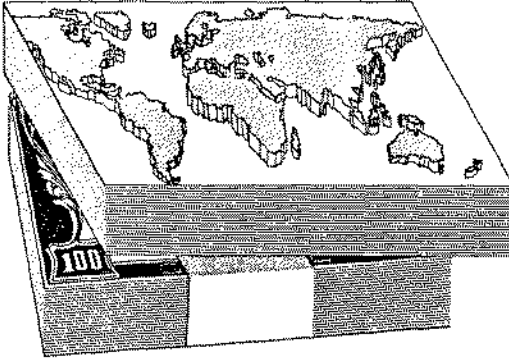


The World Economy



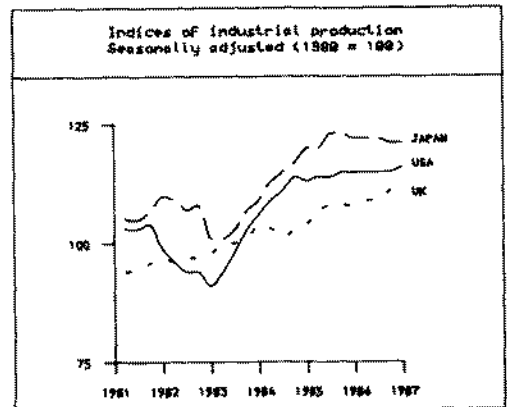
OVERVIEW

Growth appears to be faltering in the world economy due to the deflationary effects of the appreciation of the Yen and D-Mark on the Japanese and West German economies. Continuing trade imbalances and exchange rate instability reflect the absence of effective action to reduce the large US budget deficit and secure a monetary and fiscal policy induced expansion in the surplus countries.

MACROECONOMIC TRENDS

In the fourth quarter of 1986, industrial production in the OECD countries was largely unchanged over the previous quarter. Japanese and West German production continued to fall, by 0.4% in the former and by nearly 1% in the latter, while the US, and Italy both experienced positive rates of growth of 0.8% and 1.8%, respectively. For the year as a whole, OECD production was only 1.4% higher than in 1985, and the change over the twelve months to January 1987 remained below 1%. The effects of the depreciating dollar against the D-Mark and the Yen caused deflationary pressures on the West German

and Japanese economies, leading to industrial production changing, in the twelve months to January 1987, by minus 1.6% and plus 0.4%, respectively. French production also fell, although for somewhat different reasons, by 2% over the period. In contrast, the US, Italy and the UK increased their industrial production by 1.6%, 2% and 1.5%, respectively.



The outlook for the US economy continues to be governed by uncertainty. The growth of real GNP slackened during 1986 to 2.5%, the lowest rate for four years. The failure of US growth in 1986 to meet earlier expectations - the US Government had been forecasting 4% growth at the beginning of the year - reflects several factors. Lower oil prices affected the domestic energy supply industry and contributed to the downturn in private investment from the fourth quarter of 1985. Output in the farming sector remained weak, following international changes in the structure of agriculture; and import penetration increased as domestic demand again grew faster than real GNP for the sixth successive year. The dollar continued its fall during the year against the currencies of the major industrial countries, particularly Japan and West Germany. On a trade weighted basis, the dollar fell by 14% during 1986

and suffered a further marked deterioration in January of this year of 3.3%. Yet, both the visible balance and the current account failed to respond to the gain in competitive advantage, with the trade balance, at a deficit of US\$147.7bn, US\$23bn worse than in 1985, and the current account deteriorating by a similar amount to US\$140.6bn.

The failure of the trade and current accounts to improve during 1986 reflects, in part, the so-called J-curve effect as the prices of traded goods react more quickly than trade volumes to exchange rate changes. On this reasoning, the trade accounts should first worsen and then subsequently improve after currency depreciation. The February **Commentary** noted that some analysts believed that inadequate trade statistics were hiding an improvement that was already underway. Recent data provide little support for this contention. In February, the trade deficit rose sharply to US\$15.1bn, from a revised figure of US\$12.3bn in January, to stand nearly US\$3bn higher than in the same month in 1986. Many forecasters now believe that there will be little improvement in the trade and current accounts during 1987. And frustration at the failure of the external balance to improve has led to increasing pressure both outside and in Congress for trade restrictions, particularly against those countries, such as Japan, where the US bilateral deficit is large. The imposition by President Reagan of a US\$300m package of punitive import tariffs on Japanese electronics goods, ostensibly in retaliation for violations by the Japanese semiconductor industry of the bilateral agreement signed in September last year, can be viewed as an ill-judged response to these demands.

The principal reason for the failure of the US trade imbalance to adjust so far to dollar depreciation is the continuing domestic savings shortfall (see November and February **Commentaries**). The shortage of savings is the outcome of extreme fiscal imbalance as the large federal budget deficit, US\$220.7bn in fiscal year 1986, increased the demand for savings while other savings in the domestic economy actually fell. The inevitable outcome has been a substantial inflow of foreign capital to finance the budget deficit which is mirrored in the deficit on current account. Attempts are being

made to reduce the budget deficit, notably due to the requirements of the Gramm-Rudman-Hollins budget reform law, but the projections for fiscal years 1987 and 1988 of US\$173.2bn and US\$107.8bn, are considered by many analysts to be based on a mixture of creative accounting and over-optimistic assumptions about US growth.

In the first quarter of 1987, the US economy grew at a real annual rate of 4.3%, despite the index of leading economic indicators in January showing the biggest decline for two and a half years. Both the decline in the leading economic indicators and the results for first quarter growth, reflect short-term factors, such as the growth of stock-building in the first quarter following de-stocking in the final quarter of last year. The general expectation would appear to be that real GNP growth in 1987 will be little different from 1986 and probably in the range of 2.5% to 3%. And this view depends on a modest recovery in consumer spending which has declined in successive quarters, and a slow improvement in the trade deficit. The economy remains vulnerable, however, to the possibility of a further deterioration in the trading relations between the US and Japan, and to instability in the US and Japanese financial markets. This latter prospect has increased as fears about the US inflation rate grow. In the first few months of 1987, consumer price inflation in the US was running at an annual rate just below 5%. The firming of the oil price and rising import prices, following the depreciation of the dollar, are expected to push the inflation rate up from 1.9% in 1986 to over 3% in the current year, but this forecast will have to be revised if the dollar experiences a further depreciation during the year.

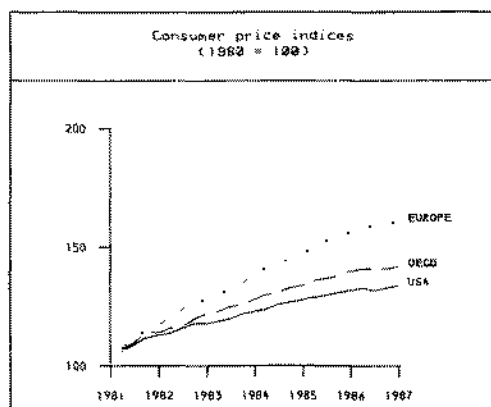
The performance of the Japanese economy remains strongly affected by the deflationary effects of the massive appreciation of the Yen against the dollar, which by the end of April had risen by 86% since January 1985. Real GNP rose by 0.8% in the final quarter of 1986, resulting in a 2.5% increase over the year, considerably less than the 4.7% growth achieved in 1985. As noted at the beginning of this survey, Japanese industrial production rose by 0.4% in the twelve months to January, while

manufacturing output increased by 0.5% over the same period. Lower energy prices and the appreciation of the Yen have, however, provided cost reductions to non-exporting sectors which probably accounts for the economy still experiencing positive growth, all be it low by historical standards. Producer prices fell by 6.4% in the year to January, although consumer prices fell by only 1%, suggesting that companies have been slow to pass on the benefits of falling costs to the domestic consumer. This may in part be due to Japanese firms seeking to increase profits on domestic sales to offset reduced profit margins in the US market, following attempts to limit the dollar price effects of the Yen's appreciation on their market share. In 1986, Japan's exports declined in volume terms while imports increased, by 1.3% and 12.5%, respectively. However, these volume changes were small compared with the extent of the Yen's appreciation. In consequence, the surplus on current account rose progressively throughout the year to US\$25.8bn in the final quarter, producing a record overall surplus of US\$86bn for the year.

Pressures on the Japanese Government to stimulate the growth of domestic demand, and so encourage imports from the US in particular, have continued. The meeting in Paris in February of the G6 finance ministers produced the following agreement to stabilise currency levels; to monitor key domestic indicators; and use macro-economic policies to promote more balance world growth. The failure of central bank intervention to prevent subsequent dollar depreciation and the inability of Mr Nakasone's Government to gain approval in parliament for its tax reform package, exacerbated the already-great protectionist pressures in the US. There appears little hope in the coming months of a monetary or fiscal stimulus of sufficient size to have much impact on the record trade surplus.

In West Germany, real GNP expanded by 2.4% during 1986, nearly 1% point lower than the government's target of 3-3.5%. After output had actually declined in the first quarter of this year, the Spring report of West Germany's five leading economic

research institutes predicted lower growth on present policies in 1987, with two of the institutes forecasting GNP growth to be no more than 1%. IMF forecasts are also pessimistic about German economic growth this year, suggesting that growth is likely to be no more than 2%. The principle constraint on performance has been the deflationary impact of the appreciation of the D-Mark against the dollar and other key currencies such as sterling. As in Japan, the J-curve effects of the appreciation, coupled with the effects of lower oil prices on the import bill, increased the current account surplus in 1986 to DM77.8bn, compared with DM38.9bn in 1985. Current forecasts suggest that increasing import volumes will reduce the surplus in 1987 but only to between DM65bn and DM58bn.



Following the Paris accord in February, the German Government has taken some steps to stimulate the domestic economy. The 3%-6% money supply growth target appears to have been downgraded somewhat in importance, with greater attention being given to stabilising the exchange rate. The discount rate was cut by 0.5% points to 3% in January, although there has been resistance to further interest rate cuts because of fears that they might add to inflation which, in terms of the GDP deflator, is currently running at an annual rate of 2.5%. Extra tax cuts of DM5bn have now been scheduled on top of the DM10bn reductions already planned to take effect in January 1988. Yet, to many observers, the growth of the West German economy will remain below its non-inflationary potential until a further policy stimulus is given to the economy.

LABOUR MARKET

Standardised rates of **unemployment** have not been published by the OECD for the fourth quarter of 1986 for the aggregate of member countries, because 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 is available for key countries it seems likely that unemployment fell slightly during this period. The US standardised unemployment rate remained unchanged at 6.8%. Japan's unemployment rate fell by one tenth of a percent point to 2.8%, but increased slightly to 3% in January of this year. Unemployment in France continued at 10.6%, rising to 11% by February, and the UK rate also reduced from 11.6% to 11.3%, falling further to 11.1% by February. The balance of the remaining countries reporting, also exhibited a slight decline during the period, but rates in Europe in particular are still generally well above those reported in other areas of the OECD.

PROGNOSIS

Growth appears to be faltering in the world economy and the main reason for the sluggish prospects is undoubtedly the effect of the appreciation of the D-Mark and the Yen against the dollar. With the West German and the Japanese economies now growing more slowly than the US economy, little change can be expected in the current account surpluses in West Germany and Japan and in the corresponding US deficit over the coming months.

Despite the currency stabilisation agreement concluded by the G6 finance ministers in Paris in February, the dollar suffered further depreciation even in the face of significant intervention to support the dollar by the main central banks. Further depreciation remains a possibility. And the imperceptible improvement in the US current account implies that further US protectionist measures against Japan, and possible retaliation, are an ever-present threat.

The policy stance of the US Government, Congress and several European governments towards the imbalances in the world economy leaves much to be desired. The focus, largely in the US, on the evident tariff and non-tariff barriers which restrict sales in particular sectors to the Japanese economy is mistaken, if it is believed that such trade imperfections account for the level and persistence of the US's current account deficit. Nor can the large bilateral deficits experienced by the US and other European countries with the Japanese be taken as a justification for retaliatory measures against that country. The principle of efficient trade on the basis of comparative advantage is perfectly consistent with bilateral deficits and surpluses with particular countries. The overall deficit or surplus experienced by a country is, rather, a macroeconomic and not a macroeconomic phenomenon. Moreover, the present large trade imbalances experienced by the US, West Germany and Japan can more properly be ascribed to a fiscal rather than a monetary cause. That is, the principle explanation of the imbalances lies not in exchange rate disequilibria but in the fiscal imbalance in the US, due to the large budget deficit producing a savings shortfall which has been financed by capital inflows from abroad, and principally from Japan. The engineering of a large appreciation of the Yen, on the one hand, and the depreciation of the dollar, on the other, has clearly produced an exchange rate alignment which does not reflect purchasing power parities, and in the absence of other policy action is likely to prove damaging to world economic growth while doing little, in the short run at least, to improve the trade imbalance.

In the February **Commentary** we argued that a currency agreement between the principals, coupled with a commitment to domestic expansion by the surplus countries and a more rapid contraction of the US budget deficit, continues to be the most pressing requirement in the world economy over the coming months. The end of February saw the realisation of a stabilisation agreement in the form of the Paris accord, but subsequent events have shown that without a serious attempt to implement the commitment to expansion in the surplus countries and the contraction of the budget deficit in the US, the goal of exchange rate stability is illusory.