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The World Economy

OVERVIEW

The slowdown in the world economy has not been as great as expected. Japan and Germany are experiencing strong growth and some inflationary pressure. There are fears of recession in the United States. But at the world level neither worsening inflation nor a slide into recession appears to be a realistic short-term prospect.

MACROECONOMIC TRENDS

In the first quarter of 1989 GDP, seasonally adjusted and at constant prices, in the major seven OECD countries rose by 1.2%, an annual rate of nearly 5%. West Germany experienced the fastest rate of growth of the G7 countries with output rising by 2.9%, a 12% annual rate. Japan also experienced a rapid rate of growth with GDP rising by 2.2% during the quarter, an annual rate of 9.1%. By these standards growth in both the United States and Canada was comparatively slow, with rates of 0.9% (3.6% annual rate) reported in each country. Similarly, France and Italy performed nearer to the USA and Canada than Japan and Germany with quarterly rates of 1.1% (4.5% annual rate) and 0.7% (2.9% annual rate) respectively. In contrast, British GDP growth, on revised figures, did not change (See British Economy section).

Industrial production - which usually accounts for around 40% of GDP - rose by 0.9% (3.6% annual rate) between January and March of this year in the OECD countries. This can be compared with a 1.2% increase (4.3% annual rate) in the previous quarter and a growth rate of 5.7% for 1988 as a whole. By individual G7 country, in the twelve months to May 1989, production rose by 7.8% in Japan, 4.7% in France, 3.4% in the USA (to June), 2.3% in Germany (to June), 1.8% in Italy (to April), 1.6% in Canada and 1.1% in the UK (to April). Overall, production in the seven major OECD countries rose by 4.8% in the twelve months to April, compared with 5.1% for the OECD as a whole.

Key developments in the three main industrial economies in recent months were as follows:

United States

The rate of growth of real GNP fell to a 2.7% annual rate in the second quarter of the year. Although this is one percentage point higher than the initial preliminary estimate of growth in the second quarter, many analysts remain concerned that recession now seems more of a risk than accelerating inflation. The tightening of monetary...
policy between 1988-89, when short-term rates were raised by 2.5% points in response to incipient inflationary pressures, is considered by many to be the main culprit.

The deficit on current account stood at $122.4bn in the twelve months to the second quarter which represented a slight fall from the $125.2bn recorded, over the year to the first quarter of 1989. Nevertheless, the strength of the dollar which has been boosted by strong capital inflows seems likely to retard the rate of improvement of the deficit. It seems unlikely, given the current scale of private flows, that recent central bank intervention will produce anything other than a short-term lowering of the dollar rate.

We noted above that the twelve-month rate of growth of industrial production stood at 3.4% in the year to June. In the year to July this indicator fell to 2.7% but edged up again to 2.8% for the twelve months to August. Other indicators such as housing and car sales cast doubt on the recessionary forebodings. However, the evidence from several leading indicators does give cause for concern. The Purchasing Manager's Index, a monthly survey of past, present and expected future business conditions, has fallen sharply over four successive months to its lowest level since July 1986. Similarly, the official Index of Leading Economic Indicators has also been registering successive declines. On these trends recession is clearly signalled unless they are reversed.

Faced with these recessionary indications, the Federal Reserve Board has begun to relax its monetary policy somewhat with the prime lending rate falling to 10.5%. The effect of the earlier tightening of monetary policy should further reduce inflationary pressure next year, reducing the annual consumer price inflation rate from the current 4.3% to below 4%. GNP growth is not expected to be much more than 2.5% this year, falling to around 1.5% in 1990.

Japan

Real GNP grew sharply in the first quarter of the year at a 9.1% annual rate. In the fiscal year to March the economy grew by 5.1%, compared with the 5.2% achieved in fiscal '87. Analysts believe that the increase in growth during the first quarter reflected a surge in demand in advance of the implementation of the consumption tax in March.

Growth is, in consequence, expected to be lower in the second quarter but recovering in the third quarter. The main problems are the evident labour shortages and capacity constraints that are appearing in the economy, with obvious inflationary implications, and the implications of the Recruit and other domestic political scandals for business confidence.

Consumption and investment continue to be the main components of demand driving the economy. Consumers' expenditure rose by 1.9% in the first quarter, a 7.8% annual rate, compared with little change in the final quarter of last year. Investment demand was even stronger rising by 4.6% during the quarter, a 19.7% annual rate. This can be compared with a 15.2% growth rate for investment during 1988 as a whole. The high rate of investment reflects both strong company profits and domestic capacity constraints. Despite the recent investment boom much investment has gone into raising efficiency and developing new, or improving existing, products. The car industry stands as an exception to this, however, since much new capacity has been laid down. Expectations are for investment growth of around 13% for 1989 as a whole with investment in new capacity becoming increasingly significant.

Net exports have contributed negatively to growth for some time, as the high Yen reduced the trade surplus. The trade surplus stood at $95bn in 1988 but Japanese net exports are expected to be fairly buoyant over the coming months and may contribute positively to growth as Japanese goods penetrate the US market after the recent strength of the dollar. The surplus on current averaged $4.96bn per month during the first six months of the year, suggesting an annual outturn of around $60bn. If achieved this would be considerably lower than the $79.6bn outturn in 1988, but in view of the expected buoyancy of Japanese net exports in the second half of the year, a figure of around $70bn looks more likely.

While there are some indications that growth may be slowing down it is likely that the growth rate will remain around 5% this year, which is considerably above the official target of 4%. Rising inflation remains a key concern, however, as the economy moves up against capacity constraints and labour shortages are particularly evident. Consumer prices had risen by 3% in the year to July but were rising at an unusual annual rate of 7.4% in the three months to July compared
to the preceding three month period. An average rate of under 3% for 1989 would still be high by past Japanese standards. It seems likely that the authorities will seek to tighten monetary conditions further in the coming months.

**West Germany**

The growth of the West German economy has benefited considerably from the world-wide investment boom, a weak D-Mark relative to the dollar and strong domestic demand. Real GNP growth during 1988 reached 3.4%, which was considerably above earlier expectations and represented the highest rate of growth achieved by the German economy since 1979. In 1989, the economy has continued to perform strongly. Real GNP grew by 4.1% in the year to the first quarter, rising to 4.9% during the twelve months to second quarter. The government now expects GNP to rise by 4% this year, compared with its earlier prediction of a 2.5% rate.

Consumers' expenditure grew by 0.5%, a 2% annual rate, between the fourth quarter of 1988 and the first quarter of this year. Investment expenditure, on the other hand, rose by 11.1% during this period, a remarkable 52.4% annual rate. Exports increased by 16% in the seven months to July resulting in a trade surplus of $74.7bn and a current account surplus of $53.4bn, both over the preceding twelve months. Current forecast suggest that in terms of D-Marks the current account surplus should rise to DM100bn this year compared with DM85bn last year.

Real GNP is forecast by the government and others to grow by around 3% next year, although the Kiel Economic Institute expects the rate to be around 2% as growth in the world economy falters. When the growth of industrial production faltered in June of this year several analysts considered that the economy may be running up against capacity constraints with obvious implications for growth and inflation. Further concern about the cause of domestic demand is raised by the prospects of the DM25bn tax cut which comes into effect in the New Year as part of the government's tax reform programme. With consumer price inflation running at 2.5% in the year to August and fears that demand pressure may push the rate up further it is not unlikely that the Bundesbank will allow interest rates to rise at some point in the next three months.

**Labour Market**

In the first quarter of 1989, standardised unemployment in the OECD continued to fall, with the rate reaching 6.5% compared with 6.6% in the previous quarter. Unemployment in the G7 countries also fell from 5.6% to 5.7%.

Unemployment data are also available for five of the G7 countries for the second quarter, that is excluding Germany and Italy. In the USA the rate rose by 0.1% points to 5.2%. Across the border in Canada the rate also increased from 7.5% to 7.6%. In Japan the rate remained unchanged at 2.3%, still by far the lowest G7 unemployment rate. France's rate of 10% remained the highest among the G7 countries but fell by 0.1% points on the previous quarter. Finally, unemployment fell in the UK by 0.4% points to 6.6%.

**Prognosis**

In the June Commentary we noted that growth in the world economy was slowing down but that there were indications that the slowdown would not be as great as expected. This has been borne out by subsequent data. The OECD is now forecasting that the 1989 growth rate will be around 3.25% on average for all its member countries falling to just below 3% in 1990. Both Japan and Germany are experiencing strong rates of growth while the effects of a tightened monetary policy in response to fears of inflation may be moving the US economy nearer to recession unless there is some slackening of monetary policy. But most analysts believe that the prospects for a world recession...
are unlikely. Similarly, the threat of worsening inflation appears to have diminished somewhat since we last reported, although we can probably expect a further tightening of monetary policy in both West Germany and Japan as strong growth pushes their economies up against capacity constraints. Intergovernmental and central bank co-operation, on exchange rate intervention and debt recycling, appear to have boosted business confidence and so consolidate the investment boom; as also, perhaps, has the recent liberalising developments on the other side of the "iron curtain", the prospect of unfettered internal markets in Europe and North America and the general easing in world political tensions. The so-called fundamental financial imbalances remain, but concern about them on the world's financial markets is at its weakest for some time. The main cloud on the horizon is the strong protectionist tendency that may perhaps be growing between major countries and trading blocs.