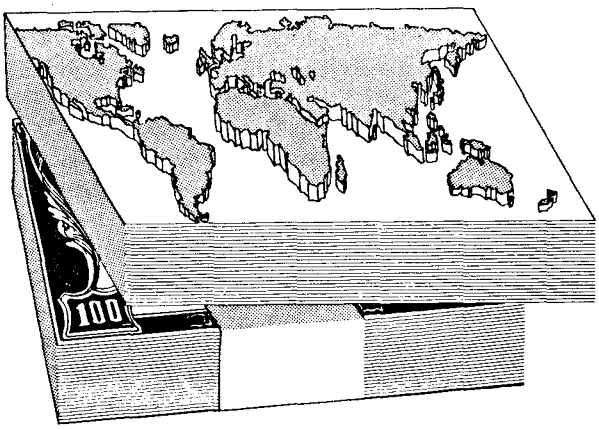
The World Economy

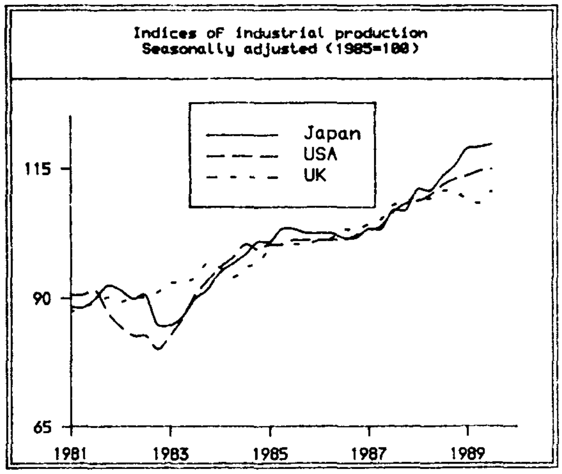


MACROECONOMIC TRENDS

In the third quarter of 1989 GDP growth in the seven largest OECD countries increased to nearly 1%, *mainly due to a rapid 2.9% rise in the quarter* in Japan. Unusually, West Germany's real GDP fell slightly during the quarter, with most other G7 countries having GDP growth in the 0.5% - 0.7% range.

A clearer picture of the continuing slowdown in the economies of the leading industrialised countries can be obtained from data on industrial production. In the twelve months to October, industrial production in the OECD as a whole rose by 2.9%, with a 2.6% rise for the G7 countries, the first occasion in which the year-on-year rise has fallen below 3% for some time. Canada remains the only country showing a fall in industrial production in the year to October (-0.6%). The other G7 countries are as follows: United States 1.1%, Japan 3.2%, West Germany 4.4% (all year to November); France 5.2%, Italy 2.9%, and the UK 1.2% (all year to October).

There is still some evidence of inflationary pressure in the OECD countries, with consumer price rises in the year to November of 5.1%, and 4.3% for G7 countries. These are both rises of 0.1 percentage points compared with the year to September. The UK still tops the inflation league AA 7.7%, followed by Italy at 6.4% per annum. The lowest inflation rates are once again recorded by West Germany (2.9%) and Japan (2.3%).



Labour market

Standardised unemployment rates continue to moderate slowly in the OECD, with an average of 6.1% in the third quarter of 1989. G7 countries had an average unemployment rate of 5.6% in the third quarter. Italy remains the only G7 nation with unemployment in double figures (11.57%). In November unemployment rose fractionally in Canada and the United States to 7.5% and 5.3% respectively.

Unemployment was unchanged in France (9.5%) and West Germany (5.5.%), while slight falls were experienced by Japan (2.2%) and the UK (5.9%).

Data on employment suffers, as does unemployment data, from definitional differences between OECD countries; nevertheless certain trends can be detected. In the year to September OECD countries showed a 1.8% increase in the employed labour force. Of the G7 countries, Japan shows the largest increase, 2.1% (year to November) with West Germany showing the lowest rate of increase at 1.3% (year to October).

United States

It now appears that earlier figures indicating a very rapid slowing of the US economy may have been overly pessimistic. The original estimate of a 0.5% fall in October house sales was subsequently revised to an increase of 0.9%. This was followed by another sharp rise in November, leaving the housing market in the year to November only 3.5% lower than in 1988. Consumer expenditure also recovered in November following a slump in September and October, which, coupled with good retail sales over the Christmas period, served to reduce the fear of recession.

During November the US trade deficit unexpectedly widened to $10.5 billion, although this may have been due to the distorting effect of the Boeing strike which was resolved early in December. However, the trade deficit fell sharply again in December, ending the year at $113.2 billion compared with $127.2 billion in 1988. Exports grew by over 13% during the year, more than twice the rate of imports.

With inflation and earnings growth apparently under control for the time being, most attention has been focused on the possibility of recession. The official line is still that growth will remain strong during 1990 with GNP growth of 2.6%, but there is clear evidence that the domestic economy continues to slow down. The improvement in the trade deficit reflects this slowdown, and industrial production fell during both December and January. Also in January the main banks lowered their prime lending rates by 0.5 percentage points to 10%, which should help give a boost to both consumer and investment demand; much of the low rise in imports in 1989 came from reduced demand for capital equipment.

Despite the administration's relaxed attitude on inflation, there is still evidence of underlying inflationary pressures in the US economy. Consumer prices rose by 4.6% during 1989, the largest annual rise since 1981, and one problem for the Bush administration is that it may err too far in attempting to prevent recession and so allow inflation to rise too rapidly.

Japan

In the third quarter of 1989 real GNP in Japan rose by 2.9%, a performance much more in line with recent years following the GNP fall in the second quarter. For 1989 as a whole, industrial production was up by 5.9%, compared with 9.5% growth in 1988.

Until recently Japan appeared to have found a happy balance of rapid growth, low unemployment and relatively low inflation. The underlying problem, however, was always the trade surplus which has been of concern for many years. In late 1989 the OECD expressed concerns that the continuation of surpluses like Japan's and deficits being run by other countries could eventually lead to disruption in international financial markets akin to October 1987.

The Japanese current account surplus has been falling steadily - in November it fell for the ninth successive month to $4.26 billion - but nevertheless remains substantial despite the package announced late last year by MITI designed to reverse the export-intensive policies of recent years.

The disruptions in the Japanese stock market during February appeared to indicate that the OECD warnings were being borne out by events. But other factors have also been at work. Inflation now shows real signs of rising; wholesale prices rose by 2.5% in 1989, the first rise for seven years. In part this was due to the last year's consumption tax, but it also reflects the steadily weakening Yen. Official intervention has been unable to stop the decline in the yen against the dollar and the government is now coming to the view that this weakness may be a long-term phenomenon. The problem here is not only the prospect of dearer imports and thus rising inflation, but also the fact that a markedly lower Yen will result in the current account surplus rising higher than its 1989 level of $61 billion.

This in turn has led to fears that the official discount rate may have to be raised higher than its February level of 4.25%. Monetary policy in Japan tightened throughout 1989 in common with most G7 countries and may now have to rise further both to curb inflation and to stem the fall in the value of the Yen which is necessary to prevent further current account imbalance.

West Germany

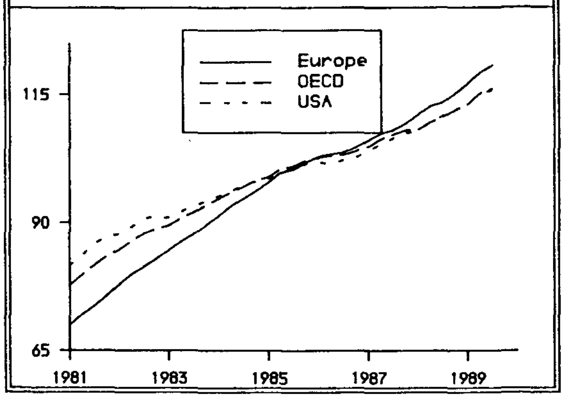
Although West Germany GNP fell by 0.5% in the third quarter of last year, 1989 will nevertheless be viewed overall as a satisfactory year. West

Germany's economy has proved to be very resilient in the face of a tightening monetary policy, as indicated by the growth of manufacturing orders in December of 5.5.%, most of which came from domestic sources.

Inflation was also kept in check during the year as one would expect from the German authorities, with consumer prices rising by 2.8% during the year.

Two developments in 1990 could be expected to keep domestic demand buoyant but also give rise to inflationary pressure. The first is the final part of the tax reform which will increase disposable income by DM25 billion, coupled with a reduction in the rate of corporation tax from 56% to 50% which should help keep investment at a high level. Second, there is the continuing influx from East Germany and elsewhere; West German population has grown by 1.5 million since 1987 and is likely to grow more rapidly during 1990. These immigrants, once they have found jobs, should provide a substantial boost to domestic demand, especially for housing and consumer durables. This is especially so given their probably very low savings ratio.

Consumer price indices
(1985=100)



Apart from the effect of monetary policy, which is likely to remain tight during 1990, the general slow-down in the economies of the G7 countries will be the main factor dampening West German economic growth. The German trade surplus was at a record level in 1989 (over DM100 billion) despite a rapid closing of the gap between imports and exports towards the end of the year as the D-Mark strengthened against the Dollar and Yen. However, most forecasts of world trade remain fairly bullish and the change in the trade surplus in 1990 is unlikely to be marked.

PROGNOSIS

The economies of the major industrialised countries have proved quite resilient to the steady tightening of monetary conditions which occurred during 1988 and 1989. Growth in the OECD countries is now expected to be just below 3% for 1990, with Japan and West Germany being the main growth economies.

There is some concern about underlying inflationary pressure, however. Although OECD inflation is expected to remain relatively steady at around 4.5% during 1990, large wage settlements could undermine this projection. The prospect of widening trade surpluses in West Germany and Japan, coupled with the recent weakness of the Yen is an area of some concern, especially if there is any hint that disruption in the financial markets could spread beyond Japan.