduction, further reductions in interest rates, and a relaxation of the present fiscal stance will be necessary, and there are already signs of movement in this direction. Higher public sector capital expenditure is being encouraged, and tax cuts of £2-£3billion are anticipated. The Chancellor's announcement on 8 November of a further cut in the national insurance surcharge is a first step in the direction of fiscal stimulus. At the same time, the government is hoping to offset the potential inflationary impact of higher import prices and monetary growth by restraining pay settlements in the public sector.

Although circumstances are propitious for a modest expansion in output, business confidence is low and there is as yet no indication of the increase in investment necessary for a sustained longer-tem recovery. Given the traumatic shocks of the past three years, industry may be slow to respond to relatively modest changes in the exchange rate and in the level of domestic demand, and more substantial pump-priming may be needed to make any impact on current unemployment levels. As noted above, however, the high level of import propensity means that even a moderately-large growth in demand may not encourage significant growth in output and employment, and may instead lead to the familiar cycle of balance of payments problems, sterling depreciation and higher import prices, and renewed inflation.