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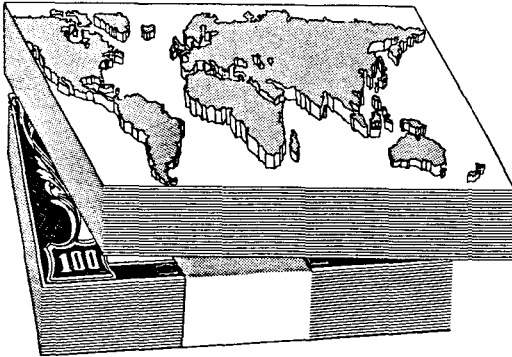
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The World Economy

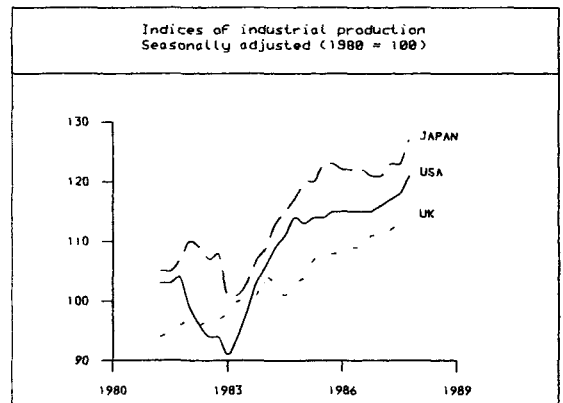
MACROECONOMIC TRENDS



In the third quarter of 1987, **industrial production** in the OECD countries rose by 1.6% compared with increases of 1.2% and 0.5% respectively, during the first two quarters of the year. West German production rose by just under 1% following a 2% increase in the second quarter and a fall of 1.9% in the first quarter. Japanese production increased markedly, rising by 3.6% after remaining unchanged between the first and second quarters of the year. The US and the UK continued to experience positive growth rates in the third quarter, at 2% and 1.6% respectively. Italy, on the other hand, experienced a drop in production of 2.8% after successive increases in the first two quarters of the year. In the twelve months to October, OECD production was 4.9% higher, with US production rising by 5.4% (12 months to November), Japanese production increasing by 7.9%, and West German production rising by 1.2%. The other major industrial countries all experienced positive growth over the year to October, with Canada, France, Italy and the UK, increasing production by 8.1%, 1.2%, 7.6%, and 3.8% respectively.

OVERVIEW

The outlook for the world economy is, on balance, probably more favourable than when we last reported in November: a further significant deterioration in equity prices has been avoided and business confidence appears to be holding up well. World economic growth will be lower in 1988 than would have been the case but there appears a good chance that recession can be avoided. The key to future exchange rate stability and the maintenance of business confidence in the world economy rests on the progress being made in the US, Japan and West Germany in introducing domestic macro-economic policies to remove the continuing financial imbalances. West Germany's weakening resolve in this connection is a major cause for concern.



Key developments in the three main industrial economies during the last quarter were as follows:

United States

Provisional figures for real GNP show that the US economy was growing at an annual rate of 4.2% in the fourth quarter of 1987. This can be compared with annualised rates of growth of 4.1%, 2.5% and 3.8% in the first, second and third quarters, respectively. The apparent buoyancy of the US economy in the post stock market crash period is less clearly supported once the components of GNP growth are examined. Real consumer spending fell more sharply in the fourth quarter than in any period since 1980. Accordingly, stockbuilding rose significantly during the period, leading many analysts to expect that growth will be much lower in the first quarter of 1988 as firms move to a more optimal balance of stocks. A reduction in domestic US demand can be viewed as a necessary step towards raising the US domestic saving ratio and so reducing the savings shortfall that underlies the deficit on current account - see earlier **Commentaries**. In the fourth quarter the personal saving ratio rose to 4.9% from 2.8% in the third quarter and this must in part be accounted for by the wealth effect of the stock market crash with investors seeking to rebuild their assets, as predicted in the November **Commentary**. The main point at issue, however, is whether the switch from domestic to external demand can be accomplished smoothly. A too rapid cut back in domestic demand could of course be the prelude to recession.

In the third quarter of 1987, the US trade deficit widened to a seasonally adjusted US\$39.83bn, which is the highest quarterly deficit on record. Nevertheless, trade volumes have been moving in favour of the US for most of 1987, but with the dollar falling during the year the effect on the external accounts of the improvement in net export volumes has been swamped by a terms of trade effect. To the extent that the dollar stabilises around present rates, the underlying conditions suggest that there should be a fairly rapid improvement in the trade and current accounts.

The November **Commentary** reported that the US inflation rate was giving some cause for concern. Retail prices rose by 0.5% in August 1987, 4.3% above the level in

August 1986, and representing an annual rate of 5.8%. However, preliminary figures for the fourth quarter were more favourable than expected suggesting an annual rate of only 2.7%.

Despite agreement between Congress and the Administration on measures to cut the Budget deficit in line with the targets set by the Gramm-Rudman Budget reform law for fiscal 1988, current forecasts suggest that the deficit could be some US\$30bn above the outturn for fiscal 1987. The Congressional Budget Office forecast in February that in the absence of further fiscal action the 1988 deficit would be US\$176bn, compared with US\$148bn in 1987. This is due to the effect of higher interest rates and lower economic growth on net revenues. Further cuts of around US\$30bn are therefore required to bring the outturn into line with the revised Gramm-Rudman target of US\$144bn for fiscal 1988. The prospects for agreement on such cuts appears to be limited in an election year. And in the short term at least, adjustment in the US external accounts will depend more heavily on the savings behaviour of the domestic private sector.

Japan

In the third quarter of 1987 real GNP grew by 2.1% over the preceding quarter, equivalent to an annual rate of 8.6%. The slowdown of growth in the second quarter, when real GNP fell slightly, has clearly been reversed in the second half of the year. In November, Industrial production had increased by 10.7% over November 1986. The favourable performance of the Japanese economy reflects the strong growth in domestic demand which appears to have been little affected by the events of last October.

In 1986 the surplus on current account stood at the record level of US\$85.8bn. During 1987 the surplus has, on revised figures, been falling to US\$24.9bn, US\$21.1bn and US\$19.9bn, in the first, second and third quarters, respectively. On a monthly basis, the surplus fell progressively during 1987, reaching US\$5.9bn in August compared with US\$7.1bn in August 1986. However, in September and October the surplus rose again to US\$7.7bn

and US\$6bn, respectively, although to lower levels than those recorded during the same periods in 1986. For 1987 as a whole Japan's overall trade surplus fell to US\$79.8bn, a reduction of 3.5% on 1986 and the first fall in five years. Further reductions depend on the significance of the J-curve effects of the further appreciation of the Yen during the latter part of 1986, the rate of growth of domestic demand, and the comparative performance of Japanese and foreign firms in taking advantage of, or adjusting to, the exchange rate movements.

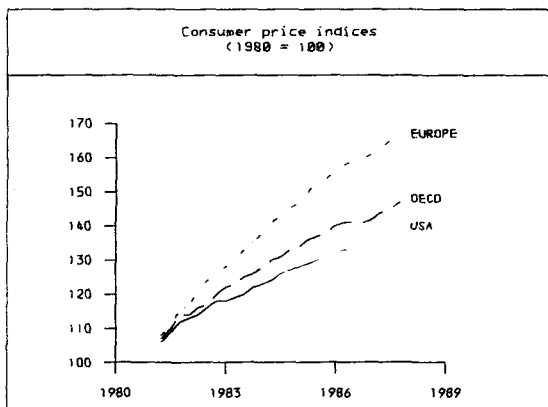
The fiscal policy stance continues to be favourable to the stimulation of domestic demand and the removal of the trade imbalances in the world economy. Following the US\$25.4bn package of spending and tax cuts announced last May, the budget for the 1988/9 fiscal year represents an overall net increase in spending of 4.3%. Monetary policy remains relatively lax in order to restrain the appreciation of the Yen. The growth of the money supply (M2) during 1987 stood at 10.4%, compared with 8.7% in 1986.

West Germany

The performance of the German economy continues to be sluggish. In the third quarter of 1987 real GNP rose by 1.3%, compared with an increase of 1.1% in the second quarter and a fall of 0.8% in the first three months of the year. Between the third quarters of 1986 and 1987 real GNP rose by 2.1% and for 1987 as a whole the increase in real GNP is estimated to be only 1.7%. The most recent forecasts by the country's five leading economic research institutes suggests that real GNP will grow by 2% in 1988, while other forecasts predict that the growth rate could be as low as 0.75%. While there are now clear signs that domestic industry is adjusting to the high D-Mark/dollar rate, the impact on the external accounts remains small. In the first eleven months of 1987 the surplus on current account stood at DM70.5bn, compared with DM80.6bn for the whole of 1986. Current forecasts suggest that the surplus is unlikely to fall below DM65bn in 1988.

The government continues to reject suggestions that it do more to stimulate

the economy. Indeed in January the government decided to cut its borrowing by at least DM10bn in the next fiscal year via increases in consumer taxes and a reduction in public expenditure. This move followed evidence of a sharp rise in the federal deficit this year to around DM40bn, compared with the original target of DM29.5bn. The growth in the size of the deficit reflects in part higher contributions to the EEC, and the failure of the Bundesbank to generate DM6bn profits which the government had expected to be earned and paid over during the year. The central bank has had to write off up to DM15bn tax cuts which became effective at the beginning of the year and because of the slower than predicted growth of the economy. There is now considerable doubt whether the government will be able to continue with its proposed tax cuts of DM20bn scheduled for 1990.



LABOUR MARKET

Standardised rates of **unemployment** have not been published by the OECD for the aggregate of member countries since the fourth quarter of 1986. The series is no longer being updated pending receipt of new data based on EEC Labour Force Surveys. However, on the basis of data that are available for key countries, it appears that unemployment again fell slightly in the third quarter of 1987. The US standardised rate of unemployment fell, on revised figures, from 6.1% to 5.9%, falling further to 5.8% in November of last year. Japan's unemployment fell by 0.2% points to 2.8%, after rising by 0.1 percent points during the second quarter of the year. By November the rate had fallen further to 2.7%. Unemployment in France fell by 0.1% points to 10.8% after rising by 0.1% points in the second

quarter. And in Canada and the UK, unemployment fell by 0.2% points in the former and 0.5% points in the latter bringing their rates to 8.8% and 9.8% respectively. West Germany, in contrast to almost every other major country, experienced a further increase with the rate rising from 6.9% to 7%.

PROGNOSIS

It is too early to say whether the world economy has successfully negotiated the more extreme recessionary possibilities resulting from the upheavals in the world's financial markets during the final quarter of last year. The outlook is on balance probably more favourable than when we last reported in November: a further significant deterioration in equity prices has been avoided and business confidence appears to be holding up well. World economic growth will be lower in 1988 than would have been the case but there appears a good chance that recession can be avoided.

Following the G7 statement in December it appears that the authorities have effectively abandoned their earlier attempts to set rigid ceilings and floors for the Yen and the D-Mark on the one hand and the dollar on the other. There appears to have been a recognition that direct intervention in the foreign exchange markets and monetary policy changes may not be the appropriate approach to the removal of the trade and financial imbalances in the world economy. Indeed, it is arguable that the exchange rate stabilisation policy adopted led to interest rate volatility which contributed to the stock market crash. There seems a greater willingness now than before to adopt the domestic macroeconomic policies that many, including this **Commentary**, have urged for some time. The expansionary measures adopted in Japan can be taken as symptomatic of this change, while in the US some, all be it limited, progress is being made in reducing the Budget deficit. An intensification of these efforts in both countries is still desirable. But what is worrying, is the weakening resolve of West Germany to introduce expansionary measures. This coupled with the need for the US trade deficit to be seen to be improving is the key to future exchange rate stability and the maintenance of business confidence in the world economy.