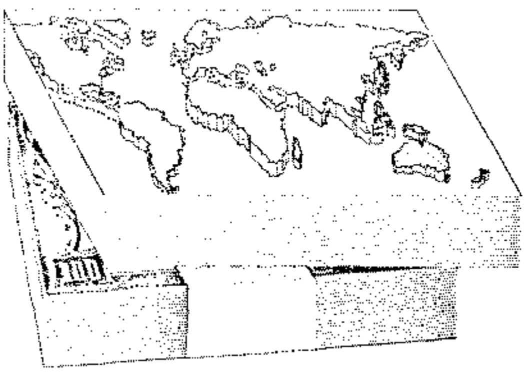
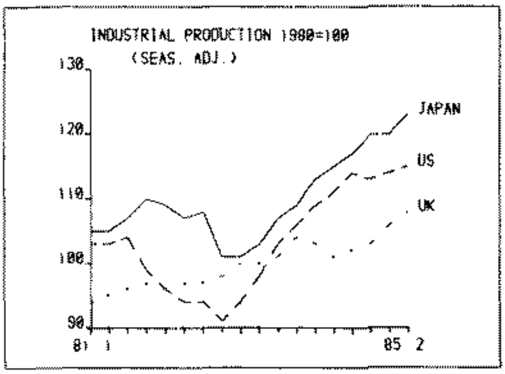
The World Economy



After the marked deceleration in the first half of the year US growth shows signs of picking up in the latter part of 1985. However, the impetus to world trade and global expansion derived from the rapid period of US growth in late 1983 and early 1984 has now largely waned. Although European countries and Japan are set to continue their recent expansion, it is unlikely that their growth will offset the impact on the world economy of a slower rate of US growth.

The last few months have seen increasing concern about slowing global growth. Fears heightened over the implications of a continuing relatively strong dollar, the growing protectionist demands in the United States and the debt problems of developing countries. The recent meeting of the Group of Five (G5) produced no substantive proposals to promote growth. Rather attention was focussed on the need to defuse protectionist sentiment through co-ordinated efforts to reverse the strength of the dollar. The significance of the G5 meeting is not only that the major problem facing the world economy is identified as the need to achieve orderly correction to trade and payments imbalances but that the US Government now accepts intervention is necessary to lower the dollar's value. This latter element contrasts sharply with the earlier US contention that exchange rate adjustment should follow from the pursuit of more rapid growth in other industrial economies. Acceptance of the need for greater intervention to offset the implications of slower world growth is also reflected in the Baker Plan for tackling the immediate debt problems of developing countries.

OUTPUT



The deceleration in US output growth in the second half of 1984 and the first quarter of 1985 has been reversed in successive quarters in 1985. During the first three months of 1985 real output grew at an annual rate of 0.3%. Recovery in the second quarter raised the real annual rate of growth during the first six months of the year to 1%. Following an initial "flash" estimate from the Commerce Department of an annual rate of growth of 2.8% for the third quarter, the preliminary estimate showed some upward revision to 3%. Such upward revision contrasts with the downwards revisions necessary in preceding quarters. Further expansion is forecast for the fourth quarter but is likely to fall far short of the growth required to achieve the Administration's forecast of a 3% rise in real output for 1985 as a whole.

Relatively slow US output growth during the second quarter of 1985 depressed the annualised rate of aggregate industrial growth in the OECD countries. In addition, the US growth rate fell some distance short of the growth rates of other major OECD countries for the second successive quarter. Japan and the UK, for example, enjoyed annualised growth rates of 5.4% and 4.7% respectively. Of the major OECD countries only France with a rate of 0.2% experienced less rapid expansion than the US.

As in the first quarter, weak US output performance contrasted with the continuing buoyancy of consumer spending. During the first six months of the year consumer spending rose at a real annual rate of 5%. This follows the now well-established pattern in the US and led to increasing imports. With imports rising by US$1bn and exports falling by US$2.5bn, the merchandise trade deficit rose to US$33bn from US$29.5bn in the first quarter. The trade deficit was partially offset by a net increase in earnings from services to produce a current account deficit for the second quarter of US$31.8bn.

The US current account deficit has its counterpart in the surpluses recorded elsewhere, as for example in West Germany and, particularly, Japan and in the improvements on current account so important to debt-burdened developing countries. Pressure on Japan, the major beneficiary of the US growth-induced expansion of world trade during 1982-84, and Japanese proposals on measures aimed at correcting its substantial trade surplus, the "import-action programme", were discussed in the last **Commentary**.

Japan has also recently announced measures designed to expand demand and which will leave the Japanese economy less susceptible to lower US growth.

The measures introduced in Japan involve the bringing forward of investment programmes by public utilities, accelerated public works programmes, an additional injection of public investment by local authorities and additional expenditure on construction. Consumer credit controls on durable goods are also being relaxed. It is expected that these measures will add 1.3% to GNP during the present fiscal year. The Japanese Government remains reluctant, however, to provide any monetary expansion since the associated lower interest rates would tend to lower the value of the yen and, thereby, exacerbate demands within the US for greater protectionism.

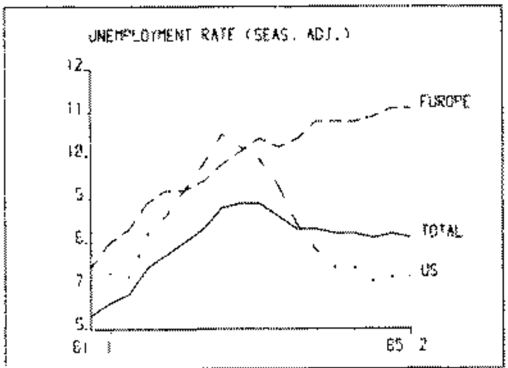
Among European economies, West Germany, has been under considerable pressure from international agencies such as the OECD, other European governments and domestic sources to undertake expansion to compensate for the slowdown in the world economy. Like other European governments, however, the West German Government eliminates from its policy options the possibility of fiscal expansion in the form of increased government expenditure on the grounds that such an option threatens the objective of reducing inflation. As with the miners' dispute in the UK, last year's strikes in German vehicle manufacturing and metal industries complicate comparisons between 1984 and 1985. However, investment and consumer expenditure have been expanding rapidly in recent quarters and both are forecast to provide a stimulus to the economy in the coming year.

In both France and Italy the over-riding target of policy remains the public sector borrowing requirement. In September the French Government announced reductions in public expenditure in real terms to permit reductions in personal and corporate taxation. Overall, it is intended to contain the budget deficit at 3% of GDP. In Italy the Government intends reducing expenditure to lower the budget deficit from a 1985 level of 15.6% of GDP to 14.6% of GDP in 1986.

While there is much self-congratulation in some European countries that growth rates are now higher than in the US, the absence of expansionary policies augurs badly against the background of slowing world trade. With only Japan taking reflationary action, total OECD growth is likely to enter a more sluggish period.

LABOUR MARKETS

After rising in the first quarter of 1985 unemployment fell in the second quarter to the level of the last three months of 1984. The standardised unemployment rate fell from 8.2% to 8.1%. Despite the deceleration of US growth in the first half of the year, the US unemployment rate of 7.2% remained similar to that in the latter half of 1984. Although in response to a fall in the Canadian unemployment rate from 11.1% to 10.5%, unemployment in North America decreased from 7.6% to 7.5%. North America's unemployment rate remains much lower than in Europe. Rates of unemployment in OECD Europe and the EEC remained unchanged at 11.0% and 10.9% respectively.

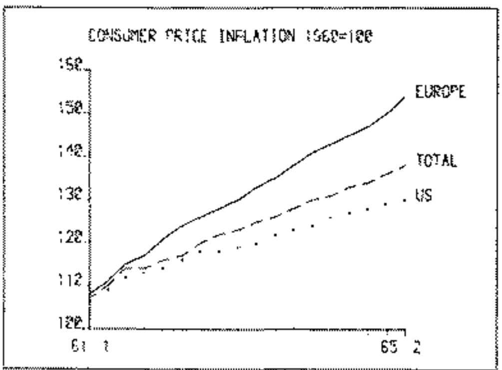


Within Europe higher second quarter levels of unemployment were recorded for West Germany and the UK. Decreases in unemployment took place in Belgium, Italy, the Netherlands, Norway, Spain and Sweden. After successive falls in the three previous quarters the downward trend in Japanese unemployment was arrested in the second quarter of 1985. The unemployment rate of 2.5% in Japan is substantially less than that in the other major OECD countries.

Despite increasing employment in Europe, particularly in the service sector, OECD forecasts suggest that European unemployment is likely to rise to 11.25% by the end of 1986. Unemployment rates in the US and Japan are expected to be much lower than in Europe at 7.25% and 2.5% respectively. European output growth is unlikely to generate sufficient jobs to prevent higher unemployment given the expected increases in labour supply. This structural change in European labour markets has been discussed in earlier **Commentaries.**

The nature of Government policies to tackle unemployment in Europe has been shaped by the view that unemployment is largely a consequence of labour market rigidities. Thus, governments are seeking to abolish or reform institutional arrangements such as wages councils, to remove arrangements for wage indexation and, more generally, to change legislation governing employment conditions. In contrast to the Japanese programme of accelerated investment in utilities and construction, European governments remain set against the use of measures to stimulate employment directly. Reliance on labour market reform holds little prospect of any immediate reductions in European rates of unemployment.

INFLATION



As discussed in the last **Commentary**, the recent recovery in the world economy has not been accompanied by any marked increase in inflationary pressures. Despite the rapid growth experienced during 1984, inflation in the OECD area in the first quarter of 1985 remained similar to the rate experienced in 1983. During the second quarter of 1985 inflation rates have fallen for a number of OECD countries as a consequence of the continuing softness in oil and commodity markets and the reductions in import prices for countries other than the US following the weakening of the dollar.

The average annual rate of inflation for the OECD area is 4.7%. As in the recent past, this average embraces diversity of experience both between North America and European countries and among European countries. The annual rate for North America is 2.1% which remains well below the averages for OECD Europe and the EEC of 5.3% and 4.0% respectively. Within Europe inflation rates range from 2.3% for both West Germany and the Netherlands through 6.1% for France and 6.9% for the UK to 16.7% for Greece and 22.3% for Portugal. With the yen's appreciation reinforcing the effects on import costs of weak oil and commodity prices, Japan's inflation rate of 2.4% remains low in comparison to those of most European countries.

As has already occurred with respect to growth rates across countries, there has been a recent narrowing of differentials in inflation rates. With continuing domestic austerity programmes, France and Italy have achieved marked reductions in their inflation rates over the past year. The pre-eminence of controlling inflation as a policy objective, some depreciation of the dollar in response to the Group of Five commitment to exchange intervention and to continuing difficulties in tackling the US budget deficit and signs of greater European success in containing unit wage costs will result in further narrowing of differentials in 1986.

In contrast, some increase in the US inflation rate above its present level of 3.6% is to be expected next year. Thus far, the effects of dollar depreciation have not worked through to the inflation rate and, as discussed in the last **Commentary**, there remains some scope, although profit margins are now being squeezed, for higher import costs to be absorbed without adjustment of dollar prices. Effects of depreciation will be felt next year, however, and in conjunction with the impact of slowing productivity growth on unit wage costs will raise the US inflation rate.

PROGNOSIS

In the absence of expansionary domestic policies, hopes for European expansion rest largely with achieving exogenously-determined reductions in interest rates. International interest rates remain at historically high levels in real terms and the prospects for continuation of the pattern of gradual reductions remains crucially dependent on developments in the US.

As argued in the last **Commentary**, expansive US monetary policy permitted reductions in US interest rates in the spring and summer but Paul Volcker, Chairman of the Federal Reserve Board, has indicated that the limits of monetary expansion have been reached. Two factors determine those limits: the inflationary implications of excessive monetary growth and the possible end to the hitherto "soft landing" experienced by the dollar were interest rates to fall further. The recent G5 agreement on intervention in foreign exchange markets provides, at least potentially, an attractive mechanism for further easing of the dollar. There is, however, as yet no imminent solution to the fundamental problem of the US budget deficit.

The US continues to attract a substantial net inflow of the world's savings to fund the budget deficit which is likely to approach US$200bn during 1985. Recent Congressional debate of the Gramm-Rudman proposals has highlighted the difficulties of legislating reductions in the deficit. Gramm and Rudman seek to impose budget ceilings and annual targets for deficits binding on the President. Such proposals have generated opposition on the grounds that mandatory targets may have to be met by politically unpalatable tax increases and/or reductions in defence expenditure.

Without effective US action to curb the deficit, dollar adjustment and its timing depends on currency markets' reactions to rising US indebtedness. The speed of adjustment under those circumstances could well differ from the recent "soft landing" and the attendant uncertainty severely constrains the prospects of European governments achieving the desired cuts in interest rates to foster growth.