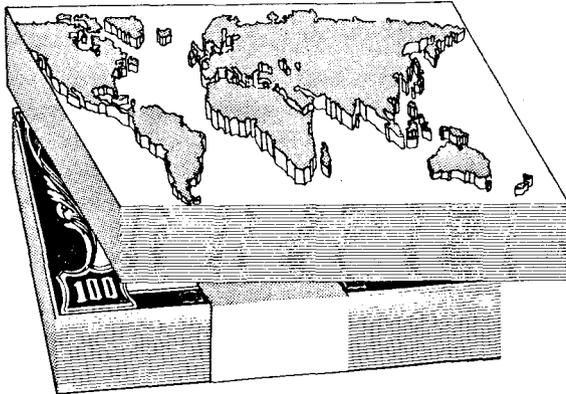


# The World Economy



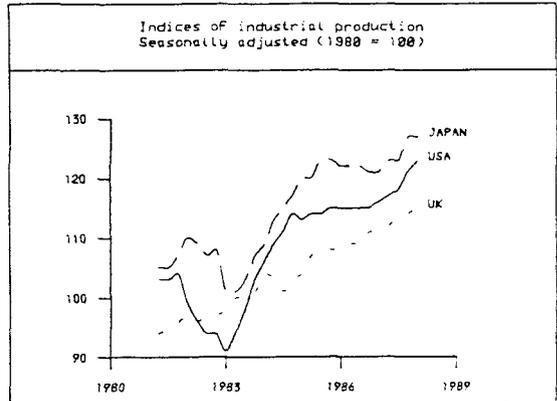
## OVERVIEW

Growth in the world economy appears to be continuing at a brisk rate. Recent forecasts suggest that output should expand by about 3% this year compared with 3.1% in 1987. The outlook therefore appears to be more favourable than when we last reported; a reflection of the limited impact to date of the October stock market crash. Some progress has been made in adjusting the key trade imbalances but progress remains slow.

## MACROECONOMIC TRENDS

In the fourth quarter of 1987, industrial production in the OECD countries rose by 1.8%, compared with increases of 1.2%, 0.5% and 1.5%, respectively, in the first three quarters of the year. West German production remained unchanged following an increase of 0.9% between the second and third quarters. Japanese production again rose markedly, by 3.3%, following the 3.4% increase between the second and third quarters. The US and the UK continued to experience positive rates of growth with production in the former increasing by 1.7% and by 1% in the latter during the fourth quarter. Production in Italy increased by 3.3%, thus reversing the sharp fall of 2.7% in the third quarter. Overall, production in the seven major countries rose by 1.8% in the fourth quarter. In the twelve months to February 1988, total OECD production was 6.2% higher, to January, with Japanese production rising by 12.5%, US and Canadian production each by 5.7%, West German

production by 4.9%, to January, Italian production by 2.9%, French production by 2.4% and UK production by 0.3%. The average for the seven major countries over this 12 month period was 5.7%.



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

### United States

Real GNP grew at an annual rate of 3.9% in the first quarter of 1988, suggesting that the buoyancy of the US economy, as indicated by the fourth quarter figures, is continuing. Real consumer spending rose by US\$26.3 bn in the first quarter, compared with a fall of US\$16.1 bn in the fourth quarter of 1987. Stockbuilding remained high in the current quarter although at a lower level than that experienced during the fourth quarter of last year. Usually an upsurge in stockbuilding presages a slowing down in economic activity, but in the current circumstances the high level of stockbuilding might reflect a decline in the demand for imports as consumers switch to domestic goods.

The outlook for growth in the US economy during 1988 appears to be favourable. The US Government's index of leading indicators rose by 0.2% in April, suggesting that growth will continue to be favourable in the coming months. Net exports - exports less imports - are likely to contribute positively to growth in the remainder of the year, despite the slow improvement in the trade deficit. The devaluation of the dollar now

appears to be having a significant effect on US export performance. In the first four months of 1988 export volumes were 25% higher than in the same period in 1987. The increase in import volumes, on the other hand, was less than 4.5%. Increased export growth in the first quarter led to the real trade deficit falling from US\$42.1 bn in the final quarter of last year to US\$36.7 bn. That reduction represents the biggest fall in the trade deficit in eight years. Yet despite the reduction it should be remembered that the demand for imports has not been very responsive to the declining exchange value of the dollar. This reflects a decrease in the price elasticity of import demand to dollar price increases as consumers have become attached to the quality of imported Japanese and German products. But the actions of exporters to the US market, in both improving their competitiveness and reducing profit margins to maintain market share, are relevant as well.

The increased growth of exports coupled with buoyant domestic demand has led to worries that the US economy may soon run up against capacity constraints. If true this could lead to overheating and accelerating inflation. Capacity utilisation is currently at a high level. If growth in demand continues at recent rates then the improvement in the trade balance may be hindered by capacity constraints. Previous Commentaries have argued that a reduction in the rate of growth of US domestic demand must be viewed as a necessary step towards raising the saving ratio. This would reduce the domestic savings shortfall that underlies the trade deficit and the deficit on current account. The recent OECD report on the US economy has forecast some further recovery in personal saving following the increase in the ratio from 2.8% to 4.9% in the fourth quarter of 1987. Of course a too rapid recovery in the saving ratio could, as the OECD report warns, tip the US economy into recession. For that other key component of domestic demand: the Budget deficit, further tightening will almost certainly have to wait until after the US presidential election.

#### Japan

In the fourth quarter of 1987 real GNP grew by 1.7% compared with a 2% increase in the preceding quarter. Real GNP is estimated to have grown by over 4% in 1987. The strong growth in domestic demand during 1987, at around 5%, reflected high

levels of housing investment - 20.6% increase during the year - and business investment - an 8.2% rise. Consumer spending grew by 3.8% last year. During 1988 it is expected to increase at an even faster rate. The saving ratio has been at a fairly high level over the last two years and there are indications that it is beginning to fall. Consumption will increase as a result. Business investment should continue to expand at a rapid rate during 1988 in response to the strong growth in domestic demand and corporate restructuring. But housing investment is unlikely to maintain the high rate achieved last year, due to capacity constraints and increases in the price of land. The apparent emergency of capacity constraints is giving some cause for concern about the prospects for inflation. However, analysts expect that consumer and wholesale prices should remain relatively stable during 1988. This is because of the expected stability of oil prices, the effects of the appreciation of the Yen allowing cheaper goods to be imported, and the absorption of rising wage and salary bills by increased productivity.

Net exports fell by 26% during 1987, reducing GNP growth by more than 0.7%. The surplus on current account actually rose on revised figures in 1987 to US\$86.7 bn, compared with US\$85.8 bn in 1986. This outturn largely reflects the J-curve effects of the Yen's appreciation and lower oil prices. But in 1988 the strong growth in domestic demand and the emerging capacity constraints are likely to result in a significant increase in imports. The current surplus for 1988 is therefore expected to be around US\$80 bn.

Current fiscal policy for the 1988 fiscal year now appears unlikely to stimulate the economy. Spending was projected to increase but the buoyancy of tax revenues following strong economic growth is likely to offset the expected effect of the increase in spending. Indeed further tax cuts may be required before the end of the year in order to maintain the Government's borrowing target. Monetary policy continues to be relatively lax to restrain the appreciation of the Yen. Money supply growth (M2) stood at 10.4% in 1987 compared with 8.7% in 1986. In the first three months of 1988 the rate appears to have risen further, averaging 12% on an annual basis.

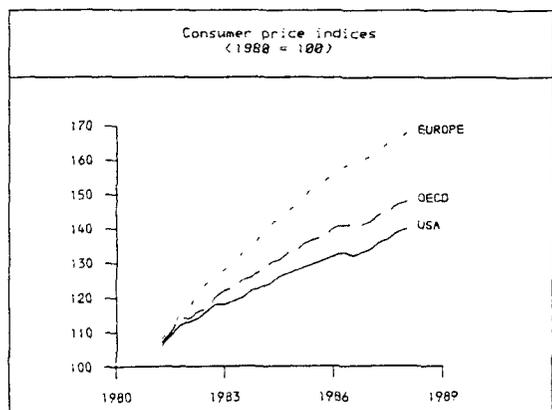
#### West Germany

Real GNP grew by 0.7% in the fourth quarter of

1987. For 1987 as a whole it was 1.7% higher than in 1986. The sluggishness of the German economy during 1987 stands in marked contrast to the performance of the other main OECD countries. Consumer demand provided the main impetus behind growth in 1987, increasing by 3.1% compared with a 1.7% increase in investment and a 1.5% rise in Government consumption. A decline in net exports of 27% during 1987 reduced growth by 1.2% reflecting the appreciation of the Deutschemark against the dollar. In the circumstances, export performance remained strong with real exports rising by 3% in 1987. Overall, the surplus on current account for 1987 remained high at DM80.5 bn compared with DM85.0 bn in 1986.

In the first quarter of 1988 real GNP grew by 1.5% to a level of 4.2% higher than in the same period in 1987. Expectations were thus raised that the economy may outperform the gloomy predictions for 1988 and exceed even the Government's 2% growth target. It would, however, be premature to draw this conclusion from one quarter's figures. The effects of the recent mild winter and the more severe winter in the preceding year are likely to have distorted the first quarter results. The country's five leading economic research institutes are forecasting growth of around 2% in 1988, while the OECD is forecasting an increase of 2.25% in real GNP. Despite the recent improvement in economic growth and improved export performance, growth in 1988 is likely to be lower than both OECD

Europe and the OECD average. Growth prospects have not been helped by the Government's decision to raise consumer taxes - see March Commentary - to offset the growing Budget deficit; itself a reflection of slow economic growth.



## 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 data that are available for key countries, it appears that unemployment fell slightly in both the fourth quarter of 1987 and the first quarter of 1988. The US standardised rate of unemployment fell from 6% to 5.8% in the first quarter to stand at 5.7% in March of this year. Japan's unemployment fell by 0.1% points to 2.7% in the fourth quarter of last year, standardised data not being available for the first quarter of 1988, although the rate averaged 2.7% in the first two months of the year. In France the rate remained at 10.6% in the first quarter but stood at 10.5% in March. Canada and the UK experienced the greatest percentage point falls with the Canadian rate falling from 8.2% to 7.8% in the first quarter and the UK experiencing a 0.5% point fall to 9%. Only in Germany has the rate been consistently stable, remaining at 6.5% in successive quarters since the second quarter of 1987.

## PROGNOSIS

Growth in the world economy appears to be continuing at a brisk rate. Recent forecasts suggest that output should expand by about 3% in 1987. The outlook therefore appears to be more favourable than when we last reported; a reflection of the limited impact to date of the October stock market crash. Nevertheless, growth is expected to slow next year to around 2.5%. Indeed, the evidence of increased stock building in late 1987 suggests that growth might slow down in the second half of 1988 as production is eventually cut-back. Investment appears to be generally buoyant. But consumer spending is expected to weaken, particularly in the US, as the delayed effects of the stock market crash lead to an increase in saving ratios.

Progress has been made in adjusting the key trade imbalances but still continues to be slow. Despite recent improvements in the US trade deficit, the deficit on current account is forecast to be around US\$150 bn in 1988, compared with US\$160.7 bn in 1987, and US\$132 bn in 1989. These OECD forecasts are higher than previously forecast. This is because of faster growth in US

domestic demand and evidence of West German and Japanese exporters benefiting more than the US from the increase in world economic activity. Further improvements in the trade imbalances require US domestic demand to grow more slowly than the rest of the world particularly Germany and Japan. US domestic demand is projected to be slowing down in 1988, at 2% compared with 2.5% in 1987, and Japanese demand continues to rise, 5.5% projected in 1988 compared with 5.1% in 1987. However, US domestic demand may be growing more quickly than these predictions suggest while the increase in German demand is forecast to fall in 1988 to 2.75% from 2.9% in 1987.

The continuation of the imbalances and the slow rate of improvement maintains the risk of future upheavals on the world's financial markets. Future exchange rate fluctuations, and the related effects on business confidence, will be minimised by the adoption or maintenance of policies to sustain demand growth in Japan and raise domestic demand in Germany. In the US further measures are required to reduce the Budget deficit and raise the personal saving ratio. But for the former at least we must await the outcome of the US presidential election.