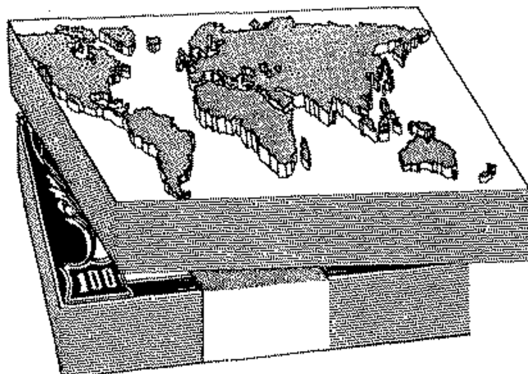
The World Economy

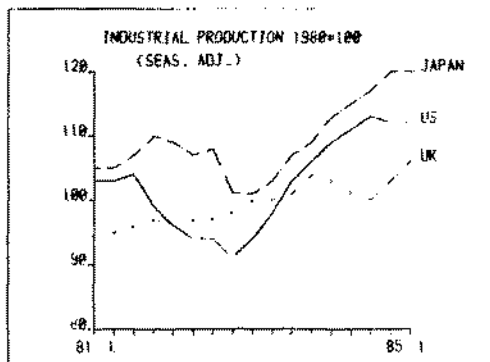


The recovery in the world economy which began in 1982 now appears to be moving out of its fastest growth phase. With the US economy growing more slowly in the first half of 1985 than in the corresponding period of 1984, the previous marked differences in growth rates between the US and the European economies are being eroded. Indeed, a number of European countries look set to achieve faster growth during 1984 than the US. Largely due to slower US growth, world trade is likely to expand this year by around 5%-6% as compared to 9% last year. The Bonn economic summit in May and subsequent policy statements provide no indications that the slackening momentum in the world economy is to be compensated for by reflation elsewhere.

During the faster phase of US growth the strength of the dollar led to the re-emergence of strong protectionist lobbies in the US manufacturing and agricultural sectors, a development which has prompted widespread concern in both developing and developed countries. With world trade growing more slowly, protectionist sentiment was reinforced during the first half of 1985 by renewed criticisms in both the EEC and North America of Japanese restraints on imports. The Japanese lack of effective commitment to an open trading system continued to invite the threat of retaliation.

Tension of a different nature and with a potentially much different outcome for the world economy is prevalent among the members of OPEC. Faced with overproduction, falling prices and a decision to break ranks on its adherence to OPEC pricing policy by non-member Mexico, OPEC was riven with disagreement on production levels and prices during the first six months of the year. The likelihood is that, despite greater recent cohesion among OPEC members, prices will continue to fall and that may stimulate activity in both developed and developing countries.

OUTPUT



The deceleration of US output growth apparent in the second half of 1984 continued in the first six months of 1985. During the first three months of 1985

output grew at an annual rate of only 0.3%. Some recovery took place during the second quarter, although, as in the first quarter, output growth fell considerably below an initial "flash" estimate. Second quarter output is estimated to have grown at a real annual rate of 1.7%. Thus, over the past four quarters US output has grown by only 2%, a much lower rate than in the immediately preceding year. Although faster output growth is forecast for the second half of 1985, the annual rate is likely to fall far short of the official forecast of 4% on which the January Budget proposals were based.

Slower US output growth reduced aggregate industrial growth in the OECD countries from an annual rate of 4.6% in the last quarter of 1984 to an annual rate of 3.3% in the first quarter of 1985. Moreover, for the first time in the recent past it caused growth in North America 2.2% to fall below the growth rates for OECD Europe and the EEC 2.8% and 2.9% respectively).

In contrast to weak US output performance, particularly in the manufacturing sector, domestic demand has continued to expand at a rate of around 4% and, following the pattern of the past two years, has been largely satisfied through imports. Although the dollar fell from its peak January levels, the first quarter's deficit on merchandise trade was $33bn. This follows a deficit of $123bn for 1984.

The importance of US demand in generating export-led growth in other major OECD countries is evident in the recent annual report from the Bank for International Settlements (BIS). Net foreign demand's contribution to GNP growth is estimated at 42% for Japan, 55% for France and 17% for West Germany. With growing uncertainties about US growth prospects and renewed, related concern over the sustainability of the US budget and current account deficits, however, the dollar has weakened against other currencies since January. Such depreciation and pressures for greater protectionism within the US diminish the prospects for a continuing world recovery. In July Paul Volcker, Chairman of the Federal Reserve Board, again encouraged other industrial nations to foster more rapid domestic expansion.

There is, however, little likelihood of European countries pursuing expansionary policies. European governments continue to focus on the control of inflation as the primary objective of policy and to exhibit no inclination to providing a direct fiscal stimulus. Reduction in government expenditure continues to occupy a central instrumental role.

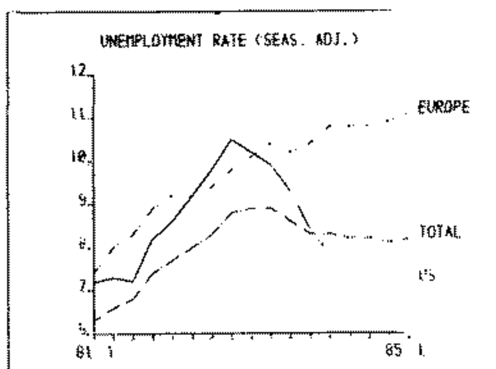
Following the devaluation of the lira within the European Monetary System in July and the accompanying programme of public expenditure reductions, the Italian Government has indicated that further spending cuts are to be announced in September. These measures are intended to reduce the Italian budget deficit to 13.5% of GDP. In France it was felt that the current austerity programme would be relaxed in the approach to the parliamentary elections next March. That now appears unlikely. Concern over slippage from both fiscal and monetary targets has prompted further plans for reductions in real public expenditure of up to 2.0%. Much pressure, both external and domestic, has been exerted on the West German Government to provide a fiscal stimulus. There also, however, the Government is reluctant to reflate despite a growing trade surplus, Government borrowing of only 1.5% of GNP, declining real investment and sluggish private consumption demand. Some limited stimulus has been provided for the construction sector in an attempt to promote employment but that is within the constraint of an unchanged tight, fiscal stance.

The major country possibly moving to policies likely to promote trade is Japan. With the exceptions of spending on defence and foreign aid, Japan still retains a firm commitment to fiscal austerity with public expenditure planned to be reduced for the third successive year. The Japanese Government has responded, however, to increasing criticism of its import controls and regulations and to the threat of retaliatory measures by the US and the EEC by announcing an "import action programme" designed to improve market access for her trading partners. In addition, with an election likely next year, proposals are under discussion for expansion of domestic demand. This expansion is to be achieved through measures such as tax reform, attracting private capital into public sector

projects and deregulation. The immediate effects of these measures on import demand are unlikely to be significant. However, if effectively implemented, this shift in Japanese policy stance will help offset increasing trade friction.

LABOUR MARKETS

After falling slightly during 1984, unemployment in the OECD area rose in the first quarter of 1985. The increase in the standardised unemployment rate from 8.1% in the last quarter of 1984 to 8.5% in the first three months of this year resulted from widespread higher unemployment. Despite the sharp deceleration of US growth, the increase in unemployment from 7.1% to 7.2% was no greater than elsewhere in terms of percentage points. In OECD Europe and the EEC unemployment rose from rates of 10.9% and 10.7% to 11.1% and 10.9% respectively.

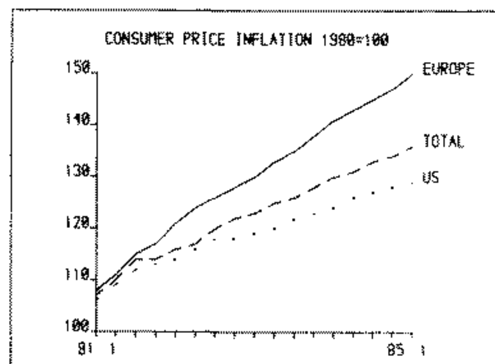


Within Europe higher first quarter levels of unemployment were recorded for the UK, Italy and France while in West Germany the downward trend in unemployment during 1984 was arrested. Of the major OECD countries only Japan experienced a reduction in unemployment, the rate falling from 2.7% to 2.5%.

The prospect in the near future is of further rises in unemployment. Average unemployment in the major OECD countries is likely to increase towards 8.5% by the end of next year. Higher levels of unemployment will be concentrated in Western Europe. Despite continuing output growth, European economies are unlikely to generate sufficient jobs to prevent a further increase in unemployment of around half a million people. This largely reflects the structural change in European labour markets discussed in previous **Commentaries.** As a consequence of differences in growth rates and in unit labour costs among European countries, Belgium, France and Ireland are likely to experience the most substantial increases in unemployment.

INFLATION

Over the past 5 years successive recoveries in the world economy have typically generated successively higher levels of inflation. The current recovery departs from this pattern. Despite the acceleration of growth, particularly in the first half of 1984 as a consequence of the extraordinary expansion of the US economy, the inflation rate of 4.5% in 1984 for the OECD area remained very similar to that for 1983 and there are no signs of any marked increase during 1985.



The average annual rate of inflation for the OECD area currently stands at 4.7%. As in the recent past, this average embraces lower inflation rates in North America than in Europe. The annual rate for North America stands at 2.5% while the rates for OECD Europe and the EEC are 7.6% and 6.4%. Moreover, there continue to be considerable differences in inflation rates among European countries. These range from 2.5% for West Germany and the Netherlands through 6.5% for France and 6.9% for the United Kingdom to 17.7% for Greece and 22.3% for Portugal.

A number of factors have contributed to the moderation of inflationary pressures. In the United States the strength of the

dollar has reduced import costs and through the associated import penetration has intensified domestic competition. World market commodity and oil prices have also remained depressed. Within Europe the thrust of macroeconomic policies has been directed primarily at reducing inflation rates. In addition, recovery has been phased differently in North America and Europe. Rapid demand growth in the US has been satisfied in large measure by imports from countries with spare capacity, thus avoiding the inflationary implications of world-wide supply constraints.

Continuing relatively low inflation rates are expected until the end of 1986. Commodity and oil markets are anticipated to remain weak and, as mentioned above, European policy continues to focus primarily on control of inflation. In addition, depreciation of the dollar against other major currencies will moderate inflationary pressures in European countries. In the US there appears to be some scope to meet the effects of a weaker dollar, unless the rate of depreciation picks up, by reducing profit margins on imports rather than by raising import prices.

PROGNOSIS

Recent events have highlighted the considerable changes that have taken place in the world economy over the past ten years. In the mid-1970's the rapid increases in OPEC oil prices precipitated widespread contraction. Now, however, with the strength of the OPEC cartel greatly diminished, oil prices are subject to continuing downward pressure and concerns over the continuation of the current recovery in the world economy centre on developments in the US.

Lower oil prices and depreciation of the dollar since February to the levels of a year ago have made an exogenous contribution to the pursuit of lower rates of inflation in Europe and Japan. Some downward movement in international interest rates has also been possible as a consequence of the reductions in US interest rates over the past six months.

Lower interest rates reflect the easing of US monetary policy. In mid-July the Federal Reserve Bank widened the target range for its principal monetary aggregate. The objectives underlying this relaxation of monetary policy are: to provide some stimulus to the slowing US economy; and to induce further dollar depreciation. This latter objective reflects major concern over import penetration and the resurgence of protectionist lobbies. The Chairman of the Federal Reserve Bank has indicated, however, that further monetary relaxation to reduce interest rates will not be attempted and that measures must be taken by Congress to reduce the budget deficit.

The prospects for substantial reductions in the budget deficit remain highly uncertain. This uncertainty is compounded by the Administrations' continuing adherence to growth targets higher than the growth anticipated by most commentators. Unless growth rebounds sharply in the second half of the year to an annual rate of 5%, the basis of the Administration's mid-year budget review is very optimistic. The borrowing necessary to finance the budget deficit will almost certainly cause interest rates to rise. Over the past two years net capital inflows have strengthened the dollar. If, however, the US government fails to tackle the budget deficit, confidence in the dollar is now more likely to weaken.

A weaker dollar will intensify the problem of slowing growth in world trade and, in conjunction with upward pressure on interest rates, will depress economic activity. Particularly affected will be those countries which have over the recent past enjoyed the benefits of trade expansion. As argued in the last **Commentary**, a combination of export contraction and higher interest rates will exacerbate the debt problems of many developing countries.

The longer the reduction in the US budget deficit is postponed, the more damaging will be the effects both in the US and elsewhere. The significance of the domestic and international implications of failure to reduce the budget deficit appear to be fully appreciated in the US. At present, however, Congress seems no nearer to achieving effective reductions than earlier in the summer.