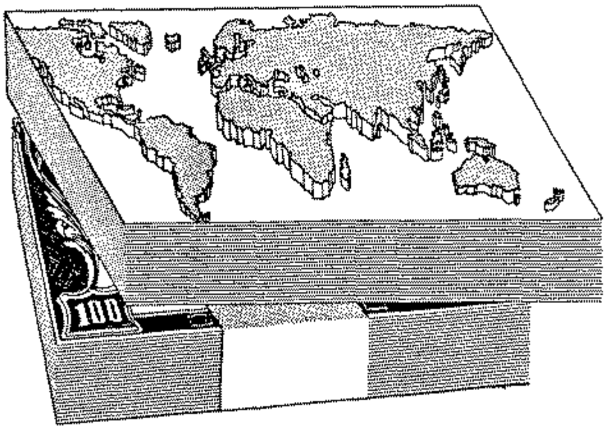
The World Economy



OVERVIEW

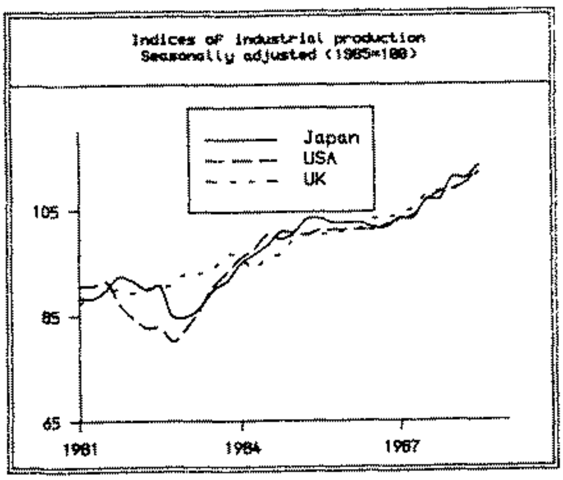
Growth in the world economy remained strong at the end of last year producing an outturn of around 4% for 1988 as a whole. By the turn of the year there were indications that the down-turn expected in 1989 was already starting to occur in some countries. Yet indications that growth in the world economy may be turning down have not been sufficient to dampen inflationary pressure, nor expectations of a deterioration in inflation rates during 1989. Monetary and fiscal policy have been tightened in several key countries in response to inflationary expectations. This general tightening of policy is expected to contribute to a lowering of world economic growth during 1989 to around 3% and to a moderation of inflation in 1990, but will do little to accelerate the removal of the world's financial imbalances.

MACROECONOMIC TRENDS

In the third quarter of 1988, industrial production in the OECD countries rose by 1.7%. This can be compared with an increase of 0.7% in the second quarter and a 1.2% increase between January and March of last year. These upward changes continued the growth experienced during 1987 when production rose by 3.2% over 1986.

In the most recent quarter there was the usual variation in individual OECD country performance. Canadian production rose by 0.8%, which was less than the increase of 1.8% enjoyed by its southern neighbour: the United States. Japanese production reverted to its upward trend, rising by 2.2% over the period. Production figures for French industry are unavailable for the third quarter. Industry in West Germany raised its output by 1.9% while production in Italy stagnated with an increase of only 0.2% being recorded. In the UK production rose by 1% over the same period. Overall, production in the seven major OECD countries rose by 1.7% in the third quarter, significantly above the 0.7% achieved in the second quarter of the year.

In the twelve months to November, total OECD production rose by 5.3%, Japanese production rose by 8.1% (12 months to December), Italian production rose by 6%, United States production by 4.7%, West Germany by 3.4%, the UK by 2.7%, and Canada by 2.5%. For the seven major OECD countries, growth averaged 5.5% over this twelve month period.



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% annual rate in the fourth quarter of 1988. For 1988 as a whole, preliminary estimates put the rate of growth at 3.8%. Some analysts believe that this annual growth estimate understates tbe underlying strength of the US economy. The severe summer drought is considered to have artificially lowered growth in the third and fourth quarters. However, with the dollar strong in the second half of the year this also contributed to a lowering of growth reducing the significance of net exports to domestic expansion.

The strong underlying growth of the economy has added to inflationary pressures. With strong growth of industrial production and employment growth of 3.7 million in 1988, capacity utilisation now stands at its highest level - 84% - since 1979. Consumer prices rose by 4.1% in 1988 and 4.7% in the year to January. This can be compared with a 3.7% increase in 1987. Wholesale prices rose by 4.4% in the year to February, 0.4% points greater than the increase in the year to December, while hourly earnings rose by 3.5% in the year to January against a 3.4% increase in the year to December. The December Commentary noted that the authorities had responded to these pressures by tightening monetary policy. Since November the Federal Funds rate has been raised to stand 2.5% points higher than a year earlier at 9.1%.

Net exports, made a positive contribution to growth during 1988, reflecting the cumulative effect of dollar depreciation since 1985. Despite the appreciation of the dollar, with the trade weighted index now 5.3% higher than a year ago, export growth was buoyant last year. The value of exports of goods and services rose by 17.7% while the value of imports rose by only 8.2%. Export volumes - of goods only - rose by an estimated 22.3% with import volumes rising by 6.4%. In the year to third quarter the current account deficit stood at $135.1bn, compared with $154bn in 1987 and $144bn in 1986. Current forecasts suggest that the deficit on this account for 1988 will be around $130bn.

US GDP growth is expected to slow down in 1989 and 1990 due principally to a significant slowing in the growth of the domestic aggregates especially investment. The tightening of monetary conditions plays a key role. In addition, the probable introduction of a fiscal package aimed at cutting the Budget deficit is likely to be announced by the Bush Administration before the end of the year. This should also have a depressing effect on GNP growth. The British National Institute of economic and Social research is forecasting a 2.5% GNP growth rate this year falling to 1.5% in 1990.

Japan

In December we reported that measured business optimism was at its highest level for fifteen years despite the 1% fall of real GNP in the second quarter of last year. This was confirmed by the third quarter GNP figures which showed a rate of increase of 2.2% over the previous quarter - a 9.1% annual rate. At a year-on-year rate of around 6% in 1988, the Japanese rate of growth is more rapid than any one of the other major industrial economies. Consumer spending and investment continue to lead Japanese economic growth while net exports maintain their negative contribution. Monetary and fiscal policy remain permissive.

Consumption rose by 1.4% in the third quarter - a 5.7% annual rate - to a level 5.5% higher than a year earlier. Investment continued to grow strongly, rising by 3.3% - a 13.9% annual rate - and business investment grew more rapidly than that. Housing investment, after faltering in the second quarter, turned in a strongly positive performance in the third quarter, increasing by 6% or a 25% annual rate. The depreciation of the Yen during the middle of last year and lower unit labour costs - reflecting the earlier significant investment in new plant and machinery - had a positive effect on exports in the third quarter with the value rising by 9%, compared with a 3.8% fall in the second quarter. The growth in the value of imports also rose somewhat with an increase of 6.3% recorded, compared with a 5.1% rise in the second quarter. The trade surplus therefore widened in successive months to November. The current account surplus also rose in the third quarter to $19.1bn from $18.6bn in the previous quarter, although that figure remained below the $21.2bn surplus realised in the third quarter of 1987. At the end of the third quarter the cumulative surplus for the latest twelve months had reached $79.6bn, smaller than the record $87bn current surplus registered in 1987. Forecasts for 1989 are for a reduced surplus ranging from around $60bn to $77bn, due to the effects of further increases in the exchange value of the Yen, increased growth in domestic demand and a relative slackening in the demand for Japanese goods as demand in the world economy falls.

Both fiscal and monetary policy are currently relatively slack. The broad definition of the money supply - M2 + CDs - was 10% higher in January than a year previously. Also Japan did not follow the other main industrial countries in raising interest rates in December. Fiscal policy has been loosened following the package of tax changes agreed at the turn of the year. Value added tax is to be introduced at a low rate of 3% on various items in April and this is to be compensated by direct tax cuts. The latter are expected to give a net stimulus to the economy of 0.5% to 1.25%.

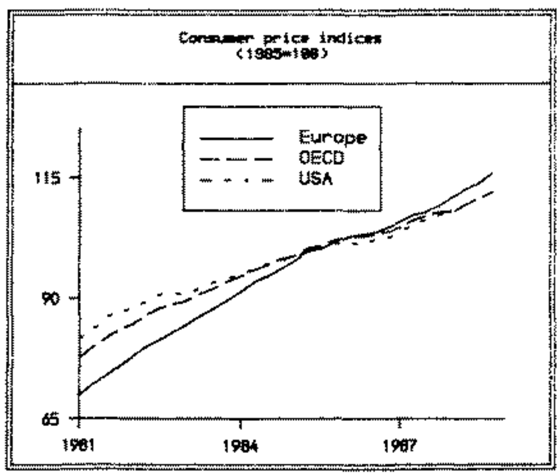
Forecasts for GNP growth in 1989 range from about 3.5% to 4.5%, compared with 6% in 1988. The slow-down in growth is due to the expected reduction in the rate of growth of real government expenditures following the January budget. The demand for Japanese goods will also be affected by the tightening of monetary conditions generally in the world economy. Inflation forecasts range from around 1% to 2%. Several factors are seen as likely to push up the rate of inflation to, by Japanese standards, fairly high levels. These include upward movements in fuel and electricity prices, higher unit labour costs, and the effects of the change in the balance of taxation in favour of indirect taxes.

West Germany

Real GNP growth slackened in the final quarter of last year. After attaining an annual rate of growth in the third quarter of 4.1%, growth in the final quarter fell to an annual rate of 0.8%, or 2.7% above the same period a year earlier. Growth for the calendar year therefore settled at 3.4%, still the highest growth rate of GNP achieved since 1979. Growth was stronger than originally expected in 1988 because: the world investment boom benefited German exporters, given their bias towards the production of capital goods; the low oil price tended to raise the value of net exports and helped lower unit costs; the unanticipated depreciation of the D-Mark helped exports; and the mild winter of 87/88 stimulated the construction industry.

Both the rate of growth of consumption and investment slackened in the second half of the year. Yet while the growth of consumption ended up lower in 1988 than in 1987, at around 2.5% compared with 3.5%, investment growth rose over the year. At an estimated 1988 growth rate of nearly 6%, this was considerably higher than the 2.2% rate achieved in 1987. But as domestic demand growth turned down in the second half of last year, so the weakening D-Mark and the buoyancy of world demand stimulated German exports. Net exports in 1988 contributed positively to growth, with export volume rising by around 8%, compared with 2.3% in 1987, and import volume by under 6%. By the end of November the current account surplus stood at DM74.7bn, suggesting an annual outturn of around DM82bn which is somewhat greater than the DM80bn recorded in 1987.

The rate of consumer price inflation rose in 1988 to 1.2% for the year, compared with 0.3% in 1987. By December prices were increasing at an annual rate of 1.6% and the annual rate increased further in January to 2.6%. The January increase is somewhat artificial because of the once-and-for-all effect on the figures of the recent rise in consumer taxes. Nevertheless, inflationary pressures have intensified within the economy. The rate of growth of the money supply (M3) has been running at an annual rate of 6.9% for the last few months, which is above the government's target range of 3%-6%. Moreover, the weakening of the D-Mark has also added to the inflationary pressure. The government's response has been to raise interest rates. After a series of increases since December, the discount and Lombard rates stood at 4% and 6% in January. In addition, a lower target for M3 growth of 5% for 1989 has been announced by the Bundesbank.



The five key economic research institutes in Germany are forecasting only a 2.5% GNP growth rate in 1989. Both fiscal and monetary tightening will contribute to a lower rate of growth this year, although with the D-Mark continuing to be relatively weak and world trade fairly buoyant, net exports should provide the main contribution to economic growth during 1989.

LABOUR MARKET

In the third quarter of 1988, standardised unemployment fell slightly from 6.8% in the second quarter to 6.7%. Unemployment in the seven major OECD countries remained unchanged on average. However, unemployment in both the EEC and OECD Europe fell from 10.2% to 10% in the former and 9.7% to 9.6% in the latter. Despite the small change, this is a welcome development in view of the high rates of unemployment that have persisted in Europe compared with other parts of the world.

For some of the key countries, data are now available for the fourth quarter and therefore the year as a whole. In Canada, unemployment averaged 7.7% in the fourth quarter, producing an average rate in 1987. In the United States, standardised unemployment averaged 5.3% in the fourth quarter, suggesting an average rate for 1988 of 5.4%, 0.7 percent points lower than in 1987. In Japan, a 0.1 percent point fall to 2.4% in the fourth quarter produced a 1988 average of 10.3%, which was only a little down on the 10.5% average of 1987. In Germany, fourth quarter figures are unavailable at the time of writing but with unemployment averaging 6.2% over the year the final outcome for 1988 looks likely to be little changed from 1987.

PROGNOSIS

Growth in the world economy remained strong at the end of last year producing an outturn of around 4% for 1988 as a whole. But by the turn of the year there were indications that the down-turn expected in 1989 was already starting to occur in some countries. Investment growth, although still performing strongly, has passed its peak. Yet indications that growth in the world economy may be turning down have not been sufficient to dampen inflationary pressure, nor expectations of a deterioration in inflation rates during 1989. The prices of industrial materials and oil have been rising rapidly in recent months and these are usually good indicators of inflationary pressure. Dollar metals prices, in particular, have risen by 14.4% during the year to mid-March, while Brent oil has risen by 25.7% over the same period and 12.3% during last month, to stand at over $18 per barrel.

Principally as a result of the growing inflationary pressure, both monetary and fiscal policy have been tightened in several key countries since we last reported. Monetary tightening has been evident, in the form of short-term interest rate rises, in the US, Germany, France and UK. Fiscal policy has also been tightened in Germany and probably also in the UK, with the US expected to tighten its policy before the year is out. Only in Japan is both monetary and fiscal policy relatively lax.

This general tightening of policy is expected to contribute to a lowering of world economic growth during 1989 to around 3%. Consumer price inflation will continue to increase but should fall back in 1990 having peaked at around 4.5% this year. Only when it is clear that the rate of consumer price inflation is falling will short-term interest rates start to fall. So, it is unlikely that we will see much downward movement in interest rates before the end of the year. Moreover, the general tightening in interest rates will do little to accelerate the removal of the world's financial imbalances. This latter point is reinforced following the recent strengthening of the dollar and the weakening of the D-Mark and the Yen, suggesting that we are unlikely to see further upward movements of the Yen and D-Mark relative to the dollar until later in the year. However, the short-term interest rate premium currently being enjoyed by dollar holders, of around 5% and 4% against the Yen and D-Mark, respectively, gives a likely indication of the expected annual depreciation of the dollar in the future.