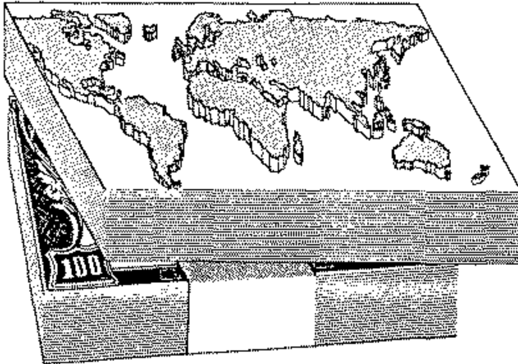
The World Economy



OVERVIEW

Despite the marked reduction in oil prices, levels of nominal interest rates lower than any experienced over the previous five years, inflation at its lowest point for over twenty years and, following the Plaza agreement, the smooth decline in the value of the dollar against the Yen and the Deutschmark, the prospects for faster and more balanced world economic growth are still uncertain. There are some signs of recovery in Europe which may intensify and spread to the US and Japan next year. The size of the US budget deficit, the resulting trade imbalances, and the reluctance of the West Germans and Japanese to administer a fiscal stimulus to their economies, remain the key policy issues.

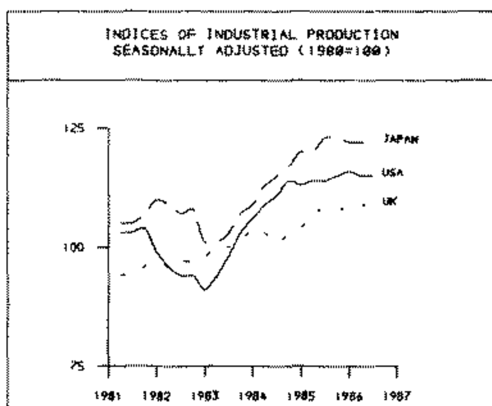
MACROECONOMIC TRENDS

In the second quarter of 1986 aggregate industrial growth in the OECD countries remained unchanged compared with the first quarter of the year. Slow US output growth continues to be the main depressing influence with US industrial production falling by 0.5% between the first and second quarters, while European OECD countries increased their industrial performance on average by 0.5% over the same period. Japanese production, however, largely remained unchanged. By August of this year total OECD industrial production had risen by 1.2% during the preceding twelve months, with US production exhibiting a small increase of only 0.3%, Japan's production actually falling by 1.7% and, in contrast, production in the European OECD countries rising by 1.5%.

During the past four years the US economy has experienced sustained economic growth. This growth has been stimulated by a large budget deficit and has provided the main impetus for the marked improvement in the growth of the world economy in the subsquent period. US growth was expected to be even stronger in 1986. As reported in the August **Commentary** a combination of factors: lower interest rates, lower inflation and the wealth effects of a booming stock market, were expected to provide a substantial boost to domestic demand. In addition, the depreciation of the dollar coupled with spare industrial capacity and low stock ratios, was expected to reduce the trade deficit by raising domestic production for export and restraining the growth of imports.

Estimates of the growth in gross national product (GNP) in the second quarter, however, appeared to suggest that growth was in fact decelerating. In the three months to June revised figures indicated that GNP growth had slowed, falling from a real annual rate of 3.8% in the first quarter to 0.6% in the second. Preliminary figures for the third quarter,

suggesting that GNP growth had accelerated to an annual rate of 2.5%, helped to ease the pessimism. The US Administration therefore remained optimistic about future performance predicting 4% growth for the final quarter of the year. However, even if this prediction is realised growth would still fall below the Administration's target of 3.2% for 1986 which, as the August **Commentary** noted, represented a downward revision of the Administration's earlier forecast of 4% growth for this year.



Several factors account for the faltering of US growth in the earlier part of 1986. In particular, there has been retrenchment in the domestic oil industry following the reduction in oil prices, the farming sector remains weak, due to worldwide changes in the structure of agriculture, and private sector investment is subject to a downward trend. On the other hand, increased disposable incomes due to the decline in oil prices and lower interest rates have raised consumer spending and housing expenditures. Consumer expenditure, and to a lesser extent Government expenditure, have been the main positive influences on recent US economic growth. Indeed with expenditures on consumer durables, particularly cars, especially buoyant, most of the increased growth in the third quarter was accounted for by the rise in consumer spending. However, with domestic demand growing at approximately twice the rate of domestic production, a high and increasing trade deficit continues to be the principle constraint on the growth of domestic production.

Since 1982 the annual trade deficit in the US has risen progressively from US$36.4bn to US$124.4bn during 1985. In the first quarter of 1986 there was a slight fall in the deficit from US$37.4bn to US$36.5bn. In the second quarter the deficit was largely unchanged at US$36bn. By July the deficit for the first seven months of this year stood at US$94.7bn and by August it was running at an annual rate of US$170bn, considerably greater than the previous year.

The recent increases in the US trade deficit have taken place against a background of a depreciation of the dollar against the Deutschemark and the Yen of over 40% since its peak in March 1985. The failure of the US trade deficit to adjust favourably is in part accounted for by the so-called J-curve effect which, as noted in previous **Commentaries**, results in the prices of traded goods reacting more quickly than trade volumes to exchange rate changes. On this reasoning we should expect the US trade deficit to improve eventually and current IMF forecasts suggest that the improvement should be evident in 1987, with further improvements in 1988 and later years. However, the slow responsiveness of import volumes into the US and the consequent sluggish response of domestic output to the depreciation of the dollar have, as noted in the August **Commentary**, been compounded by the ability of importers into the US, particularly the Japanese, to absorb the dollar price effects of the currency change by a lowering of previously high profit margins. Moreover, the value of the dollar has hardly changed against the currencies of key competitor countries such as Taiwan, South Korea and Canada. On top of this it is evident that two key structural problems are limiting the effect of the exchange rate adjustment in improving the current account deficit. First, many commentators believe that there has been a shift in the pattern of comparative advantage away from traditional US exporting industries. Secondly, the savings shortfall in the US continues to persist because of a lack of effective action to reduce the Administration's large Budget deficit which is greater than expected due to sluggish growth. This in turn has threatened the efficacy of Congressional attempts to reduce it such as the Gramm-Rudman-Hollins Budget reform law.

The failure of the depreciation of the dollar to improve the trade deficit and reduce the constraint on US domestic growth has led to further requests by the US Administration for other countries, especially Japan and West Germany, to help adjust the trade imbalances by promoting faster domestic economic growth. These requests have been accompanied by the implied threat that failure to take action will result in the US Administration finding it difficult to resist domestic protectionist pressures and that US monetary policy may have to be relaxed to secure a further, perhaps less smooth, depreciation of the dollar against the Deutschemark and the Yen.

Japanese GNP fell by 0.5% in real terms during the first quarter of the year, the first quarterly reduction in GNP for eleven years. There was a slight recovery in the second quarter with real GNP rising by 0.9%. The 40% appreciation of the Yen against the dollar since the second quarter of 1985 has undoubtedly been the major factor restraining Japan's growth. By July of this year industrial production and manufacturing output in particular had both fallen by 1.7% over the preceding year. This in part reflects the decline in export volumes which fell by 0.9% in the year to July 1986. While export volumes are now declining the fall is small compared with the appreciation of the Yen resulting in the dollar value of exports increasing by a massive 22% over the same period, another example of the J-curve effect. On the import side, there was a 44% decline in the cost of mineral fuel imports which consist largely of oil. The volume of non-oil imports increased but with lower Yen prices the overall effect was to raise the dollar value of imports by only 0.8% in the first half of 1986. The current account surplus has in consequence increased markedly reaching a record level of US$35.8bn in the first half of the year, 80% higher than the surplus in the corrsponding period of 1985. Some forecasters believe that the surplus could be as high as US$90bn for 1986, which is significantly higher than the record US$55bn surplus recorded in 1985. These large surpluses are likely to continue if the price of oil remains reasonably stable in the US$14 to US$17 range, the Yen continues to appreciate and there is no major stimulus to domestic demand. Only if the Yen stabilises will the J-curve effect begin to unwind.

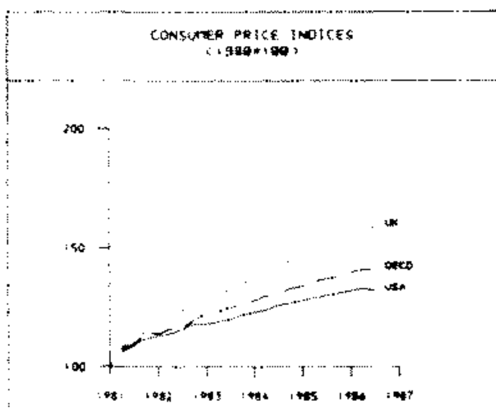
The August **Commentary** noted that the Japanese Government faced a dilemma in trying to reconcile its commitment to a policy of fiscal austerity with increasing international pressure, particularly from the US, to stimulate the growth of domestic demand. The effect of the Yen's appreciation on the growth of the domestic economy, particularly manufacturing, has now added domestic pressure for a relaxation of fiscal policy. But the measures introduced so far suggest that the Government is proceeding cautiously on the fiscal front.

The main attempts to stimulate the economy have been in the easing of monetary conditions. The official discount rate was reduced three times beween January and July resulting in a fall from 5% to 3.5%, the lowest rate during the postwar period. A further cut of 0.5% points occurred following the currency stabilisation agreement with the US at the beginning of November. The money supply (M2 plus certificates of deposit) was rising at 9% during the first three months of the year falling to a monthly average of 8.5% in the subsequent four months to July, a rate of growth only slightly higher than the preceding year. It is, however, unlikely that the slight easing in monetary conditions will have much impact on domestic demand, the current account surplus and hence on the demand for US exports.

The West German Government has also come under pressure from the US Administration to relax monetary and fiscal policy to boost the prospects of world economic growth and help reduce the US trade deficit. Growth is expected to be about 3% this year and the Government believes this is sufficient not to warrant a further relaxation of monetary and fiscal policy. Yet the Government's critics argue that 3%, if it materialises, is still well below the economy's potential. The West German Government's unwillingness to stimulate domestic demand stems largely from concern about the effects of the appreciation of the Deutschemark on export and import volumes. The nominal trade surplus increased from DM20.5bn in the last quarter of 1985, to DM25bn in the first quarter of 1986, rising to DM27bn in the second quarter. However, this increase is largely due to the J-curve

effect of the appreciating Deutschemark coupled also with the effect of the decline in oil prices in improving the terms of trade. The greater future growth in import volumes, which were 7% higher in the first few months of 1986 compared with the same period in 1985, and slower growth in export volumes, currently growing at 2%, is expected by the Government to reduce the surplus significantly in 1987. However, West Germany's five leading economic research institutes have recently predicted that the sharp rise in import volumes is likely to produce only a modest fall in the trade surplus. They forecast the current account surplus to be DM60bn in 1987 compared with DM70bn in 1986. It is therefore probable that domestic and international pressures on West Germany to stimulate domestic demand are unlikely to abate.

The rate of inflation has, on average, progressively fallen in the world economy over the last few years. Reductions in oil and commodity prices have reinforced the trend begun by tighter monetary policies in the major industrial economies. Also, as noted in the August **Commentary**, the significant depreciation of the dollar, against most but not all currencies, has had a favourable impact on the domestic prices of these countries due to the reduction in the import prices of goods denominated in US dollars.



The annualised rate of inflation for the OECD fell from 4.5% in the fourth quarter of 1985 to 2.9% in the first quarter of this year. By August, following further reductions, the annual rate of inflation stood at 2.4%. While relative inflation rates have continued to narrow, clear differences still exist between the principal economies of the OECD.

Both Japan and Germany have been experiencing negative inflation rates with prices falling by 0.2% and 0.4% respectively in the year to August. The US, despite the marked depreciation of the dollar, which would be expected to increase inflation through upward movements in dollar import prices, experienced a rate of inflation over the year to August of 1.6%, which was lower than the OECD average. This provides further indirect evidence of importers into the US responding to the depreciation of the dollar by reducing profit margins. OECD Europe and the EEC, on the other hand, while experiencing lower inflation, still had in the year to August, rates higher than the OECD average of 3.9% and 3% respectively.

The significant fall in oil prices since the end of 1985 has been the key influence on declining inflation rates in the industrialised economies during the subsequent period. The OECD has estimated that on average the rate of inflation in industrialised countries will have been reduced by 1.3% points during 1986 following an assumed fall of US$11 in the price of oil. As late as autumn last year oil prices stood at nearly US$30 per barrel then fell rapidly to US$6 for some blends of Arabian oil during the middle of the year. The severe decline in the oil price was - partly - the unintended outcome of a deliberate policy by Saudi Arabia and Kuwait, announced last December, to raise their market shares to levels more in keeping with the size of their relative oil reserves. In 1979, Saudi Arabia and the United Arab Emirates (UAE) produced 56% of OPEC's output but by 1985 their share only accounted for 45% of the OPEC total. Cheating on production quotas by other OPEC members, encouraged by the high oil prices, was viewed by the major oil-producing Gulf states as the principal reason for their declining shares. The abandoning of production constraints precipitated the oil price

fall.

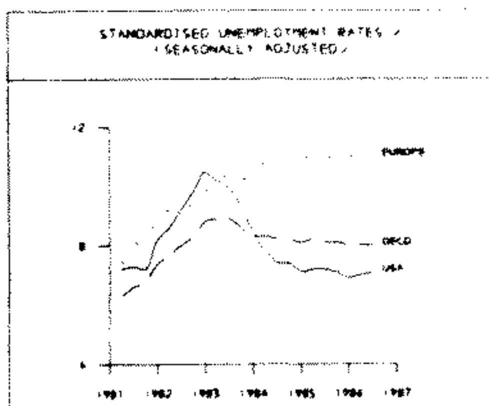
It is almost certain that neither Saudi Arabia nor Kuwait would have expected the price of oil to fall so quickly or by so much, reducing the income of OPEC members by an estimated £59bn during 1986. In May the Gulf Co-operation Council - which includes the main Gulf oil states - sought to restore oil prices to a US$17-US$19 range. The August **Commentary** discussed the outcome of several subsequent OPEC meetings in Geneva in late July and early August where a temporary agreement was finally reached on a reduction in output of 3.5m barrels per day for a twomonth period beginning in September. Oil prices subsequently rose by more than 50% to around US$15 per barrel. OPEC reconvened in Geneva in October in an attempt to extend the August agreement. Amidst conflict between members for higher quotas, specifically over the allocation of an extra 200,000 barrels per day, only 1.2% of the agreed ceiling of 16.8m barrels per day, another temporary agreement was reached until December.

The subsequent sacking of the long-standing Saudi Oil Minister, Skeikh Yamani, in late October, appeared to indicate a shift of emphasis in Saudi policy towards higher prices rather than higher production and recovery of market share. But it is still not clear whether at future OPEC meetings Saudi Arabia will be prepared to offer to reduce production to achieve its objective of raising prices to US$18 per barrel. Nevertheless, continuing falls in the oil price appear unlikely and the prospect of a longer-term agreement on production levels and quotas in December now appears less improbable. However, it is unlikely that the price of oil will rise by much above present levels in the short term due to the large oil stocks held by oil consumers which have been built up during the recent period of very low prices.

LABOUR MARKET

Despite the reduction of inflation and evidence of recovery of output in Europe, unemployment remains largely unchanged in OECD coutries. In the last two quarters of 1985 and the first quarter of 1986 the standardised rate of unemployment in the OECD remained at around the 8% mark. Also wide differences continue to persist between the unemployment rates of major OECD countries.

In the US, unemployment declined during the last three quarters of 1985. In the first quarter and second quarters of 1986 unemployment rose slightly. From the final quarter of 1985 unemployment rose from 6.9% to 7.1% in the second quarter of this year, thus reflecting the earlier deceleration in US growth. Unemployment in OECD Europe and the EEC, at 11% and 11.9% respectively in the first quarter of this year, remained largely unchanged but still significantly above both the OECD average and the rate ruling in the US. Within Europe, unemployment fell slightly in West Germany in the first quarter of this year from 8.5% to 8.4% and remained unchanged in the second quarter. France and Italy, on the other hand, experienced no change in unemployment in the first quarter of the year with rates at 10% and 10.9% respectively. But then rates increased in the second quarter to 10.3% in France and 11.3% in Italy. At the other extreme lies Japanese unemployment, which rose to 2.8% in the final quarter of 1985 then fell to 2.6% in the first quarter of 1986. In the second quarter a slight increase to 2.7% was recorded and by July the rate stood at 2.9%, suggesting perhaps that the effect of the appreciating Yen on Japanese growth is beginning to feed into the unemployment figures.



Previous **Commentaries** have noted that the outlook with respect to the continuing high levels of unemployment in Europe, both in absolute and relative terms, remains pessimistic. The reduction in demand following the oil price rise in the 1970s and the adoption by governments of tight monetary and fiscal policies undoubtedly had a significant impact on the growth of unemployment in Europe and in the rest of the OECD. However, many economists believe that supply-side factors have also played a significant role both in the relatively greater increase in unemployment in Europe and particularly in the subsequent persistence of unemployment at high levels.

The view most popular amongst European governments, which has influenced the policies adopted towards the labour market, is that labour market rigidities affecting aggregate labour costs, pay differentials and labour mobility between occupations, sectors and regions, largely account for the unemployment problem. Evidence for this view is largely impressionistic but it may be significant nonetheless. For example, recent research by the OECD found that pay differentials were much smaller in Europe than in the US and Japan, and were still narrowing. On the significance of aggregate real labour costs, the OECD provided a measure of real wage rigidity which related the degree of responsiveness of money wage changes to changes in prices and unemployment. Countries with a lower responsiveness of money wages to prices than to unemployment were classified as having relatively flexible real wages while those where the responsiveness was greater were considered to exhibit relatively rigid real wages.

On the basis of this measure, the OECD research shows that countries with the most rigid real wages such as Britain, and to a lesser extent France and Holland, have experienced the greatest percentage point rise in umeployment between 1975 and 1982. Countries such as the US and Japan, with apparently the most flexible real wages, experienced the lowest percentage point increase in unemployment over the period.

Such evidence must, however, be treated as impressionistic because it is not clear whether possible influences other than labour market rigidities on the nature and persistence of unemployment have been taken into account. One such explanation is that the level of unemployment required to maintain a stable rate of inflation may increase with the level of unemployment. This follows from the belief that the longer a person is unemployed the less marketable his or her services are to employers and so the search for work is less intensive. It follows from this that the long-term unemployed may exert little downward pressure on wages. In Europe around 60% of the unemployed have been without jobs for more than six months compared with 20% and 40% in the US and Japan respectively. Moreover the proportion unemployed for a year or more has been running at 40% in Europe and only 12% in the US. This would appear to give some support for current policy efforts in Europe which are beginning to focus on the long-term unemployed.

In addition, it is also clear that a lack of investment in Europe in the early 1980s - which might not be unconnected with labour market rigidities as well as demand deficiency - has resulted, along with the scrapping of obsolete plant and machinery, in a failure to maintain and build capacity. Current levels of capacity utilisation in Europe are high by previous standards given the rate of unemployment. Moreover, a recent study by the EEC Commission suggested that the level of capacity in the EEC is around 15% below the level required for full employment.

We cannot be certain as to which of these explanations accounts best for the persistence of unemployment in Europe, or whether other explanations not so far discussed or identified may be more relevant. However, it seems clear that in the short-term at least even if the expected improvements in output in the world economy materialise the impact on unemployment in Europe is unlikely to be significant.

PROGNOSIS

The two key developments in the world economy over the past year have been the managed depreciation in the dollar and the

fall in oil prices. These developments have been associated with a fairly co-ordinated reduction in nominal interest rates and a reduction in inflation and inflationary expectations. The favourable effects on world economic growth which were expected to result from a reduction in these imbalances have not yet materialised. However, there are some signs of recovery in Europe which may intensify and extend to the US and Japan next year. Continuing imbalances within the world economy suggest that the prospects for a sustained increase in economic growth in the future are nevertheless still uncertain.

The fall in oil prices produced a transfer of income from oil-producing to oil-importing countries which is estimated to have been of the order of US90bn. This income gain has failed to have the expected favourable impact on the economic performance of the industrialised countries. The oil-producing countries have reacted more quickly to falling revenues in reducing their expenditures than consumers in the oil-importing countries have reacted in raising their expenditures. If the oil price stabilises in the US$14 to US$17 range then the stimulus to output and trade in the industrialised countries should become more evident in 1987. However, there must be some uncertainty about the future course of oil prices in the medium term in view of the apparent change in Saudi Arabia's policy towards recovery of market share. Nevertheless, it seems unlikely that OPEC could sustain a price at US$18 per barrel and above in the short term given both the wide divisions within OPEC itself and the large stocks of oil held by the oil-importing countries which have been built up during the recent period of very low prices.

The smooth depreciation of the dollar, the subsequent fall in nominal interest rates and the reduction in inflation rates, must be viewed as only partial steps towards the removal of disequilibria in the world economy. The problem of substantial current account imbalances between the Group of Three (G3) countries, US, West Germany and Japan, and whether a co-ordinated strategy can be developed to remove them, still remains. Added to this are the partially related problems of trade disputes and increasing protectionist pressures, and the continuing debt problems of the developing countries, particularly in Latin America.

The depreciation of the dollar in relation to the Yen and D-Mark should, as the J-Curve effects begin to unwind, start to exert downward pressure on the US current account deficit and the current account surpluses in West Germany and Japan in 1987. However, the solution to the problem requires more fundamental action than a simple - all be it large - realignment of exchange rates. In many respects the key to the problem lies in the imbalance in savings and investment behaviour between the US, and Japan and West Germany and the fiscal and monetary policies adopted in each country.

The US economy has since 1980 experienced a large savings shortfall which increased as the budget deficit rose. The growth in the budget led to increased interest rates and increased capital inflows, particularly from Japan, to finance the deficit. This in turn led to an increase in the value of the dollar which, in combination with the stimulus to domestic demand provided by the growing budget deficit, served to raise US imports, producing a significant deterioration in the country's current account. The expansion of US imports and consequent growth in world trade resulted in Japan and, to a lesser extent, West Germany being the principal beneficiaries, leading to increasing current account surpluses in the two countries.

In principle, imbalances between savings and investment behaviour and the consequent effects on the current accounts of the respective countries need not constitute a problem. However, changes in deficits and surpluses and policy responses within the countries concerned, particularly large deficit countries such as the US, can prove to be destabilising to the world economy. The attendant effects on capital flows and expectations leads to increased instability in exchange rates and interest rates which may tend to depress world trade. Moreover, severe adjustment problems can occur as domestic

economies seek to adjust to the changes.

The US economy has moved from a position of essentially glorying in its borrowing role to one which began to recognise the implications of a substantial trade deficit for domestic manufacturing, agriculture and the oil-producing regions of the US. The subsequent policy of seeking reductions in the dollar exchange rate has effectively left a substantial imbalance in monetary and fiscal policy between the US and the rest of the industrialised world, particularly Japan and West Germany. For Japan and Germany, the key to the problem is the size of the US budget deficit which is likely to be in excess of US$210bn in the current fiscal year. For the US, faced with the difficulty of reducing the budget deficit in the short run and growing protectionist pressures from Congress, reflecting the impact of the persisting trade deficit on key areas of the US economy, the problem would be eased by a relaxation of monetary, and particularly fiscal, policy in Japan and West Germany. The resulting expansion of demand would serve to absorb domestic savings and reduce the surplus on current account in the two countries. A failure to do this would be likely to result in a further depreciation of the dollar and/or the US government being unable to resist domestic protectionist pressure, both of which would be damaging to West German and Japanese economic growth.

The relationship between the US and these two countries in recent months has therefore been characterised by disagreement on the most appropriate approach to the removal of the imbalances. The West German government appears to be the most reluctant to change its current policy stance. There appears little likelihood that the Bundesbank will risk a further reduction in its discount or Lombard rates, which currently stand at 3% and 5% respectively. A further relaxation of interest rate policy would be unlikely to stimulate investment overmuch given the current sluggishness of world trade and the fact that exports account for around one third of West German GDP. Traditional German sensitivity about the inflationary consequences of monetary expansion is therefore likely to prevent further policy change in the immediate future. It also appears unlikely that the government will bring forward the second stage of its programme of tax cuts which are currently scheduled to be introduced in 1988, assuming that the government is re-elected in January. However, a relaxation of fiscal policy would appear to be necessary both to reduce the trade surplus and to maintain the growth of the Germany economy by switching from export-led to domestic-led expansion. In addition, a greater willingness, by both West Germany and Japan, to lend to less-developed countries in Latin America in particular would help these debtor countries directly and, by enabling them to import more from the US, would also indirectly help the US to reduce its trade deficit.

The Japanese, while appearing to be more conciliatory towards US demands, are still nevertheless reluctant to relax fiscal policy to boost domestic demand by an amount sufficient to have much effect on their trade surplus and the US trade deficit. The Japanese Finance Minister recently concluded an exchange rate stabilisation agreement with the US Treaury Secretary. This appears to seek to link the Yen to the dollar in the range Y160 to Y170. The Japanese therefore appear to have managed to put a floor under the dollar, which will help protect Japanese export-led growth, without making any substantial concessions on the expansion of domestic fiscal and monetary policy which would help stimulate demands for US imports. The Japanese agreed to cut their discount rate by a further 0.5% point but this is unlikely to have much effect in stimulating an economy where credit is already cheap. And, the recent supplementary budget is expected only to have a minimal effect in raising the growth of the Japanese economy.

Overall then the key issues for the development of the world economy remain: the size of the US budget deficit; the still high levels of real interest rates; and the reluctance of the West German and Japanese governments to relax fiscal policy. While growth in the industrialised countries should improve next year, largely due to the delayed effects of the fall in oil prices, future balanced growth requires the satisfactory resolution of these issues.