
This version is available at https://strathprints.strath.ac.uk/53077/

Strathprints is designed to allow users to access the research output of the University of Strathclyde. Unless otherwise explicitly stated on the manuscript, Copyright © and Moral Rights for the papers on this site are retained by the individual authors and/or other copyright owners. Please check the manuscript for details of any other licences that may have been applied. You may not engage in further distribution of the material for any profitmaking activities or any commercial gain. You may freely distribute both the url (https://strathprints.strath.ac.uk/) and the content of this paper for research or private study, educational, or not-for-profit purposes without prior permission or charge.

Any correspondence concerning this service should be sent to the Strathprints administrator: strathprints@strath.ac.uk

The Strathprints institutional repository (https://strathprints.strath.ac.uk) is a digital archive of University of Strathclyde research outputs. It has been developed to disseminate open access research outputs, expose data about those outputs, and enable the management and persistent access to Strathclyde's intellectual output.
The World Economy

OVERVIEW

Performance in the world economy continues to be governed by the depressing effects of a major currency realignment following the significant depreciation of the US dollar against the yen and the D-mark since early 1985. In Japan and particularly West Germany, domestic demand is not yet rising at a rate sufficient to compensate for declining foreign demand. The deflationary effects of the currency realignment have therefore tended to offset the anticipated beneficial effects on world economic growth in 1987 of the fall in oil prices in the previous year.

MACROECONOMIC TRENDS

In the first quarter of 1987, industrial production in the OECD countries increased slightly by 0.6%, after remaining largely unchanged during the fourth quarter of 1986. While West German production continued to decline, falling by 1.9% between the two quarters, Japanese production rose by 1.3% compared with a slight fall during the previous quarter. The US, Italy and the UK all experienced positive rates of growth in the first quarter of 0.8%, 2.7% and 1.3%, respectively, representing an improvement on the previous quarter's performance. Nevertheless, in the twelve months to April OECD production was only 1% higher, with US production rising by under 3%, Japanese production increasing by 0.3%, and West German production falling by 1.2%. French and Italian production also fell by 1.8% and 0.3%, respectively, over this twelve month period, while production in the UK rose by 1.5%.

Key developments in the three main economies were as follows:

United States

The outlook for the US economy is more favourable than reported in the May
Commentary. Export production now appears to be responding strongly to the devaluation of the dollar and there are signs that the growth of domestic demand is moderating. The threat of rising inflation has, however, worsened over the last three months. Forecasts of the budget deficit, which is largely responsible for the domestic savings shortfall and is mirrored in the current account deficit (see February and May Commentaries), show that the reduction in fiscal 1987 is likely to be greater than anticipated but may be above expectations in 1988.

After the growth of real GNP slackened during 1986 to 2.5%, the lowest rate for four years, growth in the first quarter of 1987 increased to a real annual rate of 4.1%. The principal explanation for the increase was a further drop in the value of imports and inventory accumulation. However, other components of final demand actually fell, suggesting that the economy remained generally weak during this period. Despite the substantial fall in the value of the dollar against the Yen, D-mark and other major currencies, the trade and current accounts of the balance of payments have been slow to improve. After a visible balance of US$147.7bn in 1986, US$23bn worse than in 1985, a deficit of US$33.3bn was recorded in the first quarter of 1987, representing almost no change on the previous quarter. Some slight improvement followed in the April returns but in May the unadjusted trade deficit deteriorated again by over US$1bn to US$14.8bn. Nevertheless, it is clear that the volume of exports is increasing and most analysts expect both the trade and current accounts to begin to improve during the remainder of the year, as the J-curve effects of the dollar's depreciation begin to unwind.

The fears about the inflation rate have continued. Consumer price inflation was running at an annual rate of just below 5% in the first few months of 1987. The May Commentary reported that the firming of the oil price and rising import prices following the devaluation of the dollar were expected to raise the rate of inflation from the 1986 figure of 1.9% to over 3% in the current year. By June the rate of increase in consumer prices over the first six months of the year was running at an annual rate of 5.1%. However, many economists expect that the rate of increase will moderate in the second half of the year to nearer 4% as food and energy prices rise more slowly.

Japan

The performance of the Japanese economy still remains strongly affected by the deflationary effects of the massive appreciation of the Yen against the dollar since January 1985. Nevertheless, domestic demand is now showing signs of recovery. A recovery which should be enhanced by the Emergency Economic Package of US$43bn which was introduced by the government in early June in an attempt to stimulate the domestic economy.

The failure of the all-important Federal budget deficit to be reduced quickly has meant that monetary policy has borne the brunt of the administration's efforts to correct the substantial current account deficit. New forecasts of the budget deficit for 1987 suggest that after strong revenue growth it will be lower than expected at US$161bn rather than the US$176bn which had been forecasted earlier. However, the Congressional Budget Office which has compiled the forecasts suggests that the deficit for 1988 is now expected to be US$181bn rather than the US$171bn predicted earlier. These figures should be compared with the target of US$108bn for 1988 contained in the Gramm-Rudman-Hollings budget reform law.
the year as the J-curve effects of the higher Yen unwind. Nevertheless, industrial production, which fell by 0.3% during 1986, increased by 1.3% in the first quarter of 1987. This was in part due to the growth of domestic demand.

The main factors contributing to this growth in domestic demand appear to be buoyancy in the construction industry, particularly in house and office building, and increased consumer spending. The improvement in construction activity is seen to be largely a reflection of lower interest rates and stable material prices. Increased consumer spending appears to be mainly due to the growth in real disposable income which was rising at an annual rate of 2.6% in the first quarter of 1987, compared with a 1.1% annual rate in the previous quarter. Consumer prices fell by 0.7% during the first quarter of 1987 and in the twelve months to May had fallen by 0.3%, so contributing to the growth in real disposable income. However, with producer prices falling by 4.5% in the twelve months to May, it is still clear that companies have been slow to pass on the benefits of falling costs to the domestic consumer which might have accelerated the increase in domestic demand. The May Commentary noted that this could in part be due to Japanese firms seeking to increase profits on domestic sales to offset reduced profit margins in the US market. Profit margins of Japanese exporters to the US market are likely to have been cut back in an attempt to limit the effects on their market share of rising Dollar export prices following the Yen's appreciation.

Following the appreciation of the Yen, the volume of exports has declined - 6% in the twelve months to May - while import volumes have increased. However, in 1986, these volume changes were small compared with the extent of the Yen's appreciation. The surplus on current account consequently rose throughout the year to US$25.8bn in the fourth quarter, resulting in a record overall surplus of US$86bn for the year. During 1987 the surplus has begun to diminish. In the first quarter the current account still recorded a large but reduced surplus of US$20.6bn. By July, the unadjusted trade surplus had declined for the third successive month, with government officials predicting that the decline would continue throughout the year. Nevertheless, some forecasters still expect the current account to be in surplus by an amount in excess of US$90bn in the current year.

Pressures on the government, particularly from the US, to stimulate the growth of domestic demand were rewarded in late May when the government announced - prior to the Venice economic summit - a Y6,000bn package of public spending increases and tax cuts in an attempt to stimulate the domestic economy. Officials estimate that more than 90% of the package will be implemented in the current fiscal year and that real GNP should increase by an additional 2%. Even if this addition to output does materialise during the current year it appears unlikely that there will be much impact on the current account surplus during the coming months.

West Germany

Growth prospects continue to be sluggish with the growth of domestic demand not expected to offset the deflationary effects of the high D-Mark on exports. With monetary growth now well above the 3% to 6% target range and the federal budget deficit expected to exceed this year's DM22.3bn target, the government continues to resist calls for an earlier introduction of its planned tax cuts for 1990.

During 1986 real GNP expanded by 2.4%, falling below the government's target of 3% to 3.5% and slightly down on the rate achieved in 1985. A reduction of 0.5% in the first quarter of 1987, in part due to the effects of a severe winter - clearly evident in the fall in industrial production of 4.9% - led to a downward revision of earlier forecasts for the growth of GNP during 1987. The government is now forecasting real GNP growth of under 2%, while the OECD expects the outturn to be around 1.5%. Despite a drop in export volumes of 0.4% and a rise in import volumes of 3.5% during 1986, the
initial J-curve effects of the appreciating D-Mark and lower oil and commodity prices led to the current account surplus rising to US$35.8bn in 1986, compared with the US$13.2bn recorded in 1985. Further reductions in export, and increases in import, volumes have occurred during 1987 but the general consensus appears to be that the current surplus may still be slightly higher this year than last.

The government continues to resist pressures to bring forward planned tax cuts in addition to the re-scheduling of an extra DM5bn, from DM9bn to DM14bn, planned for January next year. A further net reduction of DM20bn is due to be implemented in 1990. The federal government's principal fear, buttressed by the views of several of the Lander governments, is that with already high monetary growth an earlier increase in the size of the budget deficit is likely to prove inflationary. Yet while consumer prices have now stopped falling, in May they were only 0.2% higher than twelve months earlier, and producer prices were 0.7% lower over the same period.

PROGNOSIS

On current policies there appears little prospect of an improvement in the currently lower rate of economic growth, large current account imbalances and high unemployment during 1987. OEC projections suggest that real GDP growth will be slightly lower in 1987 at 2.25% compared with 2.5% in 1986.

The limitations of monetary policy adjustments in effecting change in the external imbalances is becoming increasingly evident. It is unlikely that the relative stability of exchange rates over the last few months, although desirable, is indicative of a monetary and fiscal policy stance that is appropriate to the removal of the imbalances. Further loosening of fiscal policy is required in the surplus countries and following the lead set by Japan it is in West Germany where a fiscal policy led expansion is most urgently required. In the United States the reduction of the budget deficit is proving to be a slow and long drawn out process. However, until the US administration accepts the need for a tax increase, the process of reducing the deficit will continue to be painfully slow. It is to be hoped that further progress on co-ordinated policy action can be agreed at the IMF meeting in September.

LABOUR MARKET

Standardised rates of unemployment have not been published by the OECD for the aggregate of member countries since the fourth quarter of 1986. The series is no longer being updated pending receipt of new data based on EEC Labour Force Surveys. However, on the basis of the data that are available for key countries it appears that unemployment was broadly unchanged during the first quarter of 1987. The US standardised unemployment rate fell from 6.8% to 6.6%, falling further to 6.2% by May of this year. Japan's unemployment rate rose by one tenth of a percentage point from 2.8% to 2.9%, and by May had risen to 3.2%. West Germany's rate increased slightly from 6.8% to 6.9% but remained unchanged by May. France experienced a 0.3 percentage point rise to 10.9% in the first quarter, followed by a further 0.1 percentage point increase by May. In contrast, the UK rate fell from 10.9% to 10.7% in the first quarter, reaching 10.2% by May. In general terms rates in Europe continue to be well above those in other areas of the OECD.