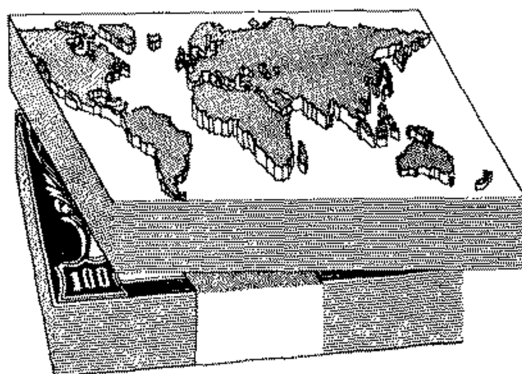
The World Economy

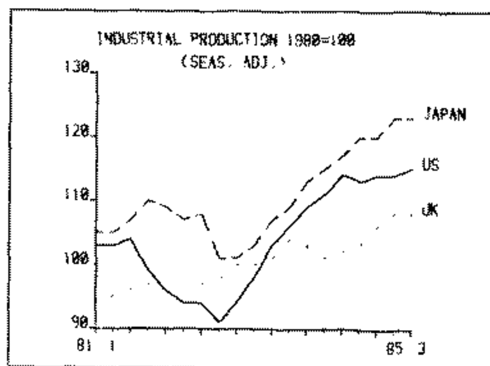


The present recovery in the world economy has now proceeded for almost twice as long as the typical cyclical phase of expansion during the past four decades. Growth in 1985 and prospective growth for 1986 is, however, modest in comparison to both the rates achieved in earlier upswings and that of 1983-4 when world expansion was driven by the strong growth of the US economy. With the deceleration of the US economy from its phase of rapid expansion and the continuing policy caution in the countries of Western Europe and Japan, growth in the major industrialised economies is likely to be of the order of 2.5% in 1986.

The present recovery in the major economies differs from earlier experience in that output growth has been accompanied by rising unemployment. Higher unemployment is not, however, universal. While unemployment has fallen in the US, it has risen in Western Europe. A further difference is that the present recovery, even during its more expansive phase, has not generated widespread iflationary pressure. Neither capacity constraints nor shortages of raw materials have been encountered. In recent years there has been considerable softness in commodity markets. Moreover, the recent downward movement in oil prices shows every sign of becoming more marked. The prospect is, therefore that inflation in the major OECD countries will be reduced further over 1986.

Developments in the world economy will continue to be largely determined in the coming months by attempts to resolve the three major imbalances that have arisen in the course of the current recovery: in trade, savings flows and international finance. These imbalances focus much attention on the US current account and budget deficits. In part also developments will be influenced by events in oil markets. In stark contrast to the substantial price increases in 1973 and 1979, oil prices have been falling sharply. OPEC now accepts the inevitability of lower prices, given present market conditions. These lower prices will contribute to growth and lower inflation in most countries and to some lessening of the international debt problems of oil-importing countries.

OUTPUT



As in earlier quarters of 1985, aggregate industrial growth in the OECD countries continued to be depressed in the third quarter by relatively slow US output growth. In addition, the US growth rate continued for the third successive quarter to fall some distance short of other major OECD countries. While US output grew at an annualised rate of 1.8%, Japan, West Germany and the UK enjoyed annualised growth rates of 3.8%, 3.4% and 5.6% respectively. Only France with a negative growth rate of -0.3% experienced less rapid expansion than the US. Total OECD growth recorded an annualised rate of 2.0%.

As for earlier quarters, the US Department of Commerce revised downwards its initial "flash" growth estimate of 3.2% to a preliminary estimate of 2.4% for the fourth quarter of 1985. Growth for 1985 as a whole is, therefore, now estimated at 2.3%, a rate considerably below that of 6.6% recorded during 1984 and the Administration's original forecast for 1985 of 4%. While there is little prospect of returning to the rapid growth of 1984, a number of factors suggest that US growth is likely to be stronger during 1986 than in 1985. Against a background of spare capacity and low stock ratios, the decline in interest rates during 1985 and lower oil prices are likely to stimulate household and business expenditure. Recent US experience, as discussed in previous **Commentaries**, has been that increased demand has generated a lesser expansion of output since much of the increased demand has been satisfied through imports. Over the past year, however, the US dollar has depreciated substantially against other major currencies. During 1985 the US dollar fell in value by almost 15% against the yen and by over 10% against the Deutsche Mark. Thus, a higher proportion of the increased demand is likely to be reflected in output growth and some improvement in the current account balance.

The major problem facing the US Government is the budget deficit. Under the Gramm-Rudman-Hollins plan, mandatory reductions in the budget deficit will cause some depression of aggregate demand. The reductions required during 1986 are, however, relatively limited and will only partially offset the effects of expansion in the other components of demand.

For other major countries the combination of a weaker dollar and some reduction in the budget deficit is likely to reinforce the recent waning of the stimulus to world trade. The implications of any trade slow-down are most serious for Japan, the principal beneficiary of the US-led expansion over 1983/85. Despite the appreciation of the yen, Japan achieved a record trade surplus of US$46bn in 1985 of which US$39.5bn was a surplus on trade with the US. There is a consensus view in Japan that growth will be more modest than in recent years and that exports are likely to account for little, if any, of that growth. Despite the resulting need, and international pressure, for expansionary policy measures, the Japanese authorities remain wedded to the need for monetary and fiscal restraint. To a great extent the room for Japanese manoeuvre on domestic policy is constrained by considerations surrounding her substantial current account surplus.

Japan is already committed to attempting to reduce that surplus by increasing imports through the "import action programme" announced last year. The effects of that programme on the current account surplus might well be unwound, however, were fiscal relaxation to precipitate a fall in the yen. The resulting curtailment of imports and stimulus to exports would most probably exacerbate discontent elsewhere, particularly in the United States where protectionist sentiment is aready high. There has been some switching to infrastructural spending within the framework of a largely unchanged fiscal stance to help promote employment (see last **Commentary**). Apart from the slight cut in discount rate in January 1985, there is unlikely to be any dramatic shift in Japanese monetary and fiscal policies with the possibility of some tax cuts in a pre-election period being the most likely, although probably limited, fiscal boost to domestic demand. The principal sources of demand growth will be consumer spending and the Government's public works and housing programme.

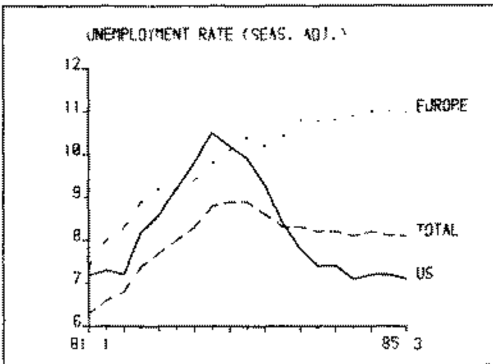
West Germany also enjoyed a substantial visible trade balance in 1985 of over £20bn as a consequence of a more than 7% increase in real exports and, as in Japan, the contribution of the external sector to growth is expected to largely disappear in 1986 while, with rising real disposable income boosted by income tax cuts, consumer spending will provide the main source of growth. In addition to the tax

cuts, fiscal policy will exert some expansionary impact through an expected 7% increase in public sector investment.

In France the export sector is likely to continue making a negative contribution to growth as a consequence of the continuing loss of competitiveness by French exporters. Increases in capital expenditure and some recovery in investment expenditure, although both still weak, are likely to be the main factors generating growth during 1986. Having failed to contain the 1985 budget deficit of 3.25% of GDP within the target of 3% of GDP, attempts to achieve budgetary restraint remain a principal policy objective. Little shift in policy is likely before the spring elections and over 1986 French growth is expected to rise towards 1.5% as compared to the rate of around 1.0% achieved in 1985.

With little sign of any significant relaxation of policy among other major OECD countries, such as Japan and West Germany, to take up the slack in the world economy, OECD growth in 1986 is forecast to fall to around 2.5% from the estimate of almost 3.0% for 1985.

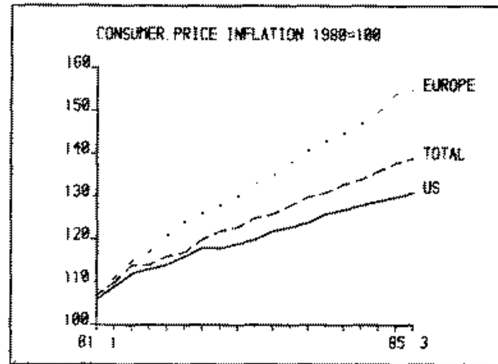
LABOUR MARKETS



After falling slightly in the second quarter of 1985, OECD unemployment remained unchanged at a standardised rate of 8.1% in the third quarter. This overall rate is the outcome of a wide diversity of experience in OECD countries. Despite the deceleration of growth between 1984 and 1985, unemployment in the US during 1985 fell below that for 1984. The average unemployment rate of 7.2% for 1985 was the lowest recorded for five years. Third quarter falls in unemployment in Canada and the US were offset by higher unemployment elsewhere. Unemployment rose in Japan, remained unchanged in France and fell in West Germany and the UK. Despite the rise in Japanese unemployment, the Japanese rate of 2.6% remains substantially below those for the European countries. Unemployment rates in the EEC and OECD Europe were 10.8% and 11.0% respectively.

The reduction in unemployment in the US during 1985 was accounted for by increases in employment in finance, insurance and other services. Job gains in these areas more than offset job losses in manufacturing, particularly in textiles, electronics, metals and chemicals, which resulted from the earlier strength of the US dollar. Around 70% of the net employment increase represented jobs for women. Given the likely pattern of the determinants of growth during 1986 in European economies, this pattern of a shift in the balance of employment towards dependence on services is set to be increasingly evident in Europe. It is unlikely, however, that European economies will achieve falls in unemployment similar to those in the US. The continuing pursuit of tight fiscal and monetary policies suggests that unemployment is likely to continue at current levels. Labour market policies in Europe continue to be directed primarily at reducing or eliminating labour market rigidities (see November 1985 **Commentary**).

INFLATION



Despite the durability of the present recovery in the world economy, there remains, as discussed in previous **Commentaries**, an absence of any marked

inflationary pressures. With the continuing softness in oil and commodity markets and reductions in import prices of items denominated in US dollars for countries other than the US following the dollar's depreciation, the annualised rate of inflation for the OECD fell to 4.3% in the third quarter of 1985 from a rate of 4.7% in the previous quarter.

As in earlier quarters, the average for the OECD area embraces considerable differences in inflation rates both between North America and European countries and among European countries. Although the annualised rate for North America rose from 2.1% to 3.3% between the second aod third quarters, the latter rate remains well below the third quarter averages for OECD Europe and the EEC of 6.1% and 4.9%. Within Europe inflation rates fell from 2.3% to 1.8% for West Germany, from 6.1% to 4.9% for France and from 6.9% to 5.4% for the UK. Of these three major European countries only West Germany achieved a lower annual rate than the 3.2% recorded for the US. Moreover, the European average is boosted by continuing high inflation rates in a number of smaller countries. Portugal, Greece, Iceland and Turkey, for example, recorded third quarter rates of 15.9%, 20.1%, 31.1% and 42.4% respectively. With the yen's appreciation reinforcing the effects on import costs of weak oil and commodity prices, Japan's inflation rate fell to 1.8% from 2.4% in the second quarter and remains lower than in any other OECD country.

The rise in the US inflation rate reflects a number of factors. Dollar appreciation has raised non-oil commodity prices. Prices of imported manufactures are also rising. While, like other exporters to the US, Japanese companies could absorb the effects of dollar depreciation in lower profit margins, they have raised prices to quell American discontent that voluntary restraints on sales to the US are being ignored and to try to avert the possibility that import quotas may be introduced. A further influence is the upward effect tightening labour market conditions, in conjunction with slowing productivity, is exerting on unit labour costs. In the coming months the most important of these influences on inflation is likely to be depreciation of the dollar and inflation is forecast to rise to 4.5% this year, thus reversing the beneficial effect over the past three years on US inflation of a strong dollar (see previous **Commentaries**).

In Europe governments remain committed to inflation control through forms of monetary control. As elections come nearer in a number of European countries, commentators increasingly focus attention on signs of an electorally attractive easing of fiscal policy, particularly in the UK and West Germany. Overall, however, the picture is one of a continuing cautious approach to policy. Weak commodity prices, the strength of European currencies against the dollar and, with the notable exception of the UK, moderate growth of unit labour costs are contributing to the control of inflation. Continuing moderation of European inflation and some rise in the US rate will contribute to further narrowing of differentials this year.

PROGNOSIS

Explicit recognition of the end of the period of benign neglect towards the US dollar came at the September 1985 meeting of the Group of Five. In the following months the dollar has depreciated against most other major currencies and the US current account deficit looks set to peak in mid-1986 and to moderate thereafter. The dollar's depreciation has been attributable only in very small part to exchange market intervention by the US authorities which has been limited in scope. Rather the reason lies primarily in the maintenance of interest rates at around the same levels as prevailed late last summer.

The combination of a depreciating dollar and no upward adjustment of interest rates provides a stimulus to US economic activity. The strength and durability of that stimulus is critically dependent, however, on developments in the US budget deficit following the Gramm-Rudman-Hollins Act. Unless reductions of the scale envisaged by Gramm-Rudman-Hollins are made in the US budget deficit, the danger remains of a "crash-landing" for the dollar with its associated adjustment problems including the need for higher interest rates. The Gramm-Rudman-Hollins Act provides a timetable for phased reductions in the deficit designed to achieve balance by 1991. Certain sensitive expenditures such as Medicaid and some forms of aid to families are completely exempt while others such as

Medicare are subject to limited cuts, should reductions be necessary. If Congress fails to achieve the budget reductions, the mandatory reductions, or Presidential "sequestering", must be split evenly between defence and non-defence expenditure.

Under Gramm-Rudman-Hollins the deficit target for 1986 is established at US$171.9bn. Government agencies forecast, however, a deficit of US$278bn. With this year's mandatory reductions limited to only US$11.7bn the 1986 target deicit cannot, therefore, be attained. Much more substantial reductions are required in following years and this has led to arguments that the Gramm-Rudman-Hollins provisions are unworkable. The President's budget proposals for the next fiscal year have now been published. As announced, these proposals seem to conform to the requirements of Gramm-Rudman-Hollins. Much debate will take place in Congress, however, on the details of the proposals and changes may be made, as is usual, before October.

Amid the uncertainty and scepticism there is a major positive impact. The new Act requires Congress to subject the budget and the implications of a continuing unchecked deficit to harsh scrutiny. As argued in previous **Commentaries**, failure to tackle the US budget deficit will seriously constrain resolution of problems in the US and the associated imbalances in the world economy.

More immediately, and more encouragingly for global growth this year, there is the prospect of continuing reductions in oil prices. Pressures on the OPEC cartel have become increasingly apparent during the 1980's. The cartel's ability to determine prices in the 1970's arose directly from the low short-run price elasticity of demand for oil and OPEC's high share of non-Communist markets. Diminution of the cartel's power reflects considerable shifts in both of these elements. Conservation and the development of substitutes have generated a declining market for oil and non-OPEC sources have increased their market shares.

The initial signs of internal weakening of the cartel were seen in the cheating on quotas and prices by a number of members. Increasing weakness also led OPEC to suggest, unsuccessfully, to non-members such as the UK and Norway over the past two years that they should restrict supplies to help forestall downward price movements. At the Geneva meeting of OPEC in December 1985 Saudi Arabia, the most powerful actor in the markets, resigned its role as "pendulum" supplier. Saudi Arabia is, therefore, no longer prepared to accept the residual quotas required to meet OPEC's overall target output. This move is directed at two proximate objectives: achievement of greater adherence to quotas on the part of other OPEC members and infliction of lower prices on non-OPEC suppliers for their failure to conform more closely to the general thrust of OPEC's strategy. More fundamentally, however, the Saudi action reflects their underlying view that the experience of conservation and economies over the past decade indicates the need for a period of lower market prices to revive a medium- to longer-term market for oil.

The prospect of further falls in oil prices presents the possibility of the reversal of the painful adjustment problems encountered by the world economy in the 1970's. Clearly the impact of lower oil prices will not be universally advantageous. Both OPEC and non-OPEC oil producers will experience deterioration in their terms of trade and reductions in foreign exchange earnings. The effects on a heavily indebted producer such as Mexico will revive the spectre of a crisis in the world financial system which has receded since 1983 and which the Baker plan seeks to tackle. For most industrial economies, however, the price reductions will contribute significantly to lower costs and the attainment of inflation targets, while oil-importing developing countries will enjoy lessening of their foreign exchange and debt problems.

Lower oil prices have come, quite fortuitously, when concern exists over where a stimulus to world growth will emerge to compensate for slowing US growth and the reluctance of other countries to take up the slack in the world economy through more active reflationary policy initiatives. This beneficial influence will be reinforced if the Gramm-Rudman-Hollins Act leads to effective action on the US budget deficit and, thereby, permits reductions in the international level of interest rates.