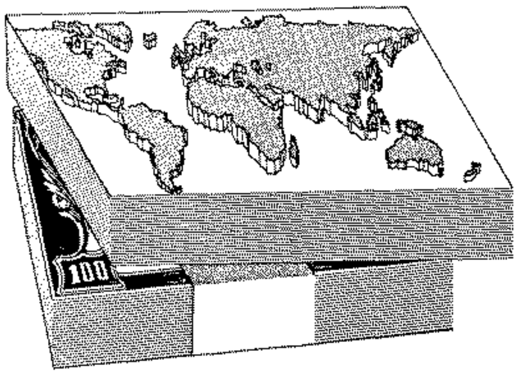
Ashcroft, Brian and Love, Jim and Boyle, Stephen and Draper, Paul and Harrigan, Frank and Jenkins, Iain and Lockyer, Cliff and McGregor, Peter and McNicoll, Iain and Pearlman, Mike and Simpson, David and Stevens, Jim (1987) The world economy [November 1987]. Quarterly Economic Commentary, 13 (2). pp. 4-8. ISSN 2046-5378 ,

The World Economy

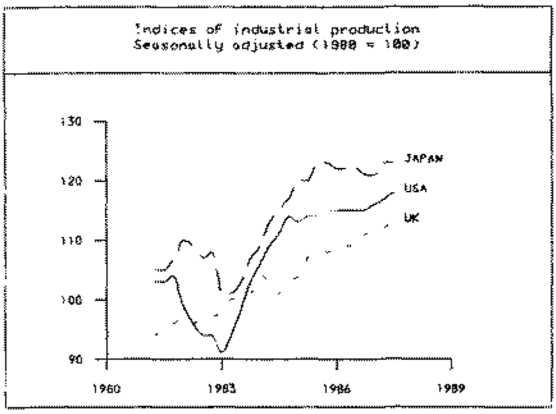


OVERVIEW

Recent events have been dominated by a major collapse of share prices in the world's stock markets followed by instability in the foreign exchange markets and a significant downward movement in the exchange value of the dollar. By the end of the first week of November, the stock markets in London, Frankfurt, New York and Tokyo had fallen by 32%, 30%, 25% and 15%, respectively, since the middle of October. Uncertainty about the attempts to cut the US Budget deficit, the course of the dollar and the future of the Louvre accord on exchange rate stabilisation, continued to have a depressing effect on share prices. While the depressing effects on trade and growth in the world economy of a once-and-for-all fall in share prices of this magnitude should be limited and not of recessionary proportions, continued uncertainty could seriously damage business confidence making a major recession more likely.

MACROECONOMIC TRENDS

In the second quarter of 1987, **industrial production** in the OECD countries rose by 1.2%, compared with a 0.5% increase during the first quarter of the year. West German production rose by 2.9%, reversing the reductions of the two previous quarters, while Japanese production remained unchanged. The US, Italy and the UK continued to experience positive rates of growth returning rates of 1.1%, 1.8% and 0.7%, respectively. In the twelve months to June, OECD production was 3.1% higher, with US production rising by 4.5% (to August), Japanese production increasing by 3.9% (to July) and West German production falling by 3.6% (to July). The other major industrial economies all experienced positive growth over the year to June, with Canada (to July), France, Italy, and the UK (to July), increasing production by 4.1%, 2.8%, 1.1%, and 3.7%, respectively.



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

United States

Before the collapse in share prices the outlook for the US economy was relatively favourable. Provisional figures for real

GNP showed that it was growing at an annual rate of 3.8% in the third quarter, compared with an annual rate of 2.5% and 4.1% in the second and first quarters, respectively. The wealth effect of the share price fall is expected to reduce the growth of GNP during 1988 by about one percentage point, with the result that the outturn is likely to be 2.5% rather than the 3.5% forecast by the Administration before the stock market upheaval.

The trade and current account of the balance of payments continues to show little improvement, despite the substantial fall of the dollar against the Yen, D-mark and other major currencies. During 1986, the US current account deficit reached US$140.6bn, US$23bn worse than in 1985. In the first quarter of 1987, a deficit of US$36.8bn was recorded, US$3bn and US$11bn worse than in the first quarters of 1986 and 1985, respectively. A further deterioration occurred in the second quarter of the year when the deficit rose to US$41.1bn, US$6.7bn and US$10.7bn, worse than in the second quarters of 1986 and 1985, respectively. The narrower merchandise trade balance reached a deficit of US$16.5m in July, having deteriorated in successive months since March. But in August there was a slight fall in the trade deficit to US$15.7bn and the provisional figures for September show a further fall to US$14.1bn. Trade volumes are beginning to move in favour of the US. For example, during the first six months of the year the volume of exports grew at an annual rate of 14%, but with the dollar continuing to decline the effect on the current account of the improvement in net export volumes has been swamped by a terms of trade effect. Nevertheless, if the dollar does stabilise within the next few months and if the fall in share prices raises the saving ratio, then an improvement in the current account should be clearly evident by the second or third quarter of next year.

Retail prices rose by 0.5% in August to a level 4.3% above the level in August 1986. Despite the view of the Administration that inflation was peaking, the recent figures do give some cause for concern. The August **Commentary** reported that many economists in the US expected the rate of increase to moderate in the second half of the year owing to smaller increases in food and energy prices. However, in August a small fall in food prices was offset by rising energy prices. On the basis of the August increase, inflation is running at an annual rate of 5.8%. While consumer expenditure growth is expected to moderate following the wealth effects of the fall in equity prices thus relieving some of the inflationary pressures, the recent sharp fall in the dollar coupled with the prospect of further dollar depreciation makes the outlook for inflation less than sanguine.

At the time of writing it appears that Congress and the Administration are nearing agreement on the nature and scale of measures to reduce the Budget deficit. If no agreement is reached by 20 November then under the revised Gramm-Rudman-Hollins (GRH) Budget reform law an automatic across-the-board cut of US$23bn will be imposed. The original 1985 GRH Budget reform law specified a target of US$108bn for fiscal year 1988 which began on 1 October of this year. The new Budget bill submitted by Congress and recently signed by the President revised the GRH deficit targets, raising the targets for 1988 and 1989 to US$144bn and US$136bn, respectively. Thus the target for 1989 has been raised by a substantial amount - US$64bn. Official projections suggest that in the absence of cuts the deficit for the 1988 financial year wil be in the range US$163bn to US$179bn compared with US$148bn in 1987. And the projection for 1989 is of a deficit in the range US180bn to US$210bn. It is clear that even if greater cuts than US$23bn are agreed the deficit will still remain at high levels for several years. However, it is by no means certain that a rapid rate of contraction of the deficit would be beneficial to the US economy. Swingeing cuts might help business and financial confidence but they could also precipitate a major recession in the US in the absence of reflationary measures elsewhere in the world economy, particularly in Germany and Japan. Moreover, it is worth noting that while the nominal value of the deficit only peaked in fiscal 1986, the ratio of the deficit to US GNP peaked in 1983 at 6.3%. By fiscal 1987 the deficit had fallen to 3.4% of GNP and on current projections, including the GRH cuts, the deficit will fall to 3.1% and 2% of GNP in 1980 and 1990, respectively. These proportions are little different from the average in the seven major industrial countries. Nevertheless, the significance of the US Budget deficit is that it is associated with a very low saving ratio in the country as a whole and it is the resulting net savings shortfall that has produced the large external deficit.

Japan

During 1986, real GNP growth in Japan fell to 2.3%, compared with 5.1% in 1984 and 4.7% in 1985. The slow-down in the growth of the Japanese economy was largely due to the deflationary effects of the significant appreciation of the Yen against the dollar since January 1985. In the first quarter of 1987 real GNP rose by 1.3%, equivalent to an annual rate of 5.3%. However, in the second quarter of the year real GNP fell very slightly. Over the year as a whole, real GNP was 2.3% higher by the second quarter compared with a 3.8% increase to the first quarter. The slowing down of growth in the second quarter appears to support the view reported in the August **Commentary**, that growth would be lower in the remainder of the year owing to the unwinding of the J-curve effects of the higher Yen. Nevertheless, domestic demand appears to be fairly buoyant. According to Japan's Chain Stores Association, retail sales were 6.4% higher in September than a year earlier, the largest increase recorded since July 1981. Industrial production was 4.7% higher in September compared with the same period in 1986 having exhibited an upward trend since July of this year. The recent sharp fall in share prices is expected to have little impact on consumer spending since in Japan equities account for only a small proportion of the financial assets held by individuals.

Following the appreciation of the Yen, export volumes declined and import volumes increased. However, in 1986, these volume changes were small compared with the extent of the Yen's appreciation. The surplus on current account consequently rose to US$25.7bn in the fourth quarter, resulting in a record overall surplus of US$85.8bn for the year. In the successive years 1983 to 1986 the surplus has been as follows: US$20.8bn, US$35bn, US$49.2bn, and US$85.8bn. In the first wuarter of 1987, the surplus fell to US$21bn but that represented an increase of US$8.3 over the first quarter of 1986. In the second quarter, the surplusrose to US$22.8bn but this time the quarter's figures represented a slight reduction on the same quarter a year ago. Since July the surplus has been falling, reaching US$5.3bn in August compared with US$7.1bn in August 1986. How quickly the surplus continues to decline depends on the importance of the terms of trade effects of the recent further appreciation of the Yen, the rate of growth of domestic demand, the success of Japanese exporters in adopting strategies to cope with the high Yen, and the difficulties encountered by foreign exporters in penetrating the Japanese market.

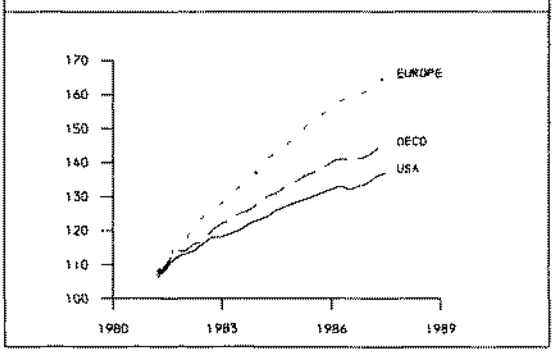
The US$25.4bn package of public spending and tax cuts announced in late May, the bulk of which was expected to be implemented in the current financial year, is still considered by many analysts to be an insufficient stimulus to domestic demand. It is considered by some that to stimulate demand by an amount sufficient to reduce the current account surplus significantly would require a package at least twice as large as that introduced in the summer. The budget for the 1988-89 fiscal year is currently being compiled so it remains to be seen whether Mr Takeshita, Japan's new Prime Minister, will be willing to adopt a more expansionary strategy than his predecessor.

West Germany

The German economy continues to perform sluggishly. During 1986, real GNP increased by 2.4%, below the government's target of 3-3.5% and slightly down on the rate achieved in 1985. In the first and second quarters of 1987, real GNP fell by 0.8%, then rose by 1.1%. While the growth in the second quarter suggests an annual rate of growth of 4.4% this is only because performance was so poor in the first quarter due to the effects of a severe winter. So, for example, between the second quarters of 1986 and 1987, real GNP rose by only 0.8%. In January, the government was forecasting real GNP growth for 1987 of 2.5%, but the OECD subsequently forecast an outturn of 1.5% for the year. The most recent forecast by the country's five leading economic research institutes, suggests that real GNP will grow by 1.75% this year rising slightly to 2% in 1988. However, these forecasts assume that the D-mark will remain relatively stable and they do not allow for the depressing effects of further D-mark appreciation or a downturn in the US economy.

Consumers' expenditure continues to provide the main contribution to economic growth but is expected to increase by only 3% this year compared with 4% in 1986. Investment spending is weak and is expected to grow by no more than 2% this year, and according to the research institutes by only 1%. Indeed the OECD contends that the low rate of investment spending is primarily responsible for Germany's continuing net savings surplus and hence the persistence of the surplus on current account. In 1986, the initial J-curve effects of the appreciating D-mark and lower oil and commodity prices led to the current account surplus rising to DM80.6bn compared with DM44.5bn in 1985. These effects were sufficient to outweigh in the short run the adjustment that was beginning to occur in external trade. Export volumes fell by 0.4% and import volumes rose by 3.5% during 1986. By this summer import volumes were 6% higher than in the same period in 1986 and export volumes were stagnating. Nevertheless, with further strengthening of the D-mark against the dollar the current account surplus is expected to reduce only slowly this year and next. By the end of August the current account surplus stood at DM46.6bn suggesting a surplus of DM70bn for the year as a whole. The five leading research institutes predict that the surplus will be DM75bn this year, falling only slightly to DM65bn in 1988.

Consumer price indices
(1980 = 100)



The government has continued to reject calls to further stimulate the economy. Short-term rates actually rose in October in an attempt to check an overshooting of money supply growth targets. But some downward movement was again allowed as the Bundesbank sought to increase market liquidity following the fall in equity prices. Tax cuts of DM14bn and DM20bn are planned for 1988 and 1990. A rescheduling of the planned 1990 cuts forward to 1989 continues to be unlikely. Both money supply growth and the budget deficit are likely to rise further, the latter due to the stagnation of tax revenues following low economic growth. In these circumstances, given the authorities abhorrence of inflation, a further relaxation of the monetary and fiscal stance appears unlikely.

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 the data that are available for key countries it appears that unemployment fell slightly during the second quarter of 1987. The US standardised unemployment rate fell, on revised figures, from 6.9% to 6.4%, falling further to 5.9% by August of this year. Japan's unemployment rose by one tenth of a percentage point, from 2.9% to 3%, but had fallen to 2.7% by July of this year. West Germany's rate increased, on revised figures, from 2.8% to 2.9% and had risen to 7% by July. Similarly, unemployment in France rose again from 10.9% to 11%. In contrast, Canada's rate fell from 9.6% to 9%, while in the UK the rate fell from 10.7% to 10.3%.

PROGNOSIS

Recent events have been dominated by a major collapse of share prices in the world's stock markets followed by instability in the foreign exchange markets and a significant downward movement in the exchange value of the dollar. Current estimates of the impact on world economic growth suggest that if markets stabilise growth in 1988 will be lower but probably by no more than a half to one percentage point. However, uncertainty about the attempts to cut the US Budget deficit, the course of the dollar and the future of the Louvre accord on exchange rate stabilisation, continue to have a depressing effect on the world's financial markets. The outturn for the world economy over the coming year depends very largely on events in the US and whether the US, Japan and West Germany can re-establish a co-ordinated policy to deal with the structural imbalances.

In the US, the continuation of the twin structural problems of a large budget deficit and the deficit on current account has been largely responsible for the recent stock market collapse. However, while the expected reduction in US domestic demand following the wealth effects of lower equity prices will lower US and world economic growth next year it may also have a favourable impact on the structural problems of the US economy. First, there should be a reduction in inflationary pressures. Secondly, domestic savings should increase if the rise in the saving ratio, as individuals seek to rebuilt their wealth holdings, more than offsets the reduction in saving as national income falls. And, if as expected, investment declines, this in turn will reduce the domestic savings shortfall resulting from the high US Budget deficit which, as noted in previous **Commentaries**, has been the root cause of the deficit on current account. The difficulty is that we cannot be certain whether recent events are not the prelude to a major recession in the US. And this uncertainty is compounded by an apparent paradox. The avoidance of a recession depends crucially on how seriously business confidence will be affected by recent events. Yet to maintain and restore business confidence the US administration may have to take actions which could in themselves precipitate a recession.

Business confidence, in the form of investment intentions and planned consumption, may be seriously affected for two reasons. First, if further share price falls are anticipated then this may generate a 'great crash' psychology similar to, and partly through an awareness of, the post 1929 experience. Secondly, if both the Reagan administration and Congress are seen to be failing to devise an appropriate policy to deal with the Budget deficit then business confidence could very easily deteriorate. Little can be done to prevent the emergence of a 'great crash' psychology except for the authorities to continue to ensure that monetary conditions are sufficiently relaxed to avoid the pressures on liquidity as the fall in equity prices raises the demand for money.

In principle, it would be fairly easy for the US authorities to restore confidence by introducing measures to gradually cut the Budget deficit and reduce domestic demand without precipitating a recession which would in any case raise the Budget deficit. Once such measures were clearly signalled it would then be politically easier for both West Germany and Japan to expand demand in their own economies. This in turn would help the US current account deficit thereby limiting the necessary deflation of US domestic demand. The likely outcome would be that the dollar would stabilise, prospects of higher US inflation would diminish, higher US interest rates would be avoided and the problems faced by highly indebted Third World countries would be eased. Moreover, in the face of such a co-ordinated policy it is likely that business confidence would be very quickly restored. Unfortunately, at the time of writing the prospects of greater co-ordination on these substantive matters appear fairly remote. The US appears to be threatening to let the dollar fall further in an attempt to induce West Germany and Japan to expand domestic demand. West Germany and Japan appear unlikely to take further steps to expand their economies unless and until the US takes positive steps to reduce its Budget deficit. But with an election next year the US administration is wary of reducing domestic demand by an amount that may precipitate a recession just as the electorate goes to the polls. A policy of letting the dollar fall may therefore appear to the US administration to be an easier option both on economic as well as political grounds: a falling dollar would direct recessionary pressures elsewhere in the world economy. However, if that policy were to be adopted there is no guarantee that business confidence in the US would be maintained and so a US domestic recession may still be the result.

It appears that in the absence of a co-ordinated policy the prospects of a recession in the US, Western Europe and Japan are considerable. The interests of Western Europe and Japan will therefore be best served by the adoption of reflationary measures irrespective of the policies adopted or not adopted in the US. Moreover, if Japan and West Germany, in particular, do stimulate their economies it is more probable that the US will adopt the policies that other countries have been urging for so long.