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Flagging Economic Upswing in the USA

Even after the collapse of international stockmarkets in October the upswing in production in the USA continued at a swift pace. However, there have been substantial inventory build-ups, probably due in part to the unexpected slackening of final demand. As in 1986, real GNP in 1987 was 2.9% up on the previous year's level. Domestic demand, excluding inventory investments, increased at a much slower pace than during the preceding year, whereas the development of net exports, which still had a clearly retardant effect in 1986, now contributed towards the increase in production. The number of employed persons continued to increase markedly, by 2.5% on an annual average. Following the marked acceleration at the beginning of 1987 the rate of inflation again slowed down considerably; increases in consumer prices during the last six months corresponded to an annual rate of between 3.5% and 4%.

The tailing off of domestic demand was marked by a more moderate increase in consumption. The latter increased by 1.8% in real terms in 1987, only half as fast as in the previous year. Consumers showed noticeable restraint in the fourth quarter of 1987, partly as a result of the discontinuation of discount campaigns by the motor vehicle industry and probably partly due to the effects of the stockmarket slump. Investment in residential construction has shown a declining trend since one year ago. The development of business investment was marked by unsteadiness for a number of years, primarily as a result of the stage-by-stage realisation of the tax reform. Following a decline at the beginning of 1987, however, an upward trend again prevailed. Business investment during the fourth quarter of 1987 was 4.5% higher than one year previously.

Marked stimuli emanated last year from the development of the external flow of goods and services. Real exports of goods and services, for example, increased by 13% in 1987 as opposed to 3% in 1986. The increase in imports, on the other hand, fell from a good 10% to 7% despite a pronounced increase in oil imports. The balance of trade deficit, however, continued to increase due to a deterioration in the terms

of trade; a slight seasonally adjusted decrease was only recorded during the last two months of the year. Altogether, the deficit of US \$ 171 billion (imports c.i.f.) in 1987 was US \$ 15 billion higher than the year before.

After two years of pronounced monetary expansion the central bank set out at the beginning of 1987 to counteract growing inflationary expectations; money supply expansion was slowed down markedly. In late summer expectations of interest rate increases spread, with an eye inter alia to the desired exchange-rate stabilisation, and long-term interest rates escalated. After the central bank supplied abundant liquidity following the stockmarket crash, and made it clear that it was not giving high priority to the safeguarding of the existing dollar exchange rate, interest rates fell. However, there were soon renewed efforts by the central bank to pursue a more restrained course. At the beginning of 1988 the money supply M1 was only 3% higher than one year previously. The stabilisation of financial markets and the reduction of inflationary fears following the downturn of the business climate caused by stockmarket turbulences encouraged a further decline in the interest rate level. In February the yield of a good 8% on ten-year government bonds was two percentage points lower than in mid-October and only one percentage point higher than at the beginning of 1987.

The budget deficit fell by a third to a level of US \$ 148 billion last year, albeit under the influence of only temporarily effective factors. As the deficit in the fiscal year 1987/88 threatened to increase again markedly the government and Congress agreed at the end of 1987 on spending cuts and revenue increases of roughly US \$ 30 billion for 1987/88 and US \$ 46 billion for 1988/89. The latest estimates show that the deficit for the current fiscal year will hardly change. The draft budget for 1988/89 presented by the government is based essentially on the budget proposals adopted at the end of 1987. The actual deficit figure will fall slightly short of the US \$ 136 billion envisaged in the Gramm-Rudman law. Calculations by Congress, however, project a markedly higher deficit in view of less optimistic assumptions

ECONOMIC TRENDS

regarding the expected economic growth. Further consolidation measures, however, are unlikely to be adopted before the elections in November.

So far, the shocks emanating from financial markets have apparently had only slightly moderating effects on the behaviour of consumers and businesses. Nevertheless, the development of the US economy continues to be marked by considerable risks. It is still uncertain whether economic policy measures will be able to effect a continual reduction of the pronounced internal and external economic imbalances without causing considerable friction. The fact that fiscal policy is currently overshadowed by election considerations is a particularly serious aspect. Uncertainty about the continuation of consolidation, therefore, will probably continue until a new president assumes office at the beginning of 1989.

This also makes it more difficult for the central bank to create the monetary conditions for a lasting economic upswing without stimulating inflationary expectations. The noticeable increase in the savings ratio since autumn, on the other hand, provides relief, since this increases the domestic supply of capital, lowers the risk of cyclically induced price increases, and at the same time curbs imports. Against this background the willingness of foreign investors to acquire American securities has also apparently again increased recently. The preconditions for a continued stabilisation on financial markets, therefore, have become more favourable. However, it is still uncertain whether economic policy measures can create the confidence needed as long as only hesitant progress is made, as is to be expected, in reducing the budget and current account deficits.

The long-term impact of the turbulences which have existed since last autumn on the behaviour of consumers and investors remains uncertain. A great deal, however, would suggest that domestic demand will

only increase slowly in 1988. The increase in real incomes and in private consumption will probably continue to be moderate; in view of the uncertainty about the development of the economy as a whole the propensity to save will probably remain high. The restraint of private households will probably also have an effect on housing construction; the drop in interest rates since last autumn will at most bring the downhill trend to a standstill. Business investment, on the other hand, will be extended at a moderate pace during the course of the year; a clear increase is to be expected in those branches in which the improved competitive position vis-à-vis foreign competitors leads to a marked improvement in sales and profit expectations. There will only be a slight increase in government demand.

Mainly as a result of the discontinuation of stock-cyclical stimuli domestic demand will increase more slowly in 1988 than last year. Under these circumstances imports may even fall from time to time. Exports, on the other hand, will probably continue to increase markedly despite the hardly expansive overall demand in major importing countries. The foreign trade situation, therefore, will markedly support the development of the US economy. On the whole, however, demand and production will increase at a much slower pace during the course of 1988 than in 1987; real GNP will probably increase by between 2% and 2.5% on an annual average. There will be no further decrease in unemployment. The rate of inflation will hardly fall any further, especially since the price of many import goods will increase as a result of the dollar depreciation; as in the previous year, consumer prices will increase on an annual average by roughly 4% in 1988. There will probably be a marked reduction in the current account deficit during the course of the year.

*Compiled by the Department of World Business
Trends of the Hamburg Institute for Economic Research
(HWWA).*

HWWA Index of World Market Prices of Raw Materials¹ (1975=100)

Raw Materials and Groups of Materials	1987				1988			
	AA ²	February	November	December	January	February	26. 2.	11. 3.
Total index	149.2 ^P	146.4 ^P	154.2 ^P	153.8 ^P	152.3 ^P	148.3 ^P	145.5 ^P	141.7 ^P
Total, excl. energy raw materials	123.8	116.1	134.9	141.2	143.7	140.6	139.9	143.6
Food, tropical beverages	91.2	91.2	95.2	98.6	103.0	101.7	100.4	99.3
Industrial raw materials	148.6	135.1	165.1	173.7	174.6	170.2	170.0	177.4
Agricultural raw materials	167.1	152.3	177.2	182.7	187.6	185.3	186.2	190.3
Non-ferrous metals	150.3	126.9	184.6	201.9	199.4	187.2	183.9	202.0
Energy raw materials	164.0 ^P	164.1 ^P	165.5 ^P	161.2 ^P	157.4 ^P	152.7 ^P	148.8 ^P	140.6 ^P

¹ On dollar basis. - ² Annual Average. ^P Provisional (due to incomplete data on oil prices).