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USA

Reaganomics and the World Economy

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The upswing in the US economy, which has long since surpassed all expectations, has undoubtedly been a great success for the economic policy embarked upon by President Reagan. But has the treatment which has done the USA so much good also been good for the rest of the world? American observers always draw attention to the import boom, whilst overseas commentators are more concerned with the worldwide effects of the USA's very high interest rates.

Over a period of a year and a half up to the middle of 1984, the US economy underwent its most powerful upswing since the late 1940s. During this period, real GNP rose at an average annual rate of 7 %, the rate of unemployment fell more than three percentage points to 7½ %, and the rate of inflation on retail prices persisted at something over 4 %, having been three times that rate when the presidency changed hands four years ago. However, the economic success scored in President Reagan's first term is qualified by the fact that, contrary to optimistic expectations, the first half was marked by an acute stabilisation crisis. The primary aspect, though, is that government expenditure has continued to surge ahead simultaneously with substantial reductions in the tax burden, hence eroding the original concept of supply-side policy. The influences of US economic processes on the rest of the world can thus only partly be associated with the fundamental turnaround from demand-oriented to supply-oriented policies: to some extent those influences are more clearly associated with the fact that the turnaround has not been completely carried through.

The conduit by which impulses are transmitted from the American economy to the rest of the world is provided – apart from expectational relationships with immediate effect – by international flows both of goods and services and of finance. In both of these categories, the USA occupies a leading position in the world economy, even though its external links are of only modest importance compared with the domestic US economy – in 1983 exports and imports of goods and services were each only 10 % of the gross national product. In absolute terms, the USA's foreign trade is by far the largest of any country. Furthermore, the American financial markets, and hence the dollar, play a central role in the world financial system, even under the present regime of flexible exchange rates. The USA's economic and political power as by far the most important market economy undoubtedly complement one another here.

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US Import Boom

As well as the demand link, the rest of the world is also made aware of the price and interest rate link with the USA. In this regard, shifts in dollar exchange rates tend to lessen the rigidity of the connection. Whether this decoupling mechanism works, and to what extent, depends especially on economic policy and the expectations it gives rise to, whether in the USA itself or in the other countries involved. The interdependencies which exist, and the areas of overlap with other influencing factors are so many and varied that it is frequently impossible to pinpoint unequivocally the factors at work, let alone precisely quantify them. It follows that when attempts to do this are actually made, the underlying assumptions do not go unchallenged in the general debate on economic theory.

The direct demand stimuli for the rest of the world emanating from the US upswing were extremely strong, for the surge in aggregate demand brought with it an extraordinary import stimulus. In the year and a half up to the second quarter of 1984, the real volume of goods being imported into the USA rose at an annualised rate of 30 %, that is to say at more than four times the rate of growth in aggregate demand, whereby there was no appreciable increase in oil imports, the growth for other products being all the more pronounced. Because, in the same period, visible exports rose only slightly in real terms, even the substantial improvement in the terms of trade brought about mainly by exchange rate movements was not enough to prevent a sharp increase in the American foreign trade deficit. If the increase between the fourth quarter of 1982 and the second of 1984 is again averaged to an annual equivalent, the figure of $ 60 billion is readily exceeded.

Besides the growth of aggregate demand in the USA and the stimuli thus generated for external flows, for the rest of the world financial and monetary aspects of the American situation became of increasing significance. The most prominent of these have been high US interest rates and the sustained rise in the international value of the dollar. How important this dual phenomenon is seen to be for the health of other countries' economies is a question which depends on the way the underlying causes and effects are assessed, and there are, especially in this particular field, vast differences of opinion.

The real rate of interest in the USA, which in the years leading up to President Reagan's first election had hardly exceeded the 1 % mark, had already risen to well over 6 % on average during 1982, and in mid-1984 stood at approximately 9 %.[1] A factor contributing to the shortage on the capital market during the phase of economic expansion – given that monetary policy has at least ceased to be restrictive since mid-1982 – was undoubtedly the cyclical increase in the private demand for credit; the slight easing of interest rates following the mid-year slackening of growth provides an indication of this. However, non-cyclical influences were a much more significant factor. Evidently, the economic policies pursued by President Reagan have, for one thing, given less of a boost to capital formation than was envisaged in the supply-side concept[2] and, for another, by introducing massive tax cuts set against expenditure reductions which were far too small, have given rise to a major structural deficit in the public sector. The sustained increase in real interest rates, which had already begun before the upswing in activity, is a sure sign that the private sector demand for capital is being choked off. One thing that is difficult to judge is whether the interest rate increase might actually have been

[1] Interest paid on long-term government stocks minus the rise in the GNP price index.

[2] On this problem cf. O. Landmann: Eine Bilanz des Reagan-Experiments, in: WIRTSCHAFTSDIENST, Vol. 64 (1984), No. 10, p. 501 ff.

fuelled by fears that the US central bank would ultimately abandon its stance on stabilisation after all, and finance the government deficit.[3] Furthermore, one might expect interest rates to incorporate a higher risk premium than in years gone by, given that the financial system in the USA, and hence in the world as a whole, still has to carry high credit risks, some but by no means all of which derive from the continually simmering debt crisis in major developing countries.

The Soaring Dollar

In the light of the above, it becomes clear that several quite different factors have combined to produce the long-lasting and extraordinary strength of the dollar on the foreign exchange markets. In the four years up to the third quarter of 1984, its average appreciation against the currencies of the USA's major trading partners was approximately 40 %; even if differences in costs and prices are taken into account, the increase is hardly any smaller. Set against most Western European currencies, in fact, the dollar's strength grew even more: in the same period, it rose 64 % against the Deutsche mark, for example.

The many false predictions in recent years that the trend in dollar exchange rates would reverse are a clear indicator of the problems involved in trying to explain the American currency's renewed strength. Evidently quantities such as the difference between price movements in the various countries or trends in their balance of payments, which used to go some way towards explaining exchange rate movements at least in the medium term, have lost their influence in favour of other factors. There have been occasions when political influences came to the fore, such as the view that the USA is a "safe haven" at times of increased international tension, but there is also a strong correlation with the phenomenon of capital flight from developing countries – especially in Latin America – because their economic position, both domestically and internationally, is in ruins.

A more important factor, however, was the American economy's attractiveness to foreign investors and savers, which has been increasing once more over the last few years. After a long period of inflation-inducing monetary policy, the central bank embarked upon a strict stabilisation course in autumn 1980, bringing a drastic abatement in the upward spiral of prices and wages within just a few years. At the same time, the advent of supply-side economic policy, with an intensified drive towards deregulation and, more importantly, with substantial income tax cuts and depreciation allowances, brought an improved climate for the development of entrepreneurial dynamism and a generally higher return on capital. These trends, together with pay restraint, represented a counterbalance in recent years to the strong increases in real interest rates. Given these favourable conditions, net US capital imports grew so rapidly[4] that the dollar remained in demand despite the rapidly gathering balance of payments deficits, maintaining its upward trend right up to the autumn of this year.

Opinions in the rest of the world run the gamut from the belief that US economic developments and policies have given the crucial push towards overcoming world stagnation and recession to the claim that the opposite is true. Because of the interdependencies on many different levels, there are major problems in trying to clear up the picture. The following investigation will concentrate, in the first instance, on short-term demand and production effects.

Propagation of Demand Stimuli

In the last two years the US import boom has had a significant effect on the expansion of world trade: two fifths of the 11 % increase achieved in the first half of 1984 could be attributed to the USA. The demand stimuli were clearly discernible in most economies, with above-average effects in the neighbouring countries of Canada and Mexico and in other markets closely geared to the American market such as Taiwan and South Korea. In Japan, increased exports to the USA in the period January-July 1984 had a direct effect equivalent to more than a 1½ % growth in GNP over the same period a year earlier; in the major European economies on the other hand, the effect was less than half as great due to the lesser interdependence with the American market.[5]

In the main, the rapid increase in US imports was a reflection of the sheer strength of the economic upswing. This was added to by the fact that other countries were lagging behind in the cycle, causing them to make intensive efforts to achieve more exports, and that non-American suppliers were made more competitive by the dollar's increase in value. In fact the average dollar prices of industrial products imported into the USA were no higher in the first quarter of 1984 than

[3] The dollar's strength on the foreign exchanges would appear to contradict this view. However, the predominant expectation could be that, if the above fears were confirmed, the prospects for stability would inevitably deteriorate all around the world.

[4] A look at total capital flows shows that this was primarily a question of capital exports declining.

[5] For details of the calculation, see: Strengthening U.S. Competitiveness, in: World Financial Markets, Morgan Guaranty Trust Company of New York, September 1984, p. 11.

in mid-1981, while US manufacturers' prices for domestic industrial products rose a good 5 % over the same period. However, a large part of the dollar's increase in value appears to have been used to expand suppliers' profit margins, considering that average values of industrial exports from countries other than the USA fell overall by 11 % in dollar terms.[6] Presumably many companies took the opportunity to widen their margins on the American market once more, as they had been severely squeezed during the period up to 1980 while the dollar was weak. There were also varying effects working against more aggressive price competition from foreign suppliers as a result of increased US protectionism. These tendencies have helped prevent an even greater increase in imports which, on the basis of experience in past upswings, might have been expected with such a massive appreciation of the currency.

If the real dollar appreciation (i.e. corrected for differences in price movements) was little lower than the nominal one, this is equivalent to saying that the changed currency parity has itself caused a shift in the cost and price ratios between the dollar zone and the rest of the world. According to IMF estimates, the rise in US wholesale prices between 1981 (average for the year) and the first quarter of 1984 was 15 % greater than the average for the other major industrial countries, and the rise in unit wage costs 21 % greater – referring back to the same currency basis in each case. Under these conditions, the direct price relationship through foreign trade tended, at least in the short term, to have a damping effect on price inflation in the USA[7], but to have a reinforcing effect in the other countries, thus impairing their stabilisation efforts. Such influences are difficult to quantify, as not only price changes in foreign trade need to be taken into account, but also adjustments in domestic costs and prices due to foreign exchange movements.

Upward Pressure on Prices

Despite the powerful dollar appreciation, which would tend to have a downward influence, the average price of US exports as a whole has actually shown a slight increase in the last few years. This means that the prices paid by importing countries will rarely have increased by less – and may have increased by more – than the equivalent of their currencies' depreciation. Even though imports from the USA constitute only an average of 2 % of GNP in Western Europe, the upward pressure on prices is broader because a large number of products originating in countries other than the USA are priced in dollars on the world market. Thus many developing countries, especially raw materials exporters (and notably the OPEC countries) belong in practice to the dollar zone.

The effect of the dollar appreciation on raw materials prices can be arithmetically illustrated by converting them into various other currencies. As an example, official oil export prices for the period January-September 1984, as posted in dollars, were 18 % below their highest level, reached in mid-1981, whereas in ECU terms they were 13 % higher. Over the same timespan, the international price level for other raw materials – as expressed by the HWWA index – eased 6 % in dollar terms, but rose 30 % in ECU terms. Even here, though, it is impossible to precisely quantify the dollar appreciation's effect in the oil and raw materials price increases falling upon countries outside the dollar zone, because overall movements included a downward tendency in dollar prices: another indication of this is the relatively limited rise in world market prices during the 1983/84 economic recovery.

The ultimate deciding factor is the constellation of supply and demand on individual markets, and any exchange-rate-induced movement in real prices or costs for purchasers or sellers of raw materials naturally leads to appropriate adjustment processes.[8] However, it always takes some time for the pressure on prices caused by exchange rate movements to be "neutralised" in this way. The lag involved[9] varies from one raw material to another depending upon market conditions. If a cartel is in operation, adjustments are generally made in stages, and sometimes with a very long delay. The most obvious example of this is the world oil market, where the official, dollar-quoted, export prices remained unchanged between the point when they were lowered in spring 1983 and the late summer of 1984; in ECU terms, this was equivalent to an exchange-rate-induced price increase of 19 % in just a year and a quarter.

If the nominal depreciation of a currency against the dollar is used as a measure of the direct price effects on

[6] The extent of the divergence can only be partly explained by structural differences in the underlying flows of goods.

[7] According to empirical investigations, a 10 % appreciation of the dollar leads to a fall in US consumer prices of approximately 1½ % over a period of two to three years. Cf. Federal Reserve Bulletin, Washington D. C., June 1984, p. 486.

[8] An IMF investigation covering the period 1972-1982 came to the surprising conclusion that a 1 % appreciation of the dollar actually led to a fall in raw materials prices of rather more than 1 %. Cf. IMF: World Economic Outlook, Washington D. C., 1983, p. 158. Other assessments have calculated the effect to be smaller than this.

[9] The OECD estimates it at "up to one year". Cf. OECD: Economic Outlook, Paris, December 1982, p. 50.

individual industrial countries resulting from the dollar's strength, the arithmetic inflationary pressures are seen to have been predominantly strong in Western Europe, but contrastingly slight in Japan. Apart from short-term fluctuations, the yen's external value has hardly decreased against the dollar in the last four years, while the ECU's has been virtually halved. It should also be borne in mind here that domestic factors of production – measured in terms of the GNP price index – became dearer by an average of 40 % in the countries of the European Community between 1980 and 1984, whereas the equivalent rise in Japan was only 6 %. Thus, in as far as different currencies' losses of ground against the dollar were in accord with the countries' relative inflation rates – this also tended to be the case when Western European currencies were compared amongst themselves – differences in the arithmetically established external price stimuli ultimately reflect the varying degrees of success in damping down inflation at home.

Terms of Trade Effects

How much overall national income is reduced due to import price rises in the wake of the dollar appreciation depends in each individual case on the extent to which higher import costs can ultimately be passed on by raising export prices too. Because so many influences are at work on the prices of goods in international trade, and especially because of the adjustment processes set in motion by the second oil price explosion at the beginning of the decade, it is almost impossible to isolate this effect. Even so, revealing comparisons can be made between individual countries or groups of countries. For example, the terms of trade applying to the USA and to Japan in the first half of 1984 were both approximately 10 % more favourable than they had been on average in 1980/81 – a low-point because of the oil price – whereas in Western Europe, they had only just begun to slightly improve. Even after allowance is made for the diluting effect on the statistics due to the large volume of intra-European trade, there remains a significant difference which is to a substantial extent attributable to the depreciation of Western European currencies against the dollar.

Thus it appears that, in contrast to the US and Japanese positions, the shift in exchange rate parities has prevented the domestic scope for apportionment being widened once more in Western Europe, following its restriction after the second oil price boom.[10] On the other hand, any analysis of cause and effect should not ignore broader interrelationships, so the real depreciation of the Western European currencies is partly a reflection of the estimation that the adjustment in income distribution between labour and capital, needed to produce growth, is not proceeding as quickly as it is in the USA and Japan. To the extent that such undesirable trends are discounted on the foreign exchange markets, the pressure to adjust makes itself felt all the more strongly right away. A further point, though, is that these distributive effects of a terms of trade deterioration cannot automatically be regarded as an absolute loss of real national income due to external trading conditions, for the improved competitiveness brought about by the depreciation of the currency provides a dual benefit by simultaneously stimulating exports and dampening imports.

However, the direct repercussions of US economic developments transmitted through the quantitative exchange of goods and services with other industrial countries and through the price linkage, under heavy influence from exchange rates, are only part of the story of overall interrelationships. Quite apart from the repercussions on the developing countries' position, which in turn indirectly affects the other industrialised nations, an important role is also played by the worldwide influences exerted upon economic policy. Once again, the connections are multi-faceted, are barely separable from other determinants and, finally, will be assessed differently according to the particular underlying concepts being applied. The greatest attention is generally paid to the monetary link via the financial markets, though there is also, to varying degrees, an undeniable radiation of supply-side ideas affecting the formulation of economic policy outside the USA.

Monetary Policy Linkage

The clearest illustrations of the great extent to which most industrialised countries' monetary policies are oriented to events in the USA came in the late summer of 1982 when restrictive policies were relaxed and an expansionary course taken up across a broad front, and again in mid-1983 when the tendency to steer a course based on stabilisation and production potential reasserted itself. There are a number of aspects to this unison in policy. In 1982, intensified recessionary tendencies in most economies coupled with a sudden worsening of the international debt crisis produced an initial impetus towards relaxation, reinforced by the view that, inflationary tendencies having generally been successfully damped down, the immediate dangers for the course of prices and wages would be slight. A year

[10] In Western Europe, a one-percentage-point movement in the terms of trade is equivalent to ¼ % of the gross national product.

later, however, the wish not to jeopardise confidence in the continuation of the stance on stability once again came to the fore.

It is often almost impossible to judge how much individual countries, at least as far as their timing is concerned, thought out their own changes in monetary policy – possibly also influenced by the example of US experience – and how much the changes resulted from an actual or feared backlash from US monetary developments. What is apparent, though, is that many countries, right up to recent months, have repeatedly tended to use monetary measures to hold back the depreciation of their own currency against the dollar. The purpose of these measures was to avoid an external impetus to price increases, though another consideration, especially in Japan's case, has been the wish to avoid any aggravation of US protectionist tendencies following further shifts in competitiveness caused by exchange rate changes. However, whether as a result the expansion of the money supply in major industrialised countries has been persistently held below their autonomous national targets, and if so by how much, is frequently uncertain. Viewed over relatively long periods of time, monetary expansion has in all cases been contained within the announced target ranges. To establish the existence of a restrictive influence on monetary policy, one has to make the assumption that the money supply would otherwise have been allowed to expand more rapidly, even though actual M1 growth – not generally used as a target measure outside the USA – has in most cases only been modest. However, in so far as the above assumption includes the possibility of exceeding the envisaged targets, the strong dollar can be said to have done no more than prod the monetary authorities into abiding by their own stated intentions.

Real Interest Rate Rises

Criticism of what has been termed the USA's high interest rate policy – and of the boost to the dollar which it has brought about – is normally not directed against monetary policy as such, but against American fiscal policy which has allowed the accumulation of a high "structural" government deficit and is causing a major diversion of investment capital into consumptive uses. Because, in contrast to other countries, the stabilisation-oriented monetary policy and improvements achieved by supply-side policies have evidently been sufficient – at least for the time being – to ensure that the USA's creditworthiness is not placed in any doubt, an adjustment process has begun which stretches beyond the country's own borders: the high real interest rates in the USA and the dollar's high exchange rate allow it to make use of both financial and material resources supplied from abroad. This causal link sometimes gives rise to the accusation that the US upswing – and hence the success of the economic policy which led to it – has gone hand in hand with an equivalent deterioration in the conditions for growth facing other countries. However, comments of this type often take insufficient account of dynamic effects, especially in a situation where resources in the world at large are being underutilised. Equally, though, suppositions made on a static balance basis that balance-of-payments surpluses outside the USA inevitably involve an equivalent surplus of savings over net investment[11] also ignore problems which are of similar importance. Indeed, this approach harbours the danger that the effects of the adjustments in relative prices necessary to induce the right final decisions between consumption, saving and net domestic investment may be underestimated.

Undoubtedly the pronounced rise in US demand for capital has tended to contribute to a worldwide shortage of monetary capital, and hence to the rise in real interest rates. Yet it would be wrong to neglect the fact that there are also many other countries apart from the USA where large government deficits and uncertainty as to the durability of monetary policies aimed at stability, not to mention a generally greater risk awareness, have all pushed in the direction of higher real interest rates. On the other hand, most of these countries have managed to make noticeable progress in their bids to consolidate government finances and have seen a much less active growth in the private demand for capital than the USA. Indeed, other countries' real interest rates – in the most important countries they currently lie between 5 % and 7 % – are markedly lower than the USA's. Thus the substantial depreciation against the dollar in the industrialised nations outside the USA was actually accompanied by a noticeable, albeit incomplete, decoupling from real US interest rates.

Developing Country Exports

For the developing countries, too, the stimuli to international flows of goods and services and of finance emanating from the USA have been an important and a many-sided influential factor on economic events for the past few years. In many respects the functional relationships were similar to those discussed above for the industrial countries, certainly as far as direct fillips to demand and the easing of the balance of payments situation were concerned. To illustrate, US imports from non-OPEC developing countries in the first half of 1984 were 28 % up overall on the previous year. There are, however, differences in the causal relationships at work because, for example, certain developing countries organise their links with the world economy in a different way, generally with less of a market basis, and because many of them are effectively strongly bound up with the dollar zone. We shall not examine these aspects here in any further detail.

For many developing countries, the balance of payments question is, in the short term, by far the most important one, as their precarious economic situation would become still worse if the debt crisis were brought to a head. From this point of view, the healthy rise in exports to the USA tended to relieve the situation. It was above all for this reason that the USA's balance of payments deficit with non-OPEC developing countries increased by approximately $15 billion in 1983, and year-on-year trends in the first half of 1984 indicated that the rate of increase was being roughly sustained. However, developments in the USA also placed an additional burden on developing countries because of the rising interest rates up to the middle of the year. The effect upon non-OPEC developing countries of a two-percentage-point rise in dollar interest rates – as in the first half of 1984 – is estimated to be approximately $6 billion;[12] this is in turn estimated to represent 7 % of their exports to the USA. Overall, though, it is clear that the US upswing has substantially eased the balance of payments situation over the last two years. Taking a longer-term view, the developing countries are faced with a special problem in that the vast majority of their foreign currency borrowings are denominated in dollars – the proportion in the major Latin American countries, for instance, is 80 % to 85 %.[13] Yet a substantial amount of their exports flow to markets outside the dollar zone. If their dollar-quoted export prices come under pressure because of the appreciation of the North American currency, as has been assumed for raw materials prices, this in itself tends to mean an increase in the real debt burden for many developing countries. This is probably again partly counteracted by a cheapening of imports from countries outside the dollar zone. For each individual developing country, then, the overall effect depends upon a complex adjustment process involving the prices and volumes in the country's international trade.

Risks for Growth

Taking the balance of all the influences on demand and production elsewhere which radiate from the USA, it is a difficult task to arrive at an overall net effect. It is

[11] Cf. A. Konrad: Is the USA Depriving the Rest of the World of Capital? in this issue of INTERECONOMICS.

[12] Cf. IMF: World Economic Outlook, Washington D. C., September 1984, p. 12.

[13] Cf. World Financial Markets, Morgan Guaranty Trust Company of New York, August 1984, p. 1.

quite possible that the direct stimuli via foreign trade were greater in the last two years than the retarding influences resulting from the linkage between interest rates (and hence also exchange rates), especially as the part played by domestic misdevelopments is accorded too low a significance in many countries. Yet any overall judgement ought not to place too much importance on short-term cyclical aspects. Of far greater moment is the question as to whether US developments will lend weight to an improvement in longer-term growth conditions around the world.

The dominance of domestically oriented economic policy in the USA, whatever immediate problems are associated with it for the rest of the world, undoubtedly does not provide justifiable grounds for complaint if it paves the way, with a promise of sustained success, towards conquering sluggish growth and underemployment. However, this can only be said with major qualifications, especially if the USA's underlying supply-side policy concept is regarded as a correct one. For unless and until a clear brake can be put on the dynamism of government expenditure, and as long as the already existing "structural" deficit continues to increase rather than decrease, one of the essential building blocks for the strategy of achieving a sustained improvement in supply conditions is missing. Although the problems thus generated were played down by other influences during the cyclical upswing of 1983/84, there is still as much reason as ever to cast doubt on whether the stimulatory forces are strong enough to properly counteract the retarding effect of extremely high real interest rates or, alternatively, whether the latter will come down far enough and quickly enough to prevent a renewal of perceptible dampening influences on growth. There are similar grounds for concern when it comes to the chances of confidence in US economic policies continuing much longer to attract capital inflows sufficient to allow such large balance of payments deficits without putting the dollar under undue pressure, which would mean an increased likelihood of the economic brakes being applied in the USA. On the other hand, the longer relative exchange rates persist which have been distorted by temporary influences, the more likely it becomes that false structural orientations will be adopted in the economies concerned. Thus the further course of events in the USA, and hence in the entire world economy, is still exposed to substantial risks.