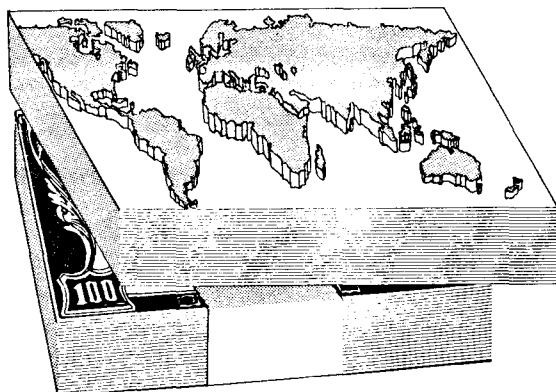

The World Economy



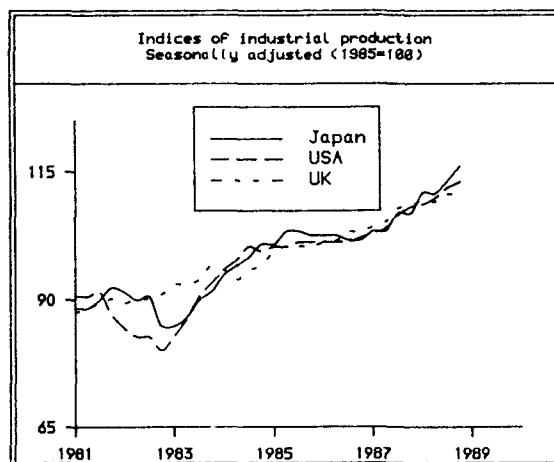
In the most recent quarter, there was the usual variation in individual OECD country performance. Canadian production fell by just above the OECD average. For the United States, production rose both in the fourth quarter and in the year as a whole: by 1.1% in the former and 5.7% in the latter. In Japan, production continued to be buoyant, rising by 2.6% in the final three months of the year and 9.2% in the year as a whole. Production stagnated in France during the fourth quarter, but rose by 4.5% during the year. West Germany enjoyed a small increase of 0.9% between September and December, resulting in industrial production being 3.9% above the 1987 level. Italy, on the other hand, saw its production leap ahead by 4.4% during the fourth quarter so that the level of production during 1988 was 6% above that of 1987. Finally, in the UK, production stagnated at the end of the year so that industrial output had risen by 3.2% over the year. Overall, production in the seven major OECD countries rose by 1.3% in the fourth quarter and 6% during 1988.

OVERVIEW

Growth in the world economy is slowing down compared with the rate achieved during 1988 but the slow-down may not be as great as expected. Inflationary pressures continue to be present, particularly in Japan and Germany, although the recent general tightening of policies should begin to show some effects by the end of the year. But the bias in favour of monetary policy is arguably contributing to the failure to remove the world economy's principal financial imbalances. Growth is now expected to be around 3.5% during 1989 compared with a rate above 4% in 1988 and the earlier expectation of 3% growth in 1989.

MACROECONOMIC TRENDS

In the fourth quarter of 1988, industrial production in the OECD countries rose by 1.4%. This can be compared with increases of 1.2%, 0.7% and 1.7% in the first, second and third quarters, respectively, of last year. For 1988 as a whole, production therefore rose by 5.7% compared with the 3.2% achieved in 1987.



In the twelve months to February 1989, total OECD production rose 5.4%, Italian production rose by 11%, United States production by 4.7% (12 months to March), West Germany by 4.5%, Japan by 4.2%, the UK by 2.2% and Canada by 1.5%. For the seven major OECD countries, growth averaged 4.7% over this twelve month period, suggesting that production growth was beginning to slow at the end

of 1988 and during the first quarter of 1989.

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

United States

The rate of growth of real GNP rose to a 5.5% annualised rate in the first quarter of this year, compared to a rate of 2.4% in the final quarter of 1988. However, analysts consider that this overstates the underlying performance of the US economy because of the way government statisticians have allowed for farm output in their seasonal adjustments following last year's drought. The underlying annual rate of growth of output in the economy after adjustment for the effects of the drought is estimated by the Department of Commerce to be more of the order of 3% in the first quarter of this year as against a 3.5% annual rate in the fourth quarter of 1988.

In the March Commentary we noted that the economy was experiencing strong underlying growth and that this was adding considerably to inflationary pressures. The tightening of monetary policy in the US over the past year, with short-term rates rising by 2.5% points, has begun to slow output growth. Despite rising by 4.7% in the year to March, industrial production has stagnated since January. Construction spending and particularly housing investment fell during the first quarter and the growth of consumer spending slowed down. Net exports again contributed positively to growth in the first quarter but the improvement in the trade balance is unlikely to continue. Oil imports are on a rising trend and the strengthening of the dollar, resulting in a 9% cumulative decline in competitiveness in 1988 and 1989, are both likely to reduce net exports significantly during the year. For 1988 the current balance stood at a deficit of \$135.3bn and because of the above is likely to rise to around \$140bn in 1989.

US GNP will slow down in 1989 compared with the 3.8% achieved in 1988. The British National Institute of Economic and Social Research is forecasting a 2.6% GNP growth rate this year falling to 1% in 1990. Inflationary pressure now appears to have reduced. The rate of increase of the GNP implicit price deflator fell to a 3.9% annual rate in the first quarter of the year compared with 5.3% in the fourth quarter of 1988.

Japan

The rate of GNP growth slowed in the fourth quarter of 1988 to 0.73% over the previous quarter, or a 3% annual rate. The estimated percentage change over the fourth quarter of 1987 was 4.8%, but comparing 1988 with 1987 Japan's rate of growth amounted to 6.1%. This represents Japan's strongest rate of growth for more than a decade and is currently faster than any of the seven main OECD countries. Investment, particularly business investment, and consumer spending continue to be the main sources of growth, while net exports continue to contribute negatively.

Fiscal and monetary policy remain permissive despite the 0.75% point increase in the Official Discount Rate (ODR) to 3.25% at the end of May.

The slowing of the rate of growth in the fourth quarter may be an indication of the effect of domestic capacity constraints and incipient inflationary pressure. Consumption remained largely unchanged in the fourth quarter, unlike investment which rose by 3.6% over the previous quarter, or a 15.2% annual rate. This offers some support for the view that the slow-down in consumption during the fourth quarter, and hence GNP growth, was to some extent due to abstinence in respect for the emperor's illness and eventual death. Exports rose in yen value terms by only 0.13% in the fourth quarter, or a 0.5% annual rate, compared with an increase in imports of 0.28% ie a 1.1% annual rate. However, a rising yen during the fourth quarter meant that the trade surplus actually rose in dollar terms. And similarly, the current account surplus increased to \$23.6bn in the fourth quarter, a culmination of progressive quarterly increases from the \$18.4bn recorded in the first quarter of 1988, which in turn represented a marked fall on earlier quarters. For 1988 as a whole, the current account surplus stood at \$79.6bn, a reduction of \$7.4bn on the surplus of 1987. Recent months have seen a declining trade surplus which in dollar terms has been overstated by the relative weakness of the yen. It seems likely that export volume growth will remain high but may have passed its peak and that import volume growth should rise during the remainder of the year. But the outlook is for only a slow reduction in the trade surplus. The current balance is not likely to be much less than \$72bn during 1989.

Forecasts for GNP growth during 1989 suggest that the outturn should not be that much lower than the rate achieved during 1988. This represents a stronger expected performance than when we last reported. The principal reasons for this are the continued buoyancy of investment and stronger export growth. Inflationary pressures continue to give some cause for concern, following the weakness of the yen in recent months and strong oil and commodity prices. These were among the reasons offered by the authorities to justify the increase in the ODR to 3.25% in May, the first change in that rate since February 1987.

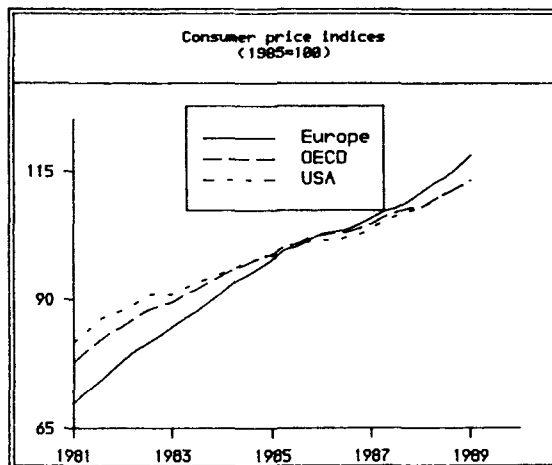
West Germany

We reported in the March Commentary that despite a slackening in the rate of growth during the fourth quarter of last year, the outturn rate for 1988 was 3.4%. This represents the highest rate of growth of GNP achieved since 1979. Industrial production rose by 3.9% in 1988 over 1987, but below the average 6% achieved by the G7 countries. Indications are that growth has remained buoyant during the first half of this year. Industrial production in March and April taken together was 0.5% above the January/February level and 5.8% higher than the same period in 1988. Both investment and consumer demand are believed to have grown above expectations in recent months and the recent weakness of the deutschemark is keeping export demand strong.

The five key economic research institutes have now revised their 1989 growth forecasts upwards from 2.5% to 3%, but the government's forecast still remains 2.5%. Nevertheless, in the first week of June Chancellor Kohl predicted that the outturn for 1989 could be as high as 4%. The buoyancy of the demand for German products, rising capacity utilisation, and the weakening of the deutschemark relative to the dollar, have fuelled fears that the Germany economy may be overheating. This prompted a further tightening of monetary policy towards the end of April when short-term interest rates were raised by 0.5% points.

The annual rate of increase of consumer prices reached 3% in April, although this partly reflected the January increase in consumer taxes. The 5 key economic research institutes are, nevertheless, forecasting a 3% inflation rate this year, as are other forecasting bodies. But the effect of a tightened monetary policy could also be seen in April with the twelve-month growth of

M1 falling to 7%, the smallest rise for two years. The growth of broad money, M3, also slowed, to 6.2% over the same twelve months. It is therefore unlikely that there will be a further tightening of monetary policy during the next two to three months.



LABOUR MARKET

In the fourth quarter of 1988, standardised unemployment in the OECD continued to fall, with the rate reaching 6.5% compared with 6.7% in the third quarter. Unemployment in the seven major OECD countries also fell from 6.2% to 6%.

Unemployment data are also available for the G7 countries for the first quarter of 1989. For the G7 countries as a whole, Canadian unemployment averaged 7.5% during the first three months of 1989, a reduction of 0.2% points on the 1988 fourth quarter figure. In the USA the first quarter rate averaged 5.1%, down on the 5.3% averaged in the fourth quarter. In Japan, a 0.1% point fall between the two quarters produced a first quarter average of 2.3%, still by far the lowest G7 unemployment rate. A large fall of 0.4% points reduced the German first quarter rate to 5.6% but in France the rate remained unchanged at 10.2%, still the highest among the G7 group.

PROGNOSIS

Growth in the world economy is slowing down compared with the rate achieved during 1988. However, there are indications that currently the slow-down is not as great as expected. The two key surplus countries, Japan and Germany, are

still experiencing buoyant demand. Inflationary pressures continue to be present although the recent general tightening of monetary policies should begin to show some effects by the end of the year. Growth is now expected to be around 3.5% during 1989 compared with a rate above 4% in 1988 and the earlier expectation of 3% growth in 1989.

We noted in the March Commentary that the general tightening of monetary and fiscal policy would do little to ameliorate the principal financial imbalances that exist in the world economy. The reasons for this are twofold: first, the countries experiencing the greatest demand and inflationary pressure are the current account deficit countries such as the USA and the UK; and secondly, monetary policy and specifically interest rate policy has been the principal

instrument used to control demand. The most spectacular result of this policy has been the appreciation of the dollar against most of the major currencies. The US has thus lost competitiveness, in the short run at least, against Japan and West Germany, both of which are able to respond rapidly to favourable price signals. Improvement of the trade imbalances has slowed as a result. Much the same can be said of the UK economy where a tight monetary policy has kept sterling above the level it otherwise would have been and so has retarded the improvement of the significant British deficit on current account. This dilemma can only effectively be resolved by a more intelligent use of fiscal policy. And from the point of view of the world economy that means a serious attempt to cut the US budget deficit.