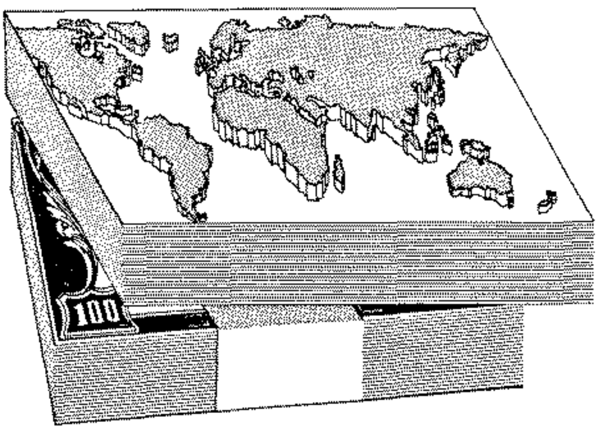
The World Economy



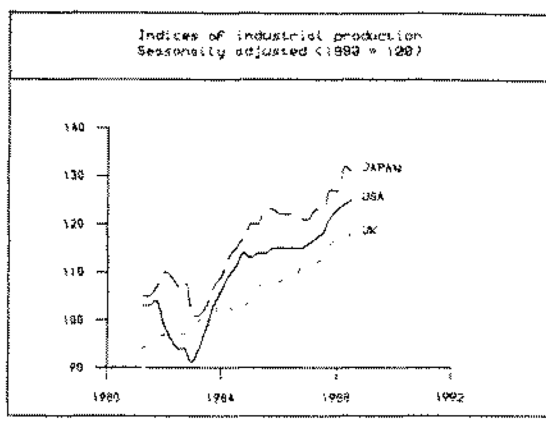
OVERVIEW

The buoyancy of the main economies continues. Investment now appears to be the principal driving force behind the current robust performance of the world economy. Growth of GNP is generally expected to be around 4% this year, a full one percentage point, and more, higher than expectations at the beginning of the year. Nevertheless, growth should decline next year due to a tightening by key governments of both fiscal and monetary policies in response to increasing inflationary pressure.

MACROECONOMIC TRENDS

In the second quarter of 1988, industrial production in the OECD countries rose by 0.7%. That can be compared with an increase of 1.2% in the first quarter and an average quarterly rate of increase of 1.25% during 1987. West German production rose by 1.8% after remaining unchanged between January and March. Japanese production surprisingly fell back slightly - by 0.3% - after the rapid increase in earlier quarters (see September Commentary). In the United States, industry continued to perform strongly. Production rose by 1.1% in the second quarter after increasing by 0.9% and 1.7% in the first quarter of 1988 and fourth quarter of 1987, respectively. Production in Canada rose by 1.1% and in the UK by 0.8%. But in Italy, production actually fell by 0.7%. Overall, production in the seven major OECD countries rose by 0.7% in the first quarter of 1988. Clearly, performance in the second quarter tended - with only a few exceptions - to be inferior to that in the first three months of the year.

In the twelve months to July, total OECD production rose by 5.6%, Japanese production rose by 7%, West German production rose by 4% and UK production rose by 5.3%. In other economies, French production rose by 3%, in the twelve months to June, the UK's production rose by 3%, while production in Italy increased by 6.9%. For the seven major OECD countries growth averaged 5.8% over this twelve month period.



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

United States

The estimated growth rate of real GNP for the third quarter has now been revised upwards to a 2.6% annual rate from the previous provisional estimate of 2.2%. The rate of expansion has clearly slowed in the third quarter but not by as much as at first thought. In the first two quarters of the year, real GNP grew at annual rates of 3.4% and 3.1%, respectively. Even before this adjustment of the third quarter provisional growth figures, the economy had grown at an estimated rate of 3.7% in the year to the third quarter. During this period, only Canada (4.9%), Japan (5.6%), and the UK (5.0%), from the seven major OECD countries, had a more rapid rate of growth. The US economy therefore remains buoyant. Investment growth is strong. The underlying rate of export growth is higher than in recent years. Capacity utilisation rates are high and the fears of rising inflation, noted in the September Commentary, continue. Monetary policy has been tightened as a result, with interest rates rising again towards the end of November. However, the appreciation of the dollar to a peak in August/September has had a relatively depressing effect on foreign trade with first invisibles and then visible trade affected. Growth has slowed as a result. In addition, the growth of consumer demand has moderated. Retail sales volume fell at an annual rate of 0.1% in the three months to September. Durable goods orders were 4.1% down in September after a strong performance in August. And, the loss of agricultural products in the summer drought has also contributed to a lowering of real GNP growth. Many forecasters are predicting that this slowdown will continues into 1989.

In the year to the second quarter, net exports began to make a not insignificant contribution to US growth. This reflects the cumulative effect of the dollar depreciation since early 1985. The appreciation of the dollar earlier in the year served to slow the improvement in the US trade balance and current account deficit, so that many analysts are now forecasting a current account deficit for 1988 of over $140bn, compared with $154bn in 1987 and $133bn in 1986. This began to be evident with the August trade figures when the trade deficit widened by $2.7bn to $12.2bn compared with the, admittedly very good, July outturn. The dollar began to depreciate again as a result. Further depreciation occurred as the prospects for an improvement in the US budget deficit looked less than sanguine following the election to the US Presidency of George Bush.

The problem for the US economy is that dollar depreciation will not lead to a significant switch of resources to export demand and the domestic production of tradeables when domestic demand and capacity utilisation are so high. In conditions of near full employment it is a truism that expenditure switching in favour of the domestic production of tradeables, due to currency depreciation, can only secure an improvement in the trade balance if there is a reduction in domestic expenditure. Without that reduction, higher inflation is the most likely result. The shortfall in US domestic savings, at conditions of near full employment, is the principal reason for the large and persistent deficit on US current account. The large US budget deficit coupled with a low domestic saving ratio has been the principal contributor to the saving shortfall and hence the current account imbalance. It follows that in present conditions a reduction in the budget deficit will have a significant and favourable impact on the current account imbalance. the corollary of this is that US growth need not suffer overmuch if the budget deficit is progressively reduced.

Prospects for further reductions in the budget deficit are at present unclear. If the new President-elect's election promises are to be believed then taxes will not be raised and the more difficult task of cutting public expenditure would be required to get the budget deficit down. The fall in the dollar exchange rate after the election largely reflects doubts about the likely success a Bush Administration will have in cutting that deficit. A more clear idea of the new Administration's policy stance should appear after the President elect enters office in January.

Japan

Real GNP fell by 1% in the second quarter of 1988 after the 2.7% increase in the first quarter. The reasons offered for this sudden deterioration in Japanese economic performance include: a slow-down in construction output due to a slackening of housing and public works investment; bottlenecks in the construction industry; slow growth of exports relative to imports, and a general decline in income from abroad, particularly property income. However, GNP growth is expected to recover in the third quarter. Business optimism is at its highest level for 15 years - as measured by the Business Outlook Diffusion Index. Personal consumption and investment in plant and machinery are both increasing at rapid rates. In addition, the small depreciation of the Yen from late June to the beginning of September will help net exports to recover and raise the domestic value of property income inflows from abroad. However, from a wider perspective, a continuing decline in Japan's trade and current account surpluses is necessary for improved financial stability in the world economy.

Consumption is growing strongly and, along with investment, contributing significantly to the change in GNP. As reported in the September Commentary, investment has grown very strongly since the second half of 1987. Annual rates of 18.7% and 27.2% were achieved, respectively, in the final two quarters of the year. During 1988, the rate of growth of investment fell to a 12.1% annual rate in the first quarter and just under 5% between April and June. These reduced growth rates were largely due to the pause in residential construction. Business investment, in contrast, remained strong. For 1988 as a whole, analysts are forecasting that consumption growth will be above 5%, compared with a 3.9% rate of growth in 1987. For investment, business investment is expected to grow at above 13%, compared with a little over 8% in 1987. However, residential investment growth is expected to fall compared with the high points of last year, from around 20% to about 10% growth. Both business investment and domestic consumption should be the principal engines of growth during 1989.

Net exports continue to contribute negatively to GNP growth. The depreciation of the yen relative to the dollar during the middle of the year will, however, have contributed to an improvement in export volumes. The prospects for a further reduction in Japan's sizeable surplus on current account have therefore diminished somewhat. The surplus on current account was 1.2% and 15.4% lower in the first two quarters of 1988 compared with the same quarters a year previously. However, the Japanese trade surplus has risen in recent months. And the quarterly data show that the rate at which the surplus is declining has slowed considerably since the beginning of the year. In the third quarter, the trade surplus stood at $22.6bn, which is $300m greater than in the same period a year previously. Factors accounting for this near reversal of the previous trend are, the lowering of oil prices, the improved rate of growth in other industrial countries, leading to an increase demand for Japanese imports, particularly investment goods, and the appreciation of the dollar relative to the yen in the middle of the year. Current forecasts suggest that the current account surplus will be around $80 bn in fiscal 1988 but could be as high as $90bn. In 1989 only a relatively small reduction of some four of five billion dollars can be expected.

Overall, real GNP is expected to grow by over 5% this year falling to around 4% to 4.5% in 1989. Consumer price inflation rose in the third quarter but even then prices were only rising at an annual rate of around 0.5%. Inflation is expected to rise next year due to the domestic pressure of demand but should not rise above a 2% annual rate and could remain much lower.

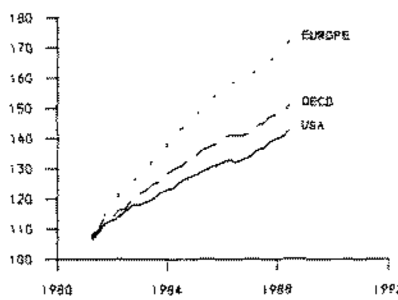
West Germany

Real GNP remained largely unchanged between the first and second quarters of the year. At the end of the second quarter, GNP therefore stood 3.4% above the level attained in the second quarter of 1987. GNP growth has been stronger than many, including the Government, expected because both investment and net exports have benefited from strong external demand and the unanticipated fall of the D-Mark against the dollar this year. Low inflation, reflecting the appreciation of the D-Mark against the dollar since 1985, has contributed to the growth in real incomes and thus the maintenance of the growth of consumer demand. The country's five leading economic research institutes are now forecasting a 3.5% GNP growth rate this year, falling to 2% in 1989.

During 1987 German GNP grew at the low rate of 1.7%. The principal source of growth during the period was consumer spending. Consumption grew by 3.1% over the year as real personal disposable incomes grew strongly and inflation continued at a low level. These underlying determinants of positive consumption growth are expected to persist into 1989. However, on the negative side, the DM9bn increase in consumer taxes which is to be introduced next year, will have a depressing effect on both consumption and GNP growth. Nevertheless, the principal forecasters are still predicting that consumption growth of around 3% will be maintained during 1989. In contrast, investment has risen significantly above the level attained in 1987. The continued growth of domestic demand has stimulated investment demand. In addition, the upsurge in export demand, due to the buoyancy of the world economy in 1988 and the surprising depreciation of the D-Mark against the dollar, has also contributed to the jump in investment. Even by the middle of this year, the Government was forecasting only a 2.5% increase in investment in 1988. Investment is now forecast to increase by around 6% during 1988, falling to around 4% next year as world demand weakens and the depreciation of the D-mark begins to reverse.

The growth of world demand and the weakening of the D-Mark against the dollar during 1988 have led net exports to contribute positively to GNP growth this year. This is unlikely to continue. Renewed appreciation of the D-Mark against the dollar and a slowing of demand growth in the country's main export markets should raise the rate of growth of import values relative to exports. It seems likely that the current balance will now be much the same this year as last, at around DM80bn. Consumer price inflation will continue at a low level and is expected to be little more than 1% this year. Some increase in the inflation rate is likely next year. This is because of the unexpected movements of the D-Mark this year and future appreciation of the D-Mark against the dollar is expected to be smaller than the annual rate between 1985 and 1987.

Consumer price indices
(1980 = 100)



Labour Market

In the second quarter of 1988, standardised unemployment in the OECD fell from a revised 7% in the first quarter to 6.8%. This fall in the OECD total was also mirrored in the seven major countries where a 6.4% first-quarter rate fell to 6.2% in the second quarter. Unemployment has therefore continued to decline at the level of the OECD as a whole, and in the major seven countries, during the last three quarters for which data are available. At the individual country level Japanese unemployment fell to 2.5% in the second quarter and the rate continued at that level to September. In the United States, the rate fell from 5.6% in the first quarter to 5.4% in the second and reached 5.3% by October. In Canada, the reduction was from 7.8% to 7.6% rising to 7.9% by October. German unemployment rose by 0.1 percentage points to 6.6% between the first and second quarters, while French unemployment fell slightly. But at 10.3% in the second quarter, and 10.2% by September, unemployment in France still remained in double figures. Overall, European countries continue to experience higher unemployment rates than elsewhere, with the average for OECD Europe in the second quarter standing at 9.8% compared with 6.8% in the OECD as a whole. The gap between Europe and elsewhere therefore widened somewhat in the second quarter.

Prognosis

The buoyancy of the main economies continues. Investment now appears to be the principal driving force behind the current robust performance of the world economy. This appears to be particularly the case in Japan and the United States, with Germany and the UK also experiencing a strong investment performance. Looser monetary conditions following the Louvre Accord in February 1987 and the reduction of interest rates in the wake of last year's stock market crash, have clearly played a major role in stimulating demand in the major economies. The delayed effects of the 1985/86 collapse in the oil price may also have contributed to greater than anticipated growth in 1988. Growth of GNP is now generally expected to be around 4% this year, a full one percentage point and more higher than expectations at the beginning of the year.

Growth should, nevertheless, decline next year and government policies appear to be mainly responsible. First, the rapid rate of growth of demand has led to a general increase in inflationary pressure. Monetary conditions have been tightened as a result. Interest rates have risen in most of the key economies since we last reported. Second, fiscal policy is to be tightened next year in several countries, notably Germany and most probably the United States. The faster rate of growth of the US economy is tending to raise tax revenues and lower the budget deficit, but many economists would argue that the

US economy requires a tightening of its fiscal policy stance before much of an impact can be expected on both the budget and current account deficits. Accordingly, the pressure on the incoming Bush Administration to lower Federal spending, and particularly, to raise taxes, will still be quite intense. On the other hand, growth in the world economy and particularly the major industrial countries could benefit from the lower price of oil which reached $12 per barrel in November. Since that date OPEC have managed to fashion an agreement which should go some way towards reducing the current oversupply. The industrial economies stand to benefit both from a reasonably low oil price in 1989 of around $13 to $15 and, perhaps as important, the relative stability of that price.

The movements of the dollar, yen and d-mark in the middle of this year have worsened the financial imbalances in the world economy. These perverse movements in exchange rates are unlikely to continue and in 1989 there should be clear evidence of a sustained upward movement in both the yen and the D-mark. The dollar will continue to depreciate but the rate and size of the depreciation will be governed not only by market responses to the trade performance of the US but will also depend on tbe view the markets take of the economic policies of the incoming administration.