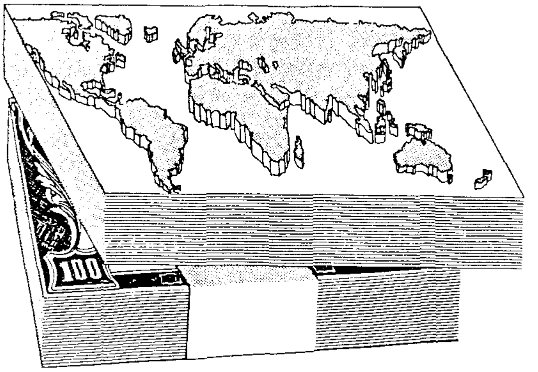
The World Economy



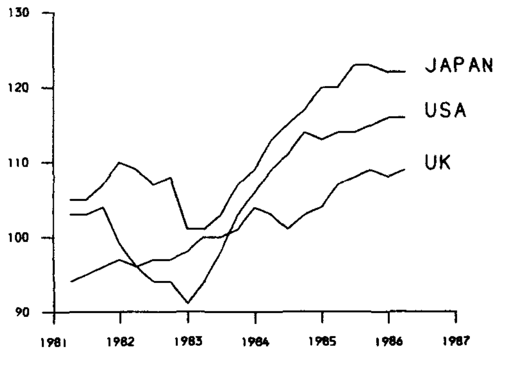
Developments throughout the first half of 1986 were dominated by the falls in the price of oil and the further deceleration of the US economy. Although output growth has slowed in the major industrial economies, the effects of lower oil prices have reduced inflation rates and helped bring interest rates down, thus improving prospects for the world economy later this year and in 1987. The fall in oil prices may well be reversed, however, following the recent signs of greater cohesion among OPEC members.

OUTPUT

As yet, lower oil prices have not resulted in faster economic growth. In the first quarter of 1986 aggregate industrial growth in the OECD countries continued to be depressed by slow US output growth. Industrial output in the US grew in the first quarter at an annualised rate of only 0.8%. For the total OECD area growth was 1.6%, a rate just below those of 1.9% and 1.7% recorded for OECD Europe and the EEC respectively.

A number of European countries achieved more rapid growth rates than the US. Portugal, Belgium, Greece, Luxembourg, Ireland, Austria, Italy, Sweden, Switzerland, West Germany and the UK had rates of 4.8%, 4.3%, 4.0%, 3.9%, 3.0%, 2.8%, 2.6%, 2.3%, 2.3%, 2.2% and 1.6% respectively. In contrast, the Netherlands, France, Finland and Norway experienced negative growth of output.

INDUSTRIAL PRODUCTION 1980=100
(SEASONALLY ADJUSTED)



The US economy is now in its fourth consecutive year of economic growth. There is increasing concern, however, that the widespread expectation of stronger growth his year than last is not being fulfilled. Lower interest rates, lower inflation and the wealth effects associated with the historically high levels recorded on Wall Street were expected to provide a substantial boost to domestic demand. Moreover, with spare industrial capacity and low stock ratios, depreciation of the dollar was expected to increase domestic output and restrain the growth of imports.

Estimates for the second quarter, however, confirm the deceleration in growth. In the three months to June growth slowed to a real annual rate of only 1.1%. The US Administration has now adjusted downwards to 3.2% its earlier growth forecast of 4% for 1986. Moreover, financial analysts have revised downwards their projections for corporate earnings. At the beginning of this year the consensus forecast was that corporate earnings, after falling by 12% in 1985, would increase by something of the order of 20% during 1986. In the first quarter, however, earnings fell by around 3%. Preliminary evidence for the second qaurter does not provide evidence of any improvement in performance. Declines took place in industrial production and capacity utilisation in May and survey evidence suggested some downward revision of companies' investment intentions.

Much of the early optimism about the prospects for US output growth this year was based on the expectation that dollar depreciation would stimulate domestic output. It was argued in the last **Commentary**, however, that the most likely result of dollar depreciation during most of 1986 would be the J-curve effect, with depreciation initially raising the dollar cost of imports and with higher export volumes and revenues and lower import volumes occurring only at some later stage. The slow responsiveness of import volumes and, therefore, of domestic output to dollar depreciation is, as indicated in previous **Commentaries**, compounded by the scope for importers into the US, and particularly the Japanese, to absorb the dollar price effects of currency changes in lower profit margins.

In the first quarter of 1985 the US trade deficit fell to US$36.6bn from a revised figure of US$37.4bn for the last quarter of 1985. For the first six months of 1986, however, the estimated trade deficit of US$83.9bn is far in excess of the deficit of US$69.3bn recorded in the corresponding period a year earlier. For 1986 as a whole the OECD projects a US trade deficit greater than that for 1985. The trade deficit will thus continue to constrain the growth of domestic output.

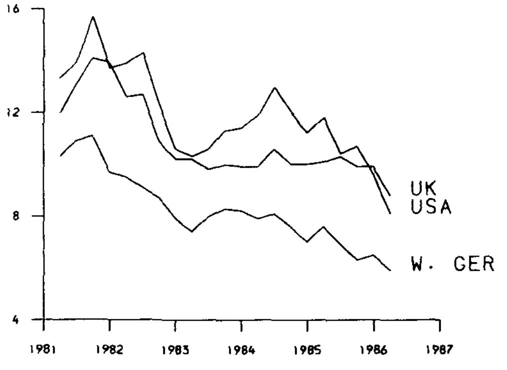
The faltering of US growth has wrought a change in the US Administration's outlook on developments in the world economy. In 1984 and early 1985 European insistence that the then high levels of US interest rates were damaging the prospects of sustained recovery in Europe was countered with the contention that European economies should look to their own efforts to promote domestic growth. That hectoring has now been replaced by increasing appeals for other countries, especially Japan and West Germany, to pursue economic growth more actively. Growth elsewhere is now required to permit US companies to take advantage of the weaker dollar and lower interest rates.

In certain respects the Japanese have become more sensitive to the consequences of the country's role in the international economy. The election in July returned to office Mr Nakasone who places considerable emphasis on the need for Japan to accept greater import penetration and policies more compatible with the needs of the other major economies. Mr Nakasone has focussed attention on Japan's international role but the extent to which the "import action programme" and the findings of the special commission chaired by a previous Governor of the Bank of Japan will be translated into a change in policy remains uncertain.

Despite the 40% appreciation of the yen against the dollar since the sec nd quarter of last year, the Japanese visible trade balance remains robustly in surplus. In real terms Japanese exports fell in the first quarter of this year; primarily in response to a decrease in car exports to the US as part of Japan's voluntary export restraints. Car exports then rose, however, in the second quarter. While the effects of the yen's appreciation will ultimately influence the trade surplus, the OECD forecasts an increase in the Japanese surplus to around US$85bn in 1986 from US$56bn last year.

The dilemma facing the Japanese is that of how demand can be injected into the economy to satisfy international pressures without jeopardising their commitment to a policy of fiscal austerity. As noted in the last **Commentary**, the Japanese Government announced a limited set of measures in April in response to the yen's appreciation. Moreover, Japanese interest rates have been reduced from 5% in January to 3.5% in July. Nevertheless, there is little indication of any more substantial reflationary measures in the immediate future, even after the 0.5% fall in GNP in the first quarter of this year. That fall was the first quarterly reduction in GNP for eleven years.

LONG-TERM INTEREST RATES %



Fiscal austerity also prevails in the other country most subject to pressures to assume a more active role in sustaining growth in the world economy, West Germany. Indicators of West German macroeconomic performance are encouraging: interest rates are low; inflation has been eliminated; oil prices have fallen; and macroeconomic policy has remained steady. As in Japan, however, there is little likelihood of reflationary measures. The Government's commitment to restraining public expenditure and reducing the public sector deficit was underlined in June when reductions in Government spending of DM1bn were announced. Despite tax cuts of DM11bn, the West German PSBR is to be held at last year's level of DM25bn.

In large part, the West German unwillingness to boost domestic demand reflects concern over shifts in export and import volumes. While the nominal trade surplus rose from DM27.5bn in the last third of 1985 to DM34bn in the first four months of this year, this rise was attributable to improvements in the West German terms of trade as a consequence of falling oil prices and the appreciation of the Deutsche Mark against the US dollar. In real terms imports rose by 7% in the first few months of 1986 as compared with the corresponding period a year earlier while exports fell 3%. This is unlikely, however, to relieve pressure both from abroad and domestically on the West German Government to reflate, expecially since real total domestic demand is no higher in the first quarter of 1986 than in 1980.

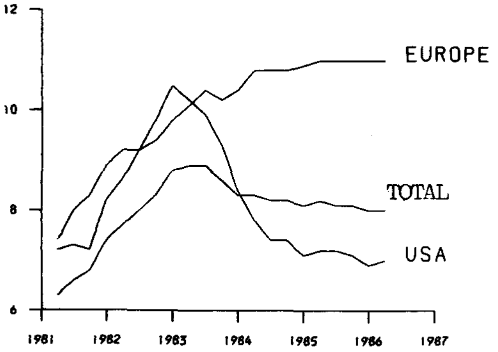
LABOUR MARKET

OECD unemployment fell slightly in the last quarter of 1985 to a standardised rate of 8.0% from the rate of 8.1% in the second and third quarters. Unemployment remained unchanged at 8.0% in the first quarter of this year. Underlying the overall rate is a continuation of the now well-established pattern of differences in unemployment rates among OECD countries.

Despite the deceleration of the US economy during 1985, unemployment declined in each of the last three quarters. The effects of slower growth were reflected, however, in a small increase in the standardised unemployment rate from 6.9% in the last quarter of 1985 to 7.0% in the first quarter of 1986. US unemployment remains well below the averages for OECD Europe and the EEC. Unemployment remained unchanged at 11.0% for the former but increased from 11.9% in the last quarter of 1985 to 12.0% in the first quarter of 1986 for the latter. Within Europe first quarter unemployment rose in the UK, Finland, Spain and Sweden but fell in Belgium, West Germany, the Netherlands, Norway, Finland and Switzerland.

After rising to 2.8% in the last quarter of 1985, Japanese unemployment, despite a faltering in Japanese growth, fell back to 2.6% in the first quarter, the same rate as in the third quarter of last year. In Europe only Norway and Switzerland with rates of 1.9% and 0.8% respectively have lower unemployment rates than Japan.

UNEMPLOYMENT RATE
(SEASONALLY ADJUSTED)



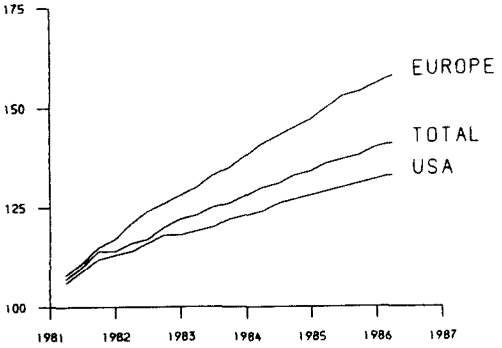
As regularly noted in previous **Commentaries**, the outlook with respect to the continuing high levels of unemployment in Europe is still pessimistic. Macroeconomic policy remains typified by a desire for fiscal restraint and policies towards labour markets continue to be directed at attempting to eliminate labour market rigidities. A recent study by the European Commission emphasises the importance of high non-wage costs in discouraging employers from hiring additional labour and suggests the need for greater flexibility in working hours and for more attention to be paid to the creation of part-time employment. The Commission concedes, however, that this last approach will not necessarily help reduce present levels of registered unemployment since part-time jobs will draw largely on unregistered females and possible also discouraged workers. Overall, there remains little prospect of employment creation in Europe on sufficient scale to reduce appreciably the high levels of European unemployment.

INFLATION

Unlike previous periods of expansion in the post-war period, the last few years have been characterised by a relative absence of inflationary pressures. Underlying reasons for the relative stability of prices have been discussed in earlier **Commentaries.** With the most rapid phase of growth having passed and the inflation experience of previous cyclical upswings not having been repeated, inflation rates are likely to be lower this year than last. This has been made particularly likely by the recent period of low prices for oil and other commodities and by the impact on domestic prices for countries other than the US of reductions in import prices of items denominated in depreciating US dollars.

In the fourth quarter of last year the annualised rate of inflation for the OECD stood at 4.5% and then fell to 2.9% in the first quarter of this year. As in previous quarters, the average for the OECD embraces diversity of experience both between North America and Europe and among European countries. Earlier **Commentaries** have discussed the erosion of differences in relative inflation rates between North America and Europe during 1985. That tendency continued in the first quarter of this year. Despite US dollar depreciation the annualised rate of inflation for North America remained unchanged at 1.8% while the rates for OECD Europe and the EEC fell from 5.6% and 4.1% to 4.2% and 3.5% respectively.

CONSUMER PRICE INFLATION
(1980=100)



Within Europe, West German prices fell in the first quarter at an annualised rate of 0.2%. A number of other countriesalso experienced inflation rates lower than that of the US, including Austria, Belgium, Luxembourg, the Netherlands and Switzerland. France and the UK had rates of 2.6% and 3.0% respectively. The European average is raised, however, by continuing high inflation rates in several smaller countries. Greece, Iceland, Portugal and Turkey, for example, recorded annualised first quarter rates of 24.7%, 26.9%, 12.3% and 35.6% respectively. With the yen's appreciation reinforcing the impact on import costs of lower oil prices, Japan's inflation rate fell to 0.9% from 1.4% in the last quarter of 1985 and remains lower than in any OECD country other than West Germany.

The single, most important influence on inflation rates in the industrial economies has been the sharp fall in OPEC oil prices since the end of 1985. Over the longer term the influence of this factor will depend on the length of the period of lower prices and the impact which lower prices exert on inflationary expectations. Some firming in demand in response to lower prices and the seasonal European and North American increase in demand will have an effect on prices towards the end of the year, but the principal factor determining the path of oil prices will be the degree of success of the OPEC cartel in maintaining the agreement on production restraint reached in Geneva at the beginning of August. The reasons for the earlier disarray in the OPEC cartel were discussed in the last **Commentary** and there was little evidence in the first half of 1986 of that disarray being reversed.

The latest of several meetings of OPEC in Geneva in late July and early August highlighted the differences among member states on two fronts. First, Iran, Iraq, the United Arab Emirates and Qatar refused to accept proposals for production ceilings designed to raise prices to between $17 and $19 a barrel. Secondly, Iran, Algeria and Libya repeated their preference for a strategy of cutting output sufficiently sharply to drive prices to $28 a barrel. In an attempt to provide some interim boost to oil prices, seven members of the cartel indicated their willingness to undertake "voluntary" reductions in production levels.

Against the background, however, of members being unwilling to disclose their actual levels of past output, scepticism existed about the viability of a system of voluntary reductions. Agreement was finally reached on a reduction in output of 3.5m barrels per day for a two month trial period beginning in September. The objective is to raise the price of oil to $17 - $19 a barrel. OPEC will later review the success of this agreement to determine whether or not to maintain the lower output levels. Given the likely alternative of continuing falls in prices this two month agreement may well be the basis for a longer-term arrangement.

PROGNOSIS

As regularly forecast in previous **Commentaries**, the world economy has slowed appreciably during 1986. While the stimulus to the industrialised economies of the fall in oil prices will ultimately work through to output and trade, that stimulus, which is essentially a transfer from oil producers to oil consumers, will operate only gradually. In the immediate future deceleration in the world economy is likely to lead to an intensification of concernon a number of fronts, including: trade disputes, protectionist pressures and commercial policy; the debt problems of developing countries, particularly in Latin America; and the reluctance of the Japanese and West German Governments to provide an expansion of demand.

The stimulus given to the internatioal economy by the US Government's expansionary policies in the early 1980s has been on the wane for the past eighteen months. Yet other Governments, as suggested in earlier **Commentaries**, have been unwilling to shift from their conservative policy framework based on the primacy of the inter-related objectives of reducing inflation rates and of reducing budget deficits to counteract "crowding out" of private investment. Expansion elsewhere would help resolve the underlying causes of the areas of concern, namely the problems of imbalance in the world economy which are the legacy of the earlier US rapid growth.

The major imbalances are the deficit on the US current account and the surpluses on Japanese and German current account. While the German surplus has been rising, that of Japan remains more substantial. Since the early 1980s increases in the US budget deficit, which provided the stimulus to US expansion, have been largely financed by inflows of capital from Japan. The high interest rates asociated with the US budget deficit kept the dollar strong. The combination of domestic demand expansion and the strength of the dollar led to increases in US imports, which in turn provided the basis for substantial expansion of world trade. The Japanese and, to a lesser extent, the West Germans were the principal beneficiaries of the resulting US visible trade deficit.

These imbalances could be corrected in a number of ways: by continuing the dollar depreciation set in train by last September's Plaza meeting; by US efforts to reduce the budget deficit; and by demand expansion in surplus economies such as Japan to reduce the surplus on visible trade and absorb domestic saving. The J-curve phenomenon limits the impact during 1986 of the first of these mechanisms. Similarly, the US supreme Court's action in early July in effectively removing the automatic enforcement provisions of the Gramm-Rudman-Hollins law removed the small remaining likelihood of the US budget deficit being reduced to $144bn in the next fiscal year. The US budget deficit is likely to be in excess of $210bn for the current fiscal year.

While there have been reductions in interest rates over the past year, these are unlikely to produce demand expansion sufficient to counteract the present deceleration of the world economy. Any effects of monetary expansion take time to materialise. In addition, the German and Japanese authorities may baulk at any further monetary expansion for fear that liquidity growth may have future inflationary consequences. Finally, there is little prospect of investment demand responding significantly to lower interest rates when international trade, which has accounted for much of the growth experienced by West Germany and, particularly, Japan over recent years is slowing.

Policy in West Germany and Japan remains characterised by fiscal conservatism. Unless, however, these countries shift away from their reliance on monetary policies and follow the Reagan example of the early 1980s in giving their economies a fiscal stimulus, resolution of the problems of imbalance and of slowing growth in the world economy remains some distance off.