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# Will There Be a Worldwide Recession?

by Dr Günter Weinert, Hamburg \*

**In recent weeks, fears of a worldwide economic recession have become widespread because more and more symptoms appear that resemble those at the start of the great depression of 1929. However, wrong conclusions may be drawn from similar symptoms unless basic development trends as well as the differences in overall data and in functional relations are seen at the same time.**

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The thesis is not new: already about 18 months ago, wide international publicity was given to fears of the dangers of a worldwide – and therefore particularly drastic – economic decline. Such considerations were based on the fact that, in the first half of 1973, all the industrialised countries of the West were going through a boom phase together. For about 20 years, such economic synchronisation had not been seen. Moreover, prices were then rising with extraordinary speed, primarily as an effect of the worldwide boom. Most countries recorded the highest price rises since the Korea crisis.

## **The Overkill Thesis**

Some fears were expressed then that the struggle against the rapid rise of inflation would lead, in various countries, to parallel policies of vigorous reduction of demand. Neglect of the effects of restrictive measures on trade partners, so it was argued, would cause a drop in their exports, leading to developed countries of the West sliding into a vigorous economic decline far superior to what was intended by quenching the feverish boom.

However, during the summer of 1973, warnings against such an "overkill" had to be considered rather a dramatisation of potential developments because it was hardly possible to infer, from the more or less parallel upward move in the trade cycle by most countries, that they would also continue to move at the same speed through its declining phase. Admittedly, in this constellation, developments in different countries tend to reinforce each other, but as movements through trade cycles, over the last 20 years, had been very different in individual industrialised countries of the West, the simultaneous high exploitation of available resources everywhere is more likely to have been accidental.

More realistic, therefore, seems the surmise that business trends in the Western World would again

be more differentiated, especially since some of the national economies involved had been using their capacities to their limits already for a much longer period than others. Moreover, the thesis quoted earlier implied that economic policy would not adequately include in its reasonings international economic trends, as is necessary in view of the strong international dependence of most western countries, especially of West European national economies. However, this rather unflattering assessment does not do full justice to most makers of economic policies. Admittedly, international economic cooperation is often less strong than desirable, but measures of economic policy are usually introduced on the basis of a thorough diagnosis and forecast of a given country's economic development; the hitherto existing as well as the prospective economic trends in the most important partner countries are considered via the analysis of imports and exports.

## **Oil as a Special Factor**

Nevertheless, it is true that worldwide economic contraction proceeded even more quickly than had been feared during the summer of 1973 but this was mainly due to a special factor: the oil crisis, and especially to the explosion of oil prices since the end of 1973. After the cut in crude shipments to the industrialised countries of the West had first had led to a temporary reduction in output in some branches, e.g. the chemical industry, and in demand especially for motor cars, the enormous rise in oil prices indirectly caused a lasting slowing down of production. Higher oil prices together with a persistent price boom in the other international commodity markets fed new fuel to the, anyway, powerful rise of prices in western industrialised countries. This worked partly through increases of production costs – where oil imports counted as a first step in the manufacturing process – and partly through higher prices for end products, especially gasoline and fuel oil, entering price indexes. The substantial price rises caused a slowdown of eco-

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conomic expansion, or even — notably in the US and Japan — an actual reduction of private householders' real incomes that led to cuts in consumption (adjusted for price).

But a generally steep decline was caused mainly by the economic policy makers in western industrialised countries, who were spurred to action by the powerful rise of crude oil prices. In almost all countries, this intervention had been brought forth by persistent, and now continuing and often accelerated, inflationary trends, but some governments, e.g. that of Italy, were forced to act by their foreign trade position, too. That was because in almost every industrialised country of the West, with a few notable exceptions including the Federal Republic of Germany, suddenly soaring payments for oil imports pushed the balance of payments into big deficits.

Thus, last summer's economic advances that had been made simultaneously on a broad front were now, indeed, followed by a similarly synchronised retreat into restrictionism — thus the prognosis became reality though under fundamentally changed conditions. At any rate, this is true in so far as the economic downswing has now become worldwide. Only Austria, Norway, Sweden, and for a long time also Belgium and France were able to escape this process. In all other countries, utilisation of productive capacities has visibly dropped.

Yet a true recession — however one defines this — has started, if at all, only in very few countries. If a recession is defined — as is frequently done in North America — as a decline of the Gross National Product (seasonally adjusted) in two subsequent quarters, only the US has experienced one. If recession is interpreted as economic stagnation, also the UK and Japan are now affected by it. In these countries, the GNP in real terms will be somewhat lower in 1974 than in 1973. In most other countries of Western Europe the utilisation rate of capacity has also gone down but actual supplies of goods and services have still grown. Western Europe's GNP in real terms in 1974 is likely to be between 2.5 and 3 p.c. higher than in 1973.

### **Parallels to the Big World Slump**

There is not only disagreement over how to define a recession but also on the probable depth of the coming recession expected by many. Warnings against a worldwide recession are often associated with memories of the pre-war world slump. In recent weeks, such fears have become more widespread because more and more symptoms appear that resemble those at the start of the great depression in 1929.

As a particularly striking signal, both of the 1929 depression and of the world slump that is expected now, people point to the — occasionally precipitate — drop of share prices in almost all international stock exchanges. Was it not the beginning of economic decay when Wall Street crashed in 1929, and do not share prices plummet now too?

However, the effects of this decline are very different now. In 1929, speculators who had operated with huge credits had been forced to sell many shares. Today, on the other hand, there are hardly any big portfolios held on a credit basis. Hitherto, even the use of shares as collateral securities for credits, in spite of the deep plunge of their prices which might catch some portfolio holders short, has caused neither selling pressure on the exchanges nor noticeable disruptions in the credit markets.

### **Different Symptoms**

This example — like many other ones, including bank crashes and the downward trend of commodity prices — demonstrates clearly the danger of drawing the wrong conclusions from similar symptoms unless basic development trends as well as the differences in overall data and in functional relations are seen at the same time. These differences strictly prohibit the habit of inferring from the similarity of many symptoms a simple duplicity of developments. On the other hand, it does not do to underrate the braking effect of psychological factors during the present stage of the business cycle, which might be produced by the growing pessimistic belief in a forthcoming crisis. Also the "destruction of capital" caused by falling share prices and by the mounting number of bankruptcies will probably reduce the propensity to spend or to invest of many, but it would be wrong to overvalue the sizes of individual fortunes, or asset structures, as factors determining the movements of demand.

On the whole, "presentiments of a coming depression" magnify too much the similarities, whilst neglecting the differences between past and present symptoms. Among decisive differences is, for example, the general price trend. It is true that quotations in international commodity markets, especially in those for industrial raw materials, have gone up during recent months, sometimes even steeply — as in 1929. But the general price level in industrialised countries has been soaring exceptionally steeply for more than two years. In the late twenties, on the contrary, general price levels declined steadily. At first sight, the following statement sounds paradoxical: but it is a fact that the difference in price trends might give more grounds now for believing in a growing risk of economic decay than do the

above-mentioned similarities of many symptoms. A counter-inflationary policy that tries to halt and roll back the process of everything becoming more expensive, in its intended effects, seems to be very similar to the policy of deflation in the past, though the latter was operated from different motivations (resulting from a currency system based on the then ruling gold standard, and due to the principle of balanced government budgets).

### **A Changed Economic Consciousness**

Both the theory of the trade cycle and cyclical policies have fundamentally changed since then, and so has the general consciousness of them, not least under the impact of the Great Depression before the last war. General awareness of the dangers of an overkill may be taken as a basis for a great measure of confidence in an economic policy which will take counter-measures in good time. The scope for the "swing" practised by different governments, it must be admitted, is of very different dimensions, not so much because the rates of inflation are varied from one country to another (the aim of a stable price level is accorded different priorities in different countries), but more so because of the development of their external trade positions.

The balances of trade and of current transactions, for most of the industrialised countries of the West, have run into heavy deficits, because of the explosion of oil prices. In accord with free market principles, the obvious alternative would be a big currency devaluation, but at the moment, this would not help them (anyway, even the lawful rates of exchange are freely floating now, except for the few EC countries that have kept within the currency union). On the side of imports, currency devaluation, in view of the — at least in the short term — probably only minor price elasticity of oil imports, could put only a very mild brake on the rise of foreign currency outgoings for imports. And the main effect of devaluation would be additional pressure to lift import prices higher, thus strengthening the forces of national inflation, and this would soon prevent governments from tolerating a further fall in the international value of their currencies.

### **Successful Japan**

A remarkable exception from this rule is, at present, Japan. The Japanese succeeded in swiftly liquidating their high import surpluses, which had been created at the turn from 1973 to 1974 by the formidable rise in oil prices. A major share in this successful operation was due to the recession in Japan, which led to cuts in imports. During the summer months, dismantling the trade deficit was often made easier, because the boom

in commodity markets which, already before the oil crisis, had led to an accumulation of trade deficits has since faded away. At the same time, Japanese exports have been strongly revived during recent months.

A devaluation of the Yen gave added support to this export drive. From April 1974, when the conversion rate for the Yen had reached a high for the current year, the external value of the Yen, weighted against the currencies of Japan's most important trading partners, has dropped until August by about 8 p.c. It was correct not to see in Yen devaluation the start of a new general devaluation competition, which had taken place during the Great Depression. The massive increase in costs which, during the spring, had chiefly resulted from the exceptional rise in wages, demanded this adjustment in conversion rates lest Japanese products become uncompetitive. That other industrialised countries acquiesced in the Yen's devaluation is another indicator for the change in economic consciousness of economic policy makers since the days of the big world slump.

Though Japan's action for reducing its own worries about the balance of trade is quite exemplary, it will not be possible for all the other industrialised countries of the West to emulate it. One of the main reasons are the enormous surpluses accumulated by oil producers from the formidable rise of prices for their principal export commodity which lead to corresponding deficits in the accounts of their clients, the most important of which are the industrialised nations of the West, as a whole.

What could be dealt with at present, is only the distribution of these deficits over individual countries. Dismantling oil-induced deficits, as Japan has done, or earning surpluses in spite of the additional import burden caused by oil, as the Federal Republic of Germany has so far succeeded in doing, therefore concentrates deficits in the accounts of several other countries. At the present time, mainly France, and more so the UK and Italy, are affected by them. Since in their cases devaluation would not wipe out the difficulties of their balances of payments but would give an additional turn to their wage and price spirals, these countries endeavour to stabilise the conversion value of their currencies. One of their principal needs is, therefore, to obtain foreign currency credits. Currency reserves which, in Italy, have already been reduced to the bare gold reserve, cannot possibly cover deficits in their balances of current transactions in the longer term.

In addition, it is probably essential to shore up the reserves of these countries against erosion as far

as possible, in order to maintain international confidence in their international credit standing. As particularly Italy's case shows, this has been undermined considerably. Already in spring 1974, Italy experienced major difficulties to place even state-guaranteed loans in the Euro-capital market.

### **Key Problem: Deficits in the Balance of Payments**

Whether autonomous "minus earnings" on international account, which are the deficits that arise through international transaction in goods, services, donations and capital between countries, can be financed whilst maintaining the present degree of foreign trade liberalisation is, for the present time, the key problem for avoiding a worldwide depression. The fight against inflation, naturally, sets up a recessive trend but, in the same way as about 18 months ago, there is still reason for trusting in "demand management", which has proved its worth in many countries for countering a downward turn in the trade cycle even before the desired development of prices. Certainly, in the past there have been differences of opinions as to when it would be necessary to start "reflation", but such differences may safely be classified as marginal compared with the questions posed by the actual situation now. It is not a question of being aimless, because among the various proposals for financing the deficits there are some that might very well be capable of overcoming the difficulties. The lack of agreement about the direction in which to travel is much more due to the different vested interests and to numerous disharmonies existing between oil-consuming countries as they have just been shown up during their Washington conference, and even more so to the clash of views between oil-consuming and oil-producing countries.

### **Unrealistic Notions**

This clash of views makes quite a number of the proposals tabled so far appear unrealistic. The principal one of those is probably the idea that OPEC countries might be persuaded to reduce the prices for their "Black Gold". The new Vienna decisions of OPEC to raise again slightly the delivered prices for crude incontrovertably "prove" the opposite. The Vienna meeting must also pull back those to the firm foundation of facts who, by analogy with earlier international commodity agreements, tried to argue that the cartel of oil-producing countries would break up soon. The fantastic profits accruing to member countries from the international oil cartel make it, at least for a short term, extremely resistant to decay.

It is only realistic to assume that OPEC countries will keep up their high-price policies and thus earn gigantic surpluses from their foreign trade.

It is up to western industrialised countries to offer them attractive investment possibilities, because the will of oil-producing countries to grant credits to LDCs, whose balances of trade have also been hit severely by the rise in oil prices, or even to communist states, may well be kept in narrow limits. Insufficient offers of chances for investment to which oil countries agree might provoke their preference for preserving their wealth of "liquid gold" in their soil. Noticeable reductions of oil production would then cause a worldwide depression, either through stultifying production or through scaring off demand. What is therefore needed is a beginning of the process of permanent "recycling" oil profits which does not affect adversely the viability of international exchanges of goods and services.

### **On the Lookout for Viable Recycling**

Up to now, re-use of oil-dollars in the West kept, by and large, within an adequate framework. It is significant that an estimate made by the US Treasury Department, which put the available proceeds surplus at \$ 23–28 bn for the first eight months of 1974, showed its very wide diversification: The source stated that about \$ 7 bn were used for investments within the US. More than half of that total was used for buying negotiable government bonds. Most of the balance was placed on deposit with business banks, and only a relatively small remainder served for buying quoted securities on the stock exchanges or real estate. In the UK, about \$ 3 bn have been invested. The lion's share of the sums left over gravitated to Euro-markets. About \$ 13 bn have probably been placed there, but not only in US but also in the other Euro-currencies.

So far, recycling has proceeded in a way which did not do any harm to international economic relations. But mistrust is growing against a possible continuation of this progress in the future. As a matter of fact, during the short period that has passed, the limits of this process have become clearly visible, both functionally and institutionally. Institutionally, the surpluses of oil producers on the search for chances to invest threaten to transcend the business potential of credit institutes that operate in Euro-markets. Investors become increasingly selective in choosing places where to deposit their monies, and their investments concentrate more and more in banks of a particularly high reputation. But these, in their turn, are being "forced" to dilute their formerly stringent rules for doing business, the more so as the, functionally aggravating, problem of changing the due dates for repayment adequately has so far not been overcome. Banks owe money to creditors whose credit balances have been placed with them on short-term conditions, whilst

potential debtors' main requirements are mostly of the medium- or long-term type.

Fears of an impending crisis are fuelled also by the fact that recycling, during recent months, has generally taken the form of *ad hoc* transactions. Individual countries have, so far, acted without long-term foresight, which is more or less understandable vis-à-vis their sudden confrontation with the oil problem and all its after-effects, but what is needed now is the conception of a fundamental solution. The least that should be made available quickly is a clear record of the actual size and the form of investment of the oil billions. Setting up a record office on such transactions, perhaps under the International Monetary Fund, might at least clear away mistrust which will always be the product of hiding the facts from public view. At the same time, if such records were kept, they might very much facilitate the decisions of international finance management.

#### Danger of Protectionism

If it proves impossible to channel a sufficient flow of foreign currencies back from surplus to deficit countries, the latter will inevitably turn to protectionism, though this would resolve the problem of liquidity only temporarily. Retaliation by other countries would become very likely. Sliding into a general trade war would then drag the world into depression along a way whose future turns and twists can hardly be foreseen to-day.

Knowing about the dangers that threaten them, western countries will make supreme efforts to resolve these financial problems. But being "condemned to success" is not a guarantee that the difficulties will be mastered — it only makes such a solution highly probable. In this case, future economic development depends to a large extent on cyclical policy. The decisions about throwing the switches will be made by industrialised countries whose international liquidity is adequate for pursuing cyclical policies in rela-

tive independence. But in view of the unexpectedly stubborn advance of inflation, such countries will loosen their restrictions only very gradually unless, as in the Federal Republic, statutory regulations already prescribe a loosening of the belt, especially by the reduction of wage and income tax rates as from January 1, 1975. Deficit countries, on the other hand, will not be able immediately to switch back even if they should incline to abandoning their anti-inflationary policies. For the time being, their economic policy will continue to operate largely under the "dictatorship" of their balance of payments. Potential donor countries for which the lowest possible price rises have higher priority, be they the industrialised countries acting as middlemen or the oil-producing states, will always provide "strings" (of good economic behaviour) for their granting of credits. They should suggest to debtor countries stabilising economic restrictions but not a policy leading to a recession.

In view of, on the one hand, rising unemployment during the coming winter and, on the other hand, at least stabilised rates of price increases, economic policy makers will increasingly incline, and the political compulsion will grow stronger, to alleviate restrictions. In a number of national economies, notably in the US, Japan and the Federal Republic of Germany, there will probably come a turn in cyclical policies and a recovery of production in 1975, though its gradual progress may lead to full recovery and fuller utilisation of available potentials only later, and the rates of price rises will only be reduced slightly. The result — always provided that world trade will not be noticeably affected by the imbalance in foreign payment accounts — will not be a recession but strong inflationary trends remaining the main economic problems of the world. Cyclical recovery tied to high and often continuing two-digit inflation rates implies directly that the danger of worldwide recession has not been cleared away but merely postponed.



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