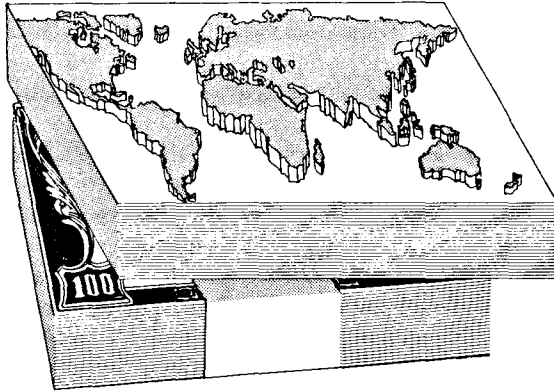


The World Economy



OVERVIEW

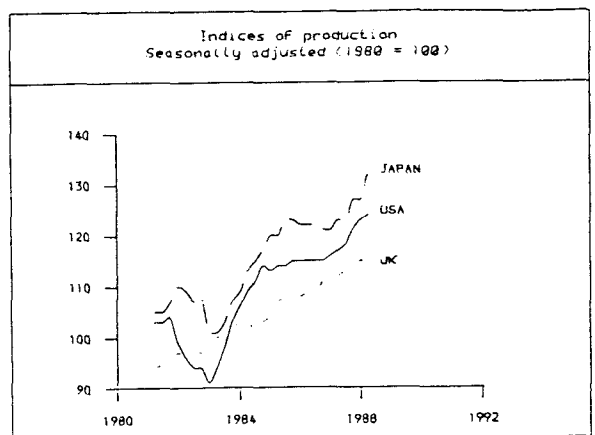
The performance of the main economies has been surprisingly buoyant in recent months. It appears likely that the growth of the world economy in 1988 will be nearer 4% than the 3% originally predicted. The balance of demand is shifting in favour of investment. The growth of investment is sufficiently strong generally to be described as a "boom". There has been some further improvement in international trade imbalances since we last reported. But the improvement is being frustrated by the recent appreciation of the dollar, the depreciation of the D-Mark, and the stronger rate of growth of the US economy.

MACROECONOMIC TRENDS

In the first quarter of 1988, industrial production in the OECD countries rose by 1.1%. That can be compared with increases of 1.2%, 0.5%, 1.5% and 1.8%, respectively, in the four quarters of 1987. West German production remained unchanged in the first quarter of the year after rising, on revised figures, by nearly 1% during the fourth quarter of 1987. Japanese production continued to rise swiftly. An increase of 3.2% during the fourth quarter of 1987 was followed by a further increase of 3.3% in the first quarter of this year. A near 14% annual rate of growth

provides a clear indication that Japan has adjusted rapidly to the high value of the yen. In the United States production grew by 1.2% in the second quarter of 1988. This followed growth rates of 1.7% during the fourth quarter of 1987 and 0.9% in the first quarter of 1988. Production in Italy has continued to grow since the sharp fall in production during the third quarter. Rates of 3.4% and 2.7% were recorded in the fourth quarter and first quarter respectively. Canada, too, has experienced favourable rates of growth, with an increase of 0.9% following the 2.2% experienced in the previous quarter. In France production stagnated during the first quarter, while in the UK production actually fell by 0.5%. Overall, production in the seven major OECD countries rose by 1.4% in the first quarter of 1988.

In the twelve months to April, total OECD production rose by 5.5%. Japanese production rose by 10.8% in the twelve months to May. US and Canadian production rose by 5.8% in the former (to June) and 6.7% in the latter (to May). Italian production rose by 5.2% (to April), and French production by 2.3% (to May). The UK experienced a 3.8% increase while West Germany's production remained little changed over the period, increasing by only 0.9%. Production growth averaged 5.9% in the seven major OECD countries in the twelve months to April.



Key developments in the three main industrial economies in recent months were as follows:

United States

In the second quarter of the year real GNP grew at an annual rate of 3.1%; a slight reduction on the annual rate of 3.4% recorded in the first quarter. But the US economy is clearly buoyant. In the year to the second quarter the economy (real GNP) expanded by 4.3%. Of the seven major OECD countries, only Japan (6.7%), the UK (5.1%) and Canada (4.9%) had more rapid growth. The balance of US growth is beginning to shift. Consumer spending is becoming less dominant as the saving ratio increases. Investment growth is strong and so too is the growth of exports. Levels of capacity utilisation are high and there is continuing concern that the inflation rate may worsen. The severe drought may also worsen the inflation rate in the short run. Many agricultural products have risen significantly in price as a result of drought induced shortages.

In the year to the second quarter, both consumer and investment spending contributed under 2 percentage points each to GNP growth of 4.3%. In the second quarter consumption grew at an annual rate of 2.3% compared with 4.5% in the first quarter. This reduction would appear to offer some support for those forecasters who are predicting that the growth of consumers' expenditure in 1988 will be around 2% to 2.5% compared with a 2.7% rate in 1987 and 4.2% in 1986. Investment in the second quarter rose at an annual rate of 10.7% compared with much lower rates of 3.3% in the first quarter and 1.7% in the fourth quarter of 1987. Several forecasters are predicting business investment to rise by 10% to 12% in 1988, although housing investment is likely to decline because the housing market is slack. Indeed, some predict that house prices in areas such as New York could fall by as much as 50%. That would further depress consumption and raise the saving ratio. Stockbuilding in the second quarter fell back significantly, by 31.8%, compared with the high levels reached in the preceding two quarters. Rates of stockbuilding are likely to fall in the remaining quarters of the year. Higher interest rates will be mainly responsible. But the effects of the drought are likely to result in some destocking of agricultural goods.

Net exports are beginning to make a not insignificant contribution to GNP growth. Several forecasters expect the contribution to increase as the year proceeds. The dollar has firmed recently, but net exports are now benefiting from

the substantial depreciation of the exchange rate since early 1985. Although the Louvre Accord in February 1987 was partially successful in stabilising the dollar, the real effective rate fell a further 10% by February 1988. At that date the cumulative depreciation of the rate since early 1985 amounted to 40%. This has provided a strong boost to export, and a deterrent to import, volumes. The J-curve effect of the depreciation - see recent Commentaries - meant that the balance of payments had at first to worsen before the lagging effect of the volume changes registered in the accounts. In the first four months of 1988 export volumes were 25% higher than in the same period in 1987. That can be compared with import growth of less than 4.5%. This improvement in net export volumes has produced improvements in the real value of the trade deficit of 13.5% during the first quarter of the year and 17.3% between April and June. A current account deficit of between \$130bn to \$140bn appears to be the likely outturn for 1988. That would be down on the \$154bn of 1987 and roughly the same as the deficit in 1986.

We noted in the June Commentary that changes in the fiscal stance of sufficient size to affect the Budget deficit must await the US presidential election. Yet, the buoyancy of US output growth has improved the short-run prospects for the deficit. Increased growth has served to raise the flow of revenues to the treasury. Current estimates point to an overall deficit of around \$150bn in 1988. That would be little different from the 1987 outturn, but below any earlier forecasts. However, at that level it would still be slightly above the amended target of \$144bn for the current fiscal year contained in the Gramm-Rudman-Hollins Act.

Japan

Real GNP grew by 2.7% in the first quarter of 1988; a further improvement on the 1.8% and 2% rates achieved in the preceding two quarters. Translated to an annual rate, the first quarter performance indicates a staggering 11.2% growth. That performance hasn't been seen since the first quarter of 1978. Some slow-down in production occurred after April but analysts do not expect the pause to continue. Construction output has recently deteriorated due to a slackening in the construction of housing and public works projects. This is unlikely to continue. Public expenditures in fiscal 1988 remain much the same as in fiscal

87, suggesting that the level of public investment will not go much lower. Worries about the emergence of capacity constraints and inflation, mentioned in the June Commentary, are still present. However, the strong growth of investment noted below is likely to ease pressures on capacity considerably. The further appreciation of the yen during 1987 lessened the pressure on wholesale prices. But the recent depreciation against the dollar means that the prospects for stable wholesale prices during the year are less certain.

Both investment and consumption growth are strong and contributing significantly to the growth of GNP. Investment grew strongly in the second half of 1987 and made the principal contribution to GNP growth. In the third quarter, investment rose by 4.4%, an 18.7% annual rate. This was followed by a growth rate of 6.2% in the final quarter of the year, an incredible 27.2% annual rate. The rate of growth fell to 2.9%, or a 12.1% annual rate, in the first quarter of 1988. This was largely due to the above mentioned pause in residential construction. But business investment remained fairly strong in the first quarter, rising by 3.6%. A strength that is expected to continue in subsequent quarters. Consumers' expenditure rose by 2.6% between January and March, and looks set to be the main engine of growth in the remainder of the year.

Net exports contributed negatively to GNP growth during 1987 and are likely to do the same in 1988. The yen appreciated further against the dollar during 1987 and the first half of 1988. J-curve effects meant that the surplus balance remained little changed in 1987 at \$86.7bn compared with \$85.8bn in 1986. During the first two quarters of 1988, the current balance stood at \$18.4bn and \$19.3bn, respectively. A fall of 12.1% and 15.4% compared with the same quarters in 1987. At that rate of decline the surplus should be around \$75bn in 1988. However, some forecasters are predicting a peak surplus of \$90bn, with some reduction in 1989 and subsequent years. The recent strength of the dollar is likely to improve the prospects for Japanese exports and reduce the volume of imports into Japan, thus slowing down the reduction in Japan's sizeable surplus on current account.

Both government consumption and investment are expected to continue to have a positive effect on GNP growth in the remainder of the year. The OECD believes that fiscal policy is broadly appropriate

but has recently expressed concern about the inflationary implications of growth in the money supply. The stock of money (M2+CD) has grown at an annual rate of around 11% since August 1987.

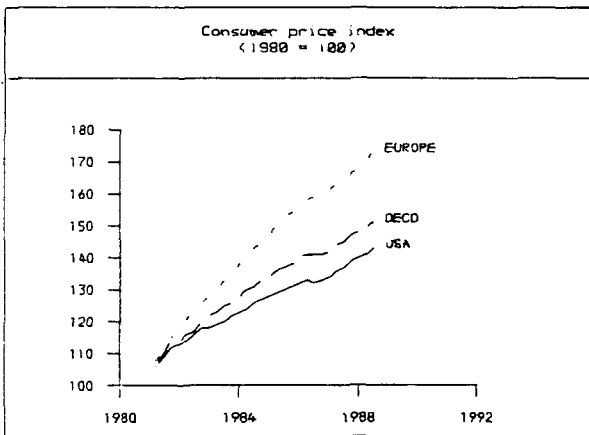
West Germany

Real GNP grew by 1.4% during the first quarter of the year to a level 4.3% above the same quarter in 1987. However, it is highly unlikely that the German economy will grow this year by the 5.7% implied by its performance in the first quarter. The June Commentary noted that the effects of the recent mild winter and the more severe winter in the preceding year are likely to have distorted the first quarter results in an upward direction. This is supported by the provisional results for the second quarter which imply a fall of 0.7% in GNP for the year as a whole. The level of GNP in the second quarter was 3.4% higher than in the same quarter of 1987. Nevertheless, with performance in the first half of 1988 exceeding expectations, the government has revised its GNP forecast for the year. Now the economy is forecast to grow by around 3%. This should be compared with the government's forecast in January of a 1.5% to 2% growth rate for 1988 as a whole.

Consumer demand provided the main impetus behind West Germany's low rate of economic growth during 1987. Current forecasts suggest that consumers' expenditure should increase at a similar rate in 1988 ie. 3.1%. Reduced taxation in the form of the tax reforms of 1986-88 and 1990, part of which has been brought forward, will serve to maintain the growth of this component of aggregate demand. Investment, on the other hand, is expected to rise significantly above the levels achieved in 1987. An increase of around 4% compared with the 1.7% recorded last year is expected. In the first quarter of the year, investment rose by 4.5% on the previous quarter. A marked rise in construction expenditures of 6% during the mild winter, compared with a 3.1% rise in investment in machinery, played a major part in the change. In the preceding two quarters investment in machinery fell slightly, while in construction expenditures were unchanged. Investment is expected to grow at a faster rate this year, but it remains to be seen what effect the recent increases in interest rates will have on expenditure under this head.

Net exports contributed negatively to growth during 1987, with export volumes rising by 2.3% and import volumes by 4.9%. The surplus on

current account stood at DM80.8bn compared with DM85bn in 1986. In the first quarter of 1988 the surplus amounted to DM14.5bn, down from the DM20.9bn recorded in the same quarter of 1987. Several forecasters are predicting that the surplus will fall again in 1988. A few months ago it would have been reasonable to expect an outturn of around DM70bn. But the weakening of the D-Mark this year, against both the dollar and the yen especially, has boosted exports and limited the demand for imports. The D-Mark has fallen by around 16% against the dollar and 7% against the yen. This has resulted in greater than expected trade surpluses in the second quarter of the year. So, in the seven months to July, the current account surplus stood at DM45.4bn. That suggests an outturn for 1988 of around \$80bn.



LABOUR MARKET

For the first time since the fourth quarter of 1986, standardised rates of unemployment are now available from the OECD for the aggregate of member countries. On the basis of these data unemployment in the OECD can be seen to have fallen between the third and fourth quarters of 1987, from 7.3% to 7.1%. This fall was reversed during the first quarter of this year when a rate of 7.3% was recorded. In the seven major OECD countries, however, unemployment has continued to decline from 5.7% to 5.5% and 5.4% during the last three quarters for which data are available. For some countries data are already available for the second quarter. In Japan standardised unemployment fell from 2.7% in the first quarter to 2.5%. In the United States, the rate reached 5.4%, falling from 5.6% in the previous quarter. In Canada, the reduction was from 7.8% to 7.5%,

while in the UK the rate fell by 0.5 percentage points to 8.5%. Only France, from the seven major OECD countries for which data are available, had an unemployment rate remaining in double figures. At 10.2% in the second quarter, unemployment was 0.2 percentage points lower than in the first quarter of the year. Overall, European countries are still experiencing higher unemployment rates than elsewhere, with the average for OECD Europe in the first quarter standing at 9.8% compared with 7.3% in the OECD as a whole.

PROGNOSIS

The performance of the main economies has been surprisingly buoyant in recent months. Some forecasters suggest that this robust performance reflects two principle influences. The looser monetary conditions following the Louvre Accord - on exchange rate stabilisation - in February of last year, and the delayed effects of the oil price fall in 1985/86. The interest rate reductions following the October stock market crash will have contributed further to a loosening of monetary conditions. To date these influences appear to have completely outweighed any negative wealth effects on demand of the fall in share prices. It appears likely that the growth of the world economy in 1988 will be nearer 4% than the 3% originally predicted by several forecasting organisations. It also appears that the balance of demand is shifting. The growth of investment is sufficiently strong generally to be described as a "boom". The growth of consumer spending on the other hand is being sustained but does not appear to be increasing. As has so often happened in the past, much new investment will begin to come on stream when world economic growth is beginning to turn down next year. Several forecasters expect a tightening of fiscal policy in key countries such as the US and Germany to lower world growth in 1989 and immediately succeeding years.

Some further improvements in the international trade imbalances have occurred since we last reported. The US trade deficit, and the Japanese trade surplus both fell by 13.5%, and 5.6%, respectively, in the first quarter of the year. However, in West Germany the trade surplus rose during the first seven months of the year. This is a reflection of the recent depreciation of the D-Mark against most major currencies and the appreciation of the dollar which accelerated between June and July.

The West German government is keen to challenge the view that the German economy is sluggish and that, by implication, the government is not doing sufficient to boost the economy. Domestic interest rates have been raised progressively to combat the recent strength of the dollar and the risk of imported inflation as well as excessive domestic monetary expansion. But given that interest rates have risen elsewhere, particularly in other parts of Europe and the US, the effect on the exchange rate is likely to be small. The rate at which the current account surplus is reduced is not going to increase by much on this account. Conversely, higher interest rates are likely to

have a depressing effect on domestic, and particularly investment, demand. Parallel attempts to reduce the federal borrowing requirement also serve to reduce the growth of domestic demand. And this at a time when both Germany and Japan need to exhibit a faster rate of growth than the United States. Yet even with improved West German growth the US economy is still growing more rapidly, although not of course as fast as Japan. A significant domestic-demand-led growth differential in favour of both surplus countries is the most certain way to remove the continuing trade imbalances in the world economy.