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## Perspectives for the world economy in 1988/89

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# Perspectives for the World Economy in 1988/89

**W**orld economic activity continued to be marked by a clearly upward trend during the first six months of the year. Demand and production increased substantially in both the USA and Japan as well as in most Western European economies. Contrary to general expectations, the expansionary forces which had asserted themselves in the middle of last year were only slightly subdued by the turbulences on international financial markets last autumn. By far the greatest increase in domestic demand was in Japan; however, in Western Europe, too, it increased at a faster pace than in the USA. These differences in demand on the one hand, and the exchange rate induced gain of market shares by American suppliers on the other, resulted in shifts in real international trade flows which stimulated the increase in production in the USA, but had a retardant effect in Japan and Western Europe. Hence the external economic adjustment to the drastic decline in the dollar exchange rate during the last three years made considerable headway. Last year this process was still concealed by counteracting changes in the terms of trade; now it is also reflected in the balances of trade. The balances on current account of the major surplus and deficit countries, however, are still very high.

Whereas, therefore, external economic instability continues – a fact which the latest strengthening of the dollar exchange rate should not disguise – the upward economic trend in industrialised countries has so far been largely free of friction in its sixth year. In many cases, however, the utilisation of productive capacities is now approaching the last peak level recorded at the end of the seventies. Especially in the USA and in Japan there has been a substantial increase in employment, resulting in a decrease in unemployment; in most Western European economies, on the other hand,

unemployment remained consistently high. Wages and prices generally continued to increase at an only moderate pace; the year-on-year increase in private consumer prices in the industrialised countries during recent months averaged about 3%. The reduction in the price of oil had a stabilising influence. The prices of many other raw materials, on the other hand, again increased due to the improved market position of the suppliers resulting from the continuing upswing in worldwide economic activity.

The strength of the expansionary forces since the middle of last year is probably due to a substantial degree to the stimuli which had been emanating for several years from an expansionary monetary policy in major industrialised countries, especially since the emergence of inflationary expectations was counteracted by the slump in oil prices in 1986. For stabilisation reasons, however, the US central bank adopted a moderate course in 1987. The fear that an increased utilisation of production potential could increase inflationary expectations will probably lead to a tightening of monetary policy reins there in future; the monetary room for manoeuvre will probably remain limited right into the coming year. Together with the tendency towards external economic improvements this policy will support the dollar exchange rate. The central banks of the surplus countries will all the sooner see scope for curbing monetary expansion, which has so far clearly exceeded the pace consonant with stability. Under these circumstances slight interest rate increases are to be expected.

The fiscal policy of the major industrialised countries has already primarily been geared towards the improvement of growth conditions via tax reforms and a

reduction of government demands on economic resources since the first half of the eighties. This process, however, has been progressing only hesitantly, resulting in changing short-term influences on income and demand. Following an almost cyclically neutral fiscal policy course during the run-up period to this year's elections, the USA can be expected to make a renewed attempt to consolidate next year. The tax increases announced for 1989 in the Federal Republic of Germany would even indicate a temporarily restrictive fiscal policy. Apparently, the majority of the other European economies are also primarily interested in reducing government budget deficits. In view of its marked economic growth there will probably also in 1989 be no significant overall financing deficit in Japan, even though the announced tax reform is likely to bring about noticeable tax relief.

Given such an economic policy setting, there will probably be an on the whole rather restrained increase in domestic demand in the USA. Retardant influences are likely to emanate from stockpiling behaviour and declining housing construction investments. Stimulated *inter alia* by the improvement in the international competitive position, investments in fixed assets, on the other hand, will probably continue to increase markedly. In the short term, however, the development of private consumption is one of the main determinant factors. A great deal would suggest that the propensity to save will remain at a much higher level than before the stockmarket crash and that consumption, in line with real incomes, will increase at a moderate pace. At the same time there will be a slight abatement of the external economic stimuli; exports will no longer increase as rapidly as they have done so far due to the less rapid expansion of demand in major importing countries. All in all, overall demand will probably increase much more slowly than it did up until spring

1988. On an annual average for 1988 real GNP will be between 3 and 3½ % higher than in the previous year. Inflation will probably accelerate slightly. With the basic economic trend remaining more or less unchanged a production increase of roughly 2 % seems likely in 1989.

The external adjustment processes will continue to exert a retardant influence in Japan and in Western Europe, since market shares – albeit to a declining degree – are still being lost to suppliers from the dollar area following the exchange rate induced deterioration in competitive strength at home and abroad.

Furthermore, as the economic policy programme runs out in Japan government investment there will more or less stagnate and housing construction will even decrease for a while. Despite a continuingly pronounced expansion of business investment in plant and equipment and a rapid increase in private consumption the cyclical expansion of overall demand, therefore, will slow down appreciably. Nevertheless, real GNP in Japan in 1988 will, with a substantial overhang, be easily 5 % higher than in the previous year. A markedly lower rate of increase, however, seems likely in 1989. In the Western European economies, too, the economic upswing will be less dynamic than it was between mid-1987 and spring 1988. Above all, the increase in private consumption will probably slow down, especially since a renewed decline in the propensity to save cannot be expected. Business investments, on the other hand, can generally be expected to increase initially at a relatively fast pace. Taking into account continuingly retardant external influences the combined real GNP in Western Europe will probably increase by well over 2½ % in 1988 and by slightly less in 1989.

All in all, the rate of increase of the real GNP of the industrialised countries will probably fall from well over 3 % in 1988 to between 2 and 2½ % in 1989. Admittedly,

### National Product and Prices

(Year-on-year change in %)

	Real Gross National Product				Domestic Demand				Consumer Prices			
	1986	1987	1988 <sup>a</sup>	1989 <sup>a</sup>	1986	1987	1988 <sup>a</sup>	1989 <sup>a</sup>	1986	1987	1988 <sup>a</sup>	1989 <sup>a</sup>
Western Europe <sup>1</sup>	2.5	2.7	2.6	2.0	4.0	3.5	3.5	2.5	2.9	2.9	3.0	3.8
USA	2.9	2.9	3.2	2.0	3.9	2.5	2.5	1.5	1.9	3.7	4.0	5.5
Japan	2.4	4.2	5.2	3.5	4.0	5.1	6.0	4.0	0.6	0.1	0.5	1.5
Industrialised countries total <sup>1</sup>	2.7	3.0	3.3	2.2	3.9	3.4	3.4	2.3	2.2	2.9	3.2	4.2

<sup>1</sup> Weighted by gross national product or domestic demand or private consumption respectively in 1982.

<sup>a</sup> Forecast.

Sources: OECD, national statistics and own forecasts.

economic forecasts are currently marked by particular uncertainty, since there is an unusually large degree of overlapping between the effects of longer-term efforts to improve growth conditions, trenchant external adjustment processes and short-term economic policy effects on demand. However, a great deal would indicate that the upward trend will now generally

continue once again at a more modest pace. Bearing in mind the relatively high utilisation of capacities this would reduce the risk of a marked acceleration of inflation, which would trigger restrictive measures. As against that, the latest stability signals by major central banks are merely aimed at preventing excesses and thus securing the continued economic upswing.

## More Rapid Expansion of World Trade

The marked increase in demand and production in the industrialised countries since the middle of last year also gave world trade a substantial boost. Its estimated average rate of increase of roughly 10 % in real terms on an annualised basis for the second half of 1987 was twice as high as the average increase for 1987 as a whole. The uptrend appears to have continued in early 1988. At the moment, however, it is difficult to reliably measure its momentum, especially since the statistical data on the foreign trade of the EC countries – which account for over two fifths of world trade turnover – are distorted by changes in the data-collecting methods.

The effects of cyclical factors on international trade flows intermingled with the effects of the shift in competitive positions induced by exchange rates. In the first quarter of 1988 real merchandise imports in the USA were only 6 to 7 % higher than one year previously despite the pronounced upswing. The corresponding increase in Japan was 20 % and – taking into

consideration the afore-mentioned statistical uncertainties – averaged probably about 10 % in the Western European economies. On the other hand, merchandise exports in the USA increased at the same time by over 25 %, but only by 2 % in Japan; the increase in Western Europe can be estimated at approximately 7 %. These rates of increase for a very limited period are undoubtedly influenced by chance factors. Nevertheless, the varying developments of imports and exports do reflect the processes of adjustment in the industrialised countries, caused above all by the drastic changes in exchange rates since spring 1985.

Altogether, the Yen appreciated by roughly 100 % against the dollar, and the European currencies – measured in terms of ECU – by roughly 80 %, within the three years up until the first quarter of 1988. This meant that the dollar exchange rates were even lower than at the beginning of the eighties, before its revaluation phase. The far-reaching shifts in exchange rate

The Development of World Trade

	1980-84 <sup>a</sup>	1985	1986	1987 <sup>b</sup>	1988 <sup>c</sup>	1989 <sup>c</sup>
World trade in US \$ billion <sup>1</sup>	x	1845	2010	2350	2650	2850
Growth over previous year, in %						
Value	3	1	9	17	13	7
Price level <sup>2</sup>	1	-2	4	11	7	3
Volume <sup>3</sup>	2	3	4	5	6	4
of which:						
Industrial products <sup>4</sup>	4	5	2	5	6	4
Imports by country groups <sup>3</sup>						
Industrialised countries	3	5	8	6	7	4
Oil-exporting countries	2	-12	-20	-12	0	0
Other developing countries <sup>5</sup>	2	3	1	7	10	7

<sup>a</sup> Annual average. <sup>b</sup> Partly estimated. <sup>c</sup> Forecast. <sup>1</sup> Average exports/imports, excl. trade between state-trading countries. <sup>2</sup> Average values on a dollar basis. <sup>3</sup> Value adjusted for changes in prices and exchange rates. <sup>4</sup> Only exports of industrialised countries. <sup>5</sup> Incl. newly industrialising countries.

Sources: Calculated from IMF and UN data; own estimates.