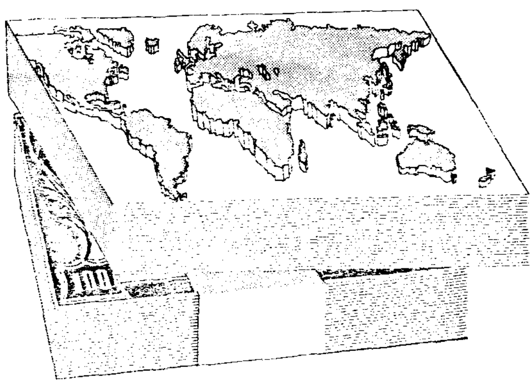
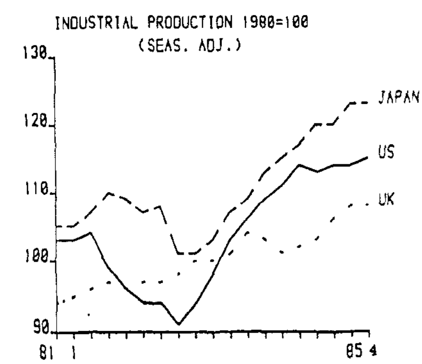


be depressed in the fourth quarter by relatively slow US output growth. The US economy grew in the fourth quarter at an annualised rate of only 0.7%, considerably below the original "flash" estimate in December of 3.2%, and the lowest quarterly growth rate since the last three months of 1984. Overall, US growth in 1985 was around 2.2%, the lowest rate since 1982.



Developments in the first part of 1986 continue to be dominated by the sharp fall in the price of oil and the deceleration of the US economy. With the lack of agreement on pricing and output policy among OPEC members the outlook for oil markets remains uncertain. The present low oil prices provide benefits to oil-importing countries in the form of falls in industrial costs and improvements in trade balances. In the short-run it may have also helped trigger reductions in interest rates. The longer OPEC fails to exercise effective control over oil markets, the greater these benefits will be. However, while there is the resulting possibility of growth without the usual inflationary consequences, the world economy remains characterised by major imbalances.

Industrial growth for the total OECD area in 1985 was 2.4%, a rate also achieved by OECD Europe. Within Europe a wide range of countries recorded more rapid annual growth rates of industrial output than the US. Belgium, Luxembourg, Spain, Portugal, Norway, UK, Greece and West Germany had rates of 10.7%, 6.9%, 6.1%, 5.9%, 5.2%, 3.8%, 3.7% and 2.3% respectively. In contrast, industrial output during 1985 grew less rapidly than in the US in Japan and France where rates of 1.8% and 0.9% respectively were recorded.

OUTPUT

Reflecting the pattern of the first three quarters of 1985, aggregate industrial growth in the OECD countries continued to

As argued in the last **Commentary**, there is little prospect of the US returning to the rapid growth of 1984 but a number of factors point to stronger growth this year than last. With spare industrial capacity and low stock ratios, the combination of lower interest rates, lower oil prices and depreciation of the dollar are expected to stimulate domestic demand and help ensure that an increasing proportion of demand is satisfied through higher domestic output rather than increased imports. Preliminary evidence for the first quarter suggests, however, that these expectations are not, as yet, being fulfilled. In April, the US Department of Commerce announced that real output is estimated to have declined by 0.5% in the first quarter.

This first quarter faltering in the performance of the US economy raises doubts about whether the US will achieve the growth rate of around 3% widely forecast for this year. It also reinforces those elements which cast considerable uncertainties over both US and world-wide prospects, namely, the degree of likely success of the Gramm-Rudman-Hollins Act to reduce the US budget deficit and further changes in exchange rates and oil prices. Success in reducing the US budget deficit and the effects of lower oil prices on demand in oil exporting countries will offset at least partially the expansionary impact of lower oil prices on non-oil producing economies.

Despite the marked depreciation of the dollar against most major currencies during the past year, there has been little impact in the US current account deficit. In the fourth quarter of last year the trade deficit increased to $39.5bn, the highest recorded fourth quarter deficit. It remains unclear what impact dollar depreciation will exert on the US trade deficit during the remainder of 1986.

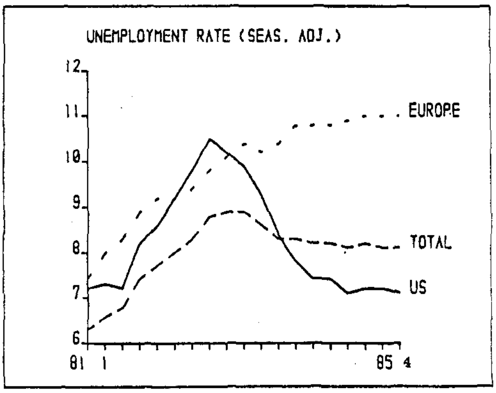
Over the last few years the main beneficiary of the stimulus given to international trade by the US trade deficit has been Japan. As a counterpart to the continuing US deficits, Japan continues to record trade surpluses. In the Japanese fiscal year to the end of March, Japan recorded a trade surplus of $61.6bn and a current account surplus of £55bn. In large part, these surpluses reflect the J-curve phenomenon and Mr Nakasone has argued that yen appreciation, particularly against the dollar and less substantially against the stronger European currencies, is unlikely to exert any substantial effect on Japan's external position before the fourth quarter of this year. Thus, it is anticipated that Japan will have a trade surplus of around $70bn for this calendar year.

In the face of considerable international pressure to take up some of the slack in the international economy and to absorb higher imports, Japan announced its "import action programme" in the autumn of last year. That has now, at least superficially, been reinforced by further measures taken in April to increase the level of domestic demand. These measures include increasing the front-loading of the public works budget, utility rates rebates and aids to residential construction and small businesses. This package followed the announcement in March that Japan's nine electric power companies, presently enjoying substantial windfall profits as a result of lower oil prices, are increasing their capital spending by 14% during the current fiscal year. Overall, however, the measures contained nothing that was not already in the process of being introduced and are undertaken within the constraint of the Japanese Governments' firm commitment to fiscal austerity.

A substantial measure of austerity in policy also remains the general rule. This has prompted further US pressure for reflationary measures in West Germany where inflation has been virtually removed from the system but where unemployment is higher than in the US. In France the Government with the new Prime Minister, Jacques Chirac, has introduced a budget to continue attempts to reduce government spending. The Budget involves reductions in public spending, a programme of public asset sales and the transfer of local authority funds to central government. While savings on the cost of oil imports have contributed to the expectation of an overall improvement in the French current account during 1986, much concern remains over the continuing loss of market share by French exporters of manufactures. France's export growth of 1.8% in real terms during 1985 reflects further losses in international price competitiveness and a failure to adapt to changing market conditions. Poor trade performance contributes to the Government's unwillingness to introduce policies to stimulate domestic demand. It also accounts for the devaluation of the Franc against the Deutsch Mark in the April EMS realignment. While much uncertainty remains, the falls in oil prices have helped the expectation that the present recovery in the world economy, which is already lengthy by post-war standards, will be sustained during 1986 and into next year.

LABOUR MARKETS

After remaining unchanged at a standardised rate of 8.1% during the second and third quarters, OECD unemployment fell slightly to 8.0% in the last quarter of 1985. Underlying these overall rates is a continuation of the pattern, now well-established over recent years, of quite different experiences across OECD countries. Despite the deceleration of US growth during 1985, unemployment fell in the third and fourth quarters to rates of 7.1% and 6.9% respectively. The rate of 7.1% continued the year-on-year reductions since 1981.



While there were fourth quarter reductions in unemployment in both Canada and the USA, unemployment in Europe remained unchanged with OECD Europe and the EEC experiencing rates of 11.0% and 10.8% respectively. Within Europe, fourth quarter unemployment rose in Italy, remained unchanged in the UK and fell in France and West Germany. Despite a further rise in Japanese unemployment, the Japanese rate of 2.8% remains substantially below the rates in North America and in most European countries. In Europe only Norway and Sweden with rates of 2.4% and 2.7% respectively have lower levels of unemployment than Japan.

As argued in previous **Commentaries**, the outlook for unemployment remains pessimistic. In Japan the measures to front-load public expenditure and to raise capital investment and levels of construction activity will help restrain the growth in unemployment. The prospects continue to be most pessimistic in Europe where macroeconomic policy is still typified by caution and where policies towards labour markets remain directed at removing labour market rigidities.

INFLATION

The falls in oil prices, continuing softness in non-oil commodity markets and the impact for countries other than the US of reductions in import prices of items denominated in US dollars have contributed to the continuing absence of marked inflationary pressures. Inflation for the OECD fell to 5% in 1985 from a rate of 6% in 1984 and in the fourth quarter of last year inflation stood at an annualised rate of 4.5%.

As in earlier periods, the average for the OECD embraces some diversity of experience but there is further evidence of differences in relative inflation rates between Europe an North America being eroded. Inflation in North America at 3.8% is higher than the rate of 3.3% in the third quarter but remains below the fourth quarter averages of 5.6% and 4.1% for OECD Europe and the EEC respectively.

These latter rates are, however, lower than in the third quarter. Within Europe inflation rates fell from 1.8% to 1.3% for West Germany and from 4.9% to 4.2% for France, but remained unchanged for the UK at 5.5%. With the effects of lower oil prices working through the system West Germany's annualised inflation rate fell by February 1986 to 0.7%, the lowest rate for almost twenty years. Like West Germany, a number of other European countries such as Austria, Denmark, the Netherlands and Switzerland had lower inflation rates than the US. The European average is raised, however, by continuing high inflation rates in several smaller countries. Portugal, Greece, Iceland and Turkey, for example, recorded annualised fourth quarter rates of 16.3%, 25.0%, 35.9% and 42.5% respectively. With the yen's appreciation reinforcing the impact on import costs of lower oil prices, Japan's inflation rate fell to 1.4% from 1.8% in the third quarter and remains lower than in any OECD country other than West Germany.

PROGNOSIS

Recent months have seen a considerable change in attitudes towards economic policy. Heralded by the G-5 Plaza meeting and the Baker Plan, there has been an accelerating shift towards the viewpoint that governments should take a more active role in influencing macroeconomic developments. The most obvious sign of this retreat from reliance on market forces is the increasing pressure on Japan and also West Germany to expand domestic demand. Now that inflation rates have been reduced in the major OECD countries and the US economy has continued to decelerate, emphasis is shifting towards recognition of the need for more direct pursuit of the objective of economic growth.

The outcome of the G-5 Plaza meeting was agreement on an attempt to engineer a "soft-landing" of the US dollar. Although the dollar has depreciated since then, as a consequence of reductions in US interest rates and slowing US growth, the issue of the dollar's exchange rates against other currencies particularly the yen, and the inter-related problems of the US current account and budget deficits remain at the centre of the major imbalances in the world economy. With the Japanese Government increasingly worried about the extent of the yen's appreciation against the dollar and the J-curve phenomenon, resolution of the problem of the US visible trade deficit remains some distance off.

The US current account deficit also reflects the position of the US as the world's major importer of capital. This element is inextricably linked with the US budget deficit, a problem which the Gramm-Rudman-Hollins Act will help resolve over the next few years. If adjustment to deal with the imbalances in the world economy is dependent on developments in the US alone, however, the prospects are not bright. Dollar appreciation brings with it domestic inflationary pressures in the US which will offset, at least partially, real exchange rate adjustment. Moreover, against the background of such inflationary pressure, attempts to reduce the budget deficit in the absence of an increase in the US savings ratio will most probably require higher interest rates. More generally, without expansionary initiatives elsewhere resolution of the US twin deficit problem may require lower levels of domestic absorption in the US.

The current pressure for macroeconomic measures to promote growth and to free trade, especially in Japan, is a product of the need to divert surplus savings to domestic investment and to offset the impact of slowing US growth and dollar depreciation on levels of international trade. In response to that pressure the May 1986 Economic Summit of the Group of Five plus Italy and Canada agreed in principle on a number of matters including: more frequent consultation on policy; examination of the compatability of individual country's national macroeconomic objectives at least once each year; and the need to counteract protectionist sentiments and to reduce barriers to trade.

Agreement on these matters was clouded, however, by reservations on the part of Japan and West Germany. Those reservations, against the background of the widespread policy restraint of the recent past, did little to dispel uncertainties in foreign exchange markets and almost immediately the dollar fell to its lowest-ever level against the yen. Without a strong commitment from Japan and West Germany efforts to resolve the imbalances in the world economy through policy co-ordination are of only limited consequence.