WEP FORECAST

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MELLISS TO CX 23 JUN

FROM: C MELLISS (IF2)
DATE: 23 June 1989
X4700

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Thanks

WORLD ECONOMIC PROSPECTS : JUNE 1989

1. I attach a report on the latest WEP exercise, with a summary on the first page. It provides the world economic background to the forecast report circulated by Mr Sedgwick. Attached to the report is an annex on prospects for the German economy.

2. UK figures will be excluded from any version of the forecast shown to outside departments.

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WORLD ECONOMIC PROSPECTS: JUNE 1989

1. The forecast is summarized in table 1. A comparison with the FSBR and outside forecasts is given in table 2. The main features are:-

(i) Activity now appears to have weakened in the US and Canada, but continues to grow strongly in other major countries, especially Japan and Germany. The forecast is for growth this year of 3¼ per cent, about the rate of growth of productive potential.

(ii) A further tightening of monetary policy is assumed in Continental Europe and Japan later this year.

(iii) Commodity prices were quite strong at the beginning of the year, but have weakened recently. Oil prices are expected to weaken at the beginning of next year: other commodity prices are assumed to remain constant in real terms at about current levels.

(iv) Some special factors have contributed to the rise in consumer price inflation in G7 countries this year. A peak of 4½ per cent is expected in the second half of this year, before the effects of tighter monetary policy and the unwinding of the special factors allow inflation to fall back to about 3¾ per cent in 1990 and 1991.

(v) World trade in manufactures is expected to slow gradually through the forecast period. The period 1986 to 1991 would on the basis of our forecast represent the fastest period of world trade growth since the 1960s.

(vi) The rise in the dollar has eroded only a small proportion of the competitiveness adjustment of the last two years. Nevertheless it contributes to a widening of the surplus and deficits in 1990 and 1991. In 1989 it contributes to a reduction in the US deficit via the terms of trade effect.

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Table 1: Output, Inflation and Trade

Percentage change on year earlier	1987	1988	1989 partly forecast	1990 forecast	1991
Major 7 real GNP	3.4	4.2	3¼	2¾	2¾
Major 7 real domestic demand	3.6	4.4	3¼	2¾	3
Major 7 industrial production	3.3	6.0	4¼	2¾	3
Major 7 consumer prices	2.7	3.1	4½	4	3¾
World trade					
- total	7.2	9.6	7½	5½	5
- manufactures	8.0	10.5	8½	6½	5½

Table 2: Comparison of World Forecasts

		FSBR March	WEP June	IMF WEO April	OECD Economic Outlook June
Major 7 real GNP	1988	4.2	4.2	4.2	4.2
	1989	3	3¼	3½	3¼
	1990	2½	2¾	3	2¾
Major 7 real domestic demand	1988	4.4	4.4	4.4	4.6
	1989	3¼	3¼	3½	3½
	1990	2½	2¾	3¼	2¾
World trade - total	1988	8.4	9.6	9.3	8.7
	1989	6	7½	5¾	7½
	1990	5	5½	6	7
World trade in manufactures	1988	10.0	10.5	n.a	10.1
	1989	8	8½	n.a	8
	1990	6	6½	n.a	7½
Major 7 consumer prices	1988	3.2	3.1	3.1	2.9*
	1989	4¼	4½	3¾	4
	1990	3½	4	3½	4¼

* Consumers Expenditure Deflator

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RECENT DEVELOPMENTS

2. National Accounts data for 1989Q1 are now provisionally available for the US, Japan, Germany, France and Canada[1]. Industrial production data are also available. These data suggest that there has been a gradual slowing of activity in the US and, particularly, Canada. Elsewhere growth continues to be strong with only a very slight and probably insignificant deceleration in activity being apparent in France. In Germany and Japan growth may have accelerated compared with the final quarter of 1988.

3. Adjustment in the personal sector is the main factor behind the slowdown in the US. The savings ratio rose sharply in the first quarter to 5.8 per cent, its highest level since early 1985. Housing investment and starts both fell significantly. As in other G7 countries business investment and exports continued to grow strongly. In Germany GNP is provisionally estimated to have been over 4 per cent up on a year earlier in Q1. This compares with a growth of about 3 per cent in 1988H2. The acceleration appears to be due to exports and investment and an extremely mild winter. Growth of private consumption remained subdued. (An annex is available giving fuller details of recent developments and prospects in Germany.)

4. Indicators of capacity utilization - derived from business surveys - show utilization rates that are at least as high as those which occurred at the last cyclical peak in 1979-80 (chart 1). Latest figures show new orders and investment intentions at high levels: investment intentions are even stronger than they were a year ago.

FORECAST ASSUMPTIONS

Monetary Policy

5. The profile of interest rates assumed in the forecast shows

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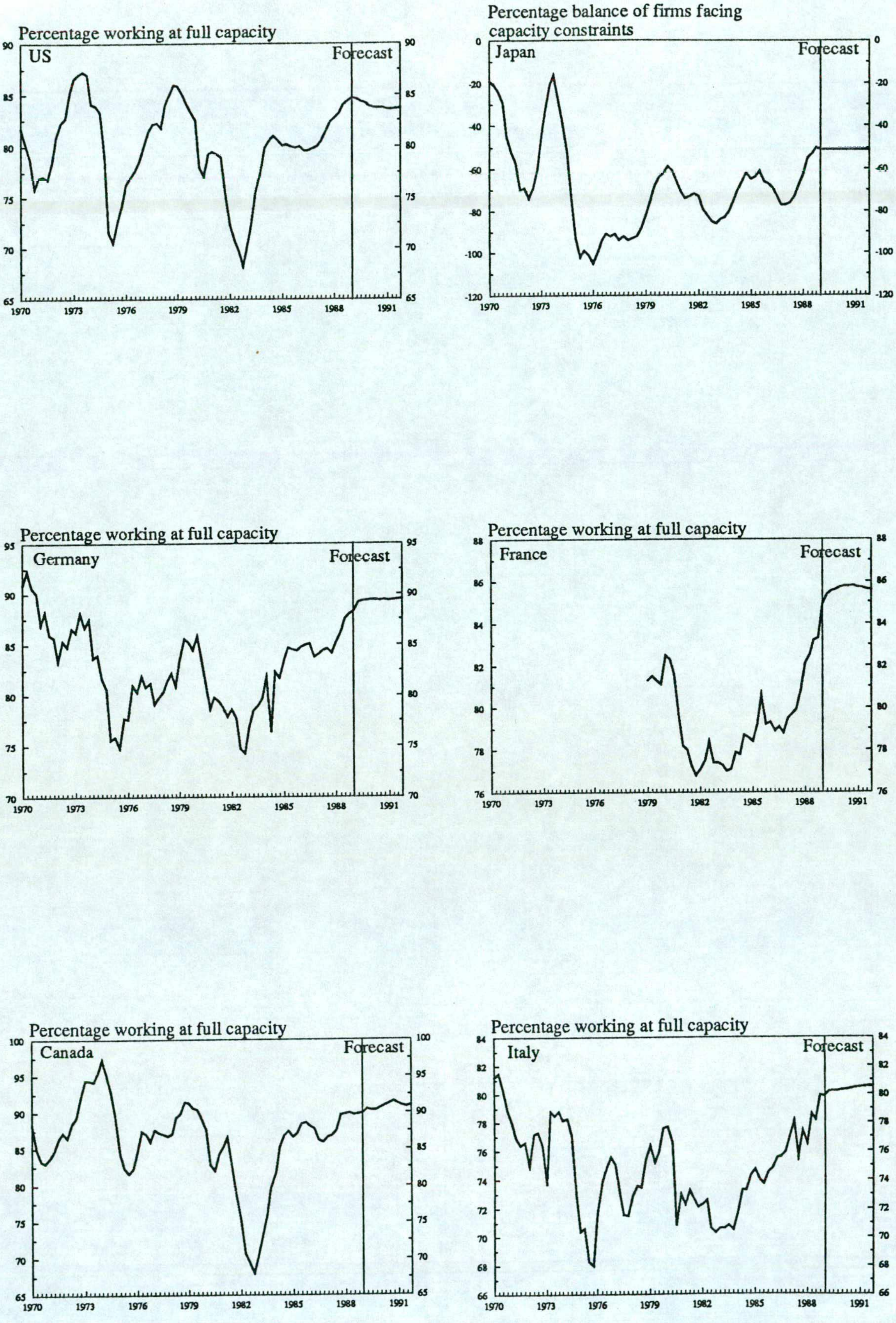
(1) Only the data for US and Germany were available before this forecast was finalized.

Chart 1 : Capacity Utilisation



short term rates in the US reaching a peak of 10 per cent in the first quarter of 1989. The slowing of growth and the strength of the dollar are assumed to allow the Fed to ease interest rates further towards the end of the year. US interest rates are assumed to fall to 8¾ per cent at the beginning of 1990. In Continental Europe interest rates have risen since the beginning of the year, by between ½ and 2½ percentage points. In Japan they have risen by ¾ percentage point. There are no signs of growth or inflation abating in these economies. Two further rises in short interest rates each of ½ per cent are therefore assumed to take place in Continental Europe at the beginning of Q3 and Q4. In Japan a single further rise of ½ per cent is assumed at the beginning of Q3.

6. By the end of this year we expect that there will be preliminary indications that growth has slowed in the majority of countries and that inflation has stopped accelerating. A small reduction in interest rates is therefore assumed to take place in 1990Q1. These assumptions, and the implied real interest rates, are set out in table 3 and chart 2. Real interest rates peak in 1990 at 5.2 per cent, only ¾ percentage point above the average for 1984 to 1988. Long rates have remained stable since the beginning of this year there has been a small reverse yield gap.

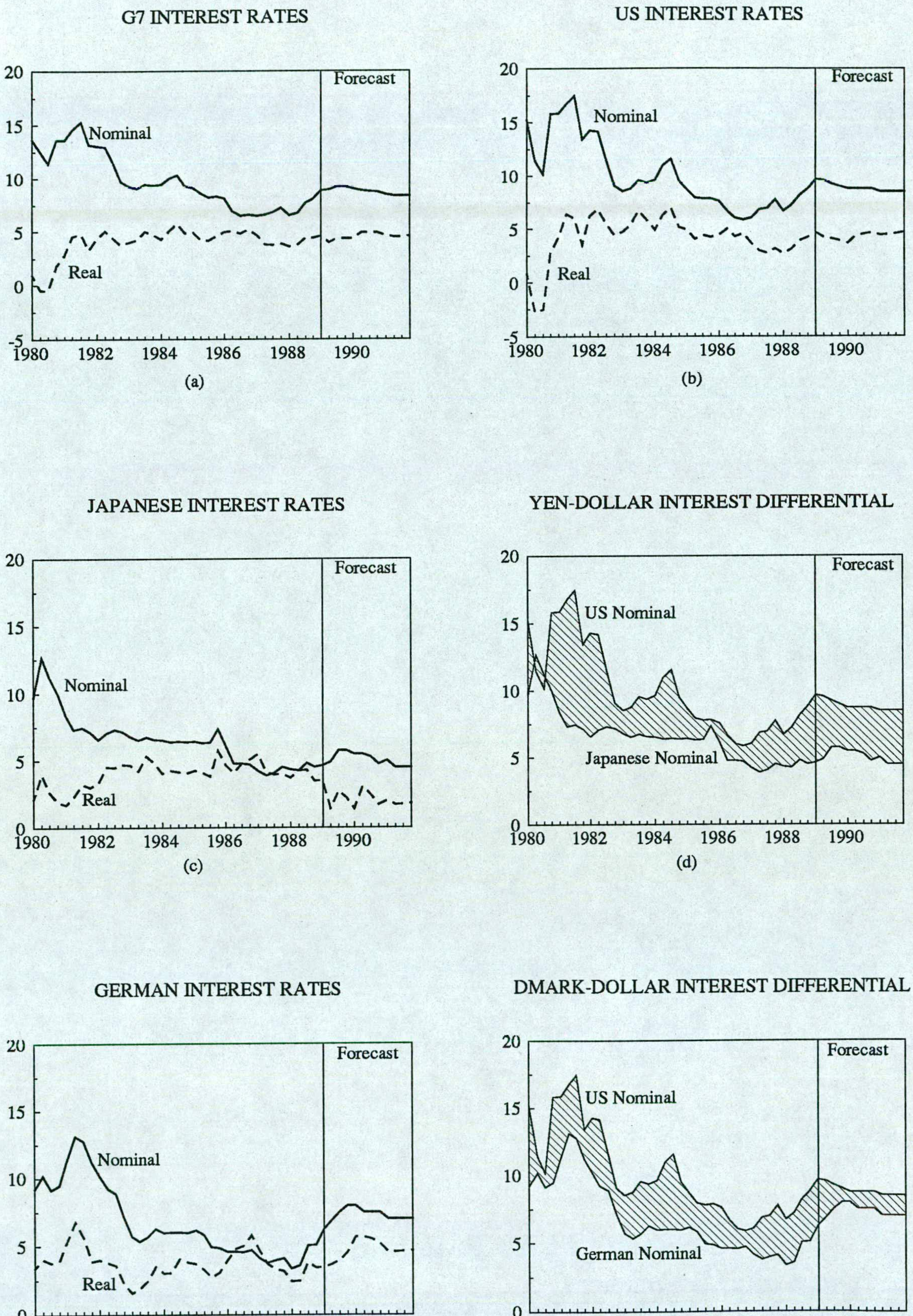
Table 3: Short term interest rates

	Nominal				**Real(*)**			
	1988	**1989**	**1990**	**1991**	**1988**	**1989**	**1990**	**1991**
US	7.7	9.4	8¾	8½	3.5	4.5	4.5	4.7
Japan	4.5	5.3	5¼	4½	4.5	3.1	2.7	2.1
Germany	4.3	7.2	7½	7	3.0	3.9	4.1	4.8
France	7.9	9.3	9½	9	5.2	5.8	6.6	5.9
Italy	11.2	12.9	13½	13½	6.4	6.8	7.7	7.3
Canada	9.5	12.0	11¼	10½	6.0	7.9	6.6	3.5**
G7	7.3	9.1	8.9	8.4	4.1	4.9	5.2	4.8

* Nominal Interest Rate deflated by CED.

** Influenced by rise in inflation due to the introduction of the General Sales Tax.

Chart 2 : Short Term Interest Rates



Exchange Rates

7. The strength of the dollar, largely unanticipated, has been a major new factor. Chart 3 shows that the dollar effective rate has risen by 12 per cent since the beginning of the year. The Yen has depreciated by 9 per cent and the Deutschemark has been virtually unchanged. There are indications that the terms of trade effects of these exchange rate changes are already being reflected in the current account balances.

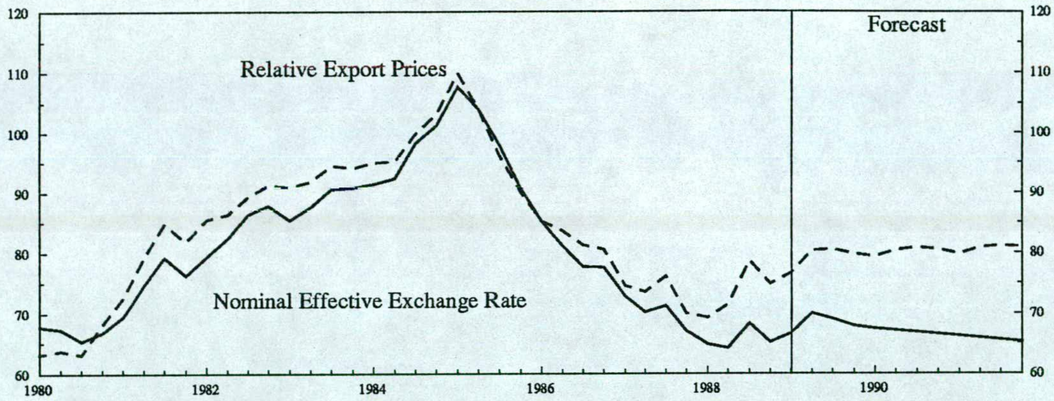
8. The forecast assumption is that real effective exchange rates are constant from the end of 1989 to the end of the forecast period. The recent dollar strength may in part be due to political uncertainty in the rest of the world and the dollar interest differential. As chart 2f shows, the dollar/DM interest differential has narrowed significantly since the beginning of the year, and a further narrowing to historically low levels is implied. The dollar/yen differential, chart 2d, remains large throughout the forecast period. Some reversal of the recent rise in the dollar would be consistent with the changes in interest differentials. The forecast therefore assumes a small dollar weakening in the second half of the year. The counterpart to this is a small yen appreciation, larger in nominal terms because of the low inflation rate in Japan. The Deutschemark is assumed to change little from recent levels. Chart 3 shows the implications of these assumptions for export price competitiveness. Only a relatively small part of the large changes in competitiveness that occurred between 1985 and 1987 is reversed this year. Nevertheless, the competitiveness position of Japan is about 10 per cent better than in the January WEP, and of Germany about 3 per cent better.

Fiscal Policy

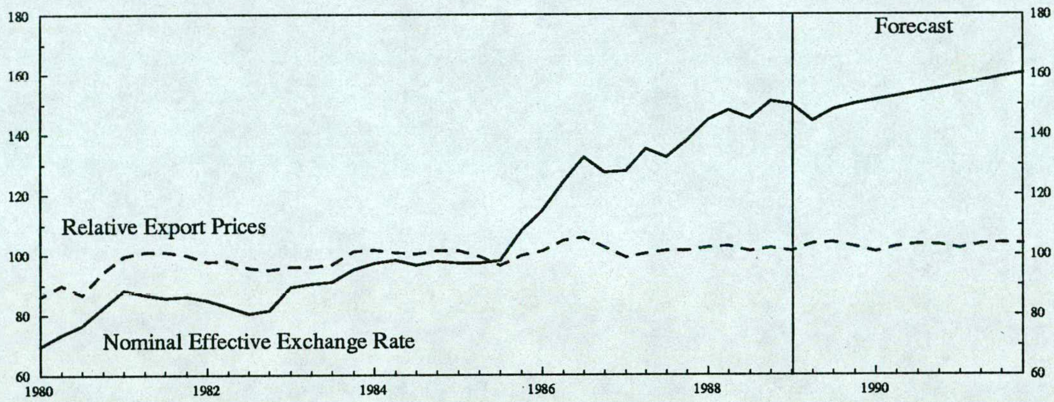
9. United States. With the FY1990 budget negotiations still underway the forecast assumptions on the US fiscal position are necessarily stylized. OMB's assessment of the prospective deficit will probably meet the Gramm-Rudman targets by a mixture of highly optimistic assumptions, accounting devices and with a minimum of

Chart 3 : Exchange Rates and Competitiveness

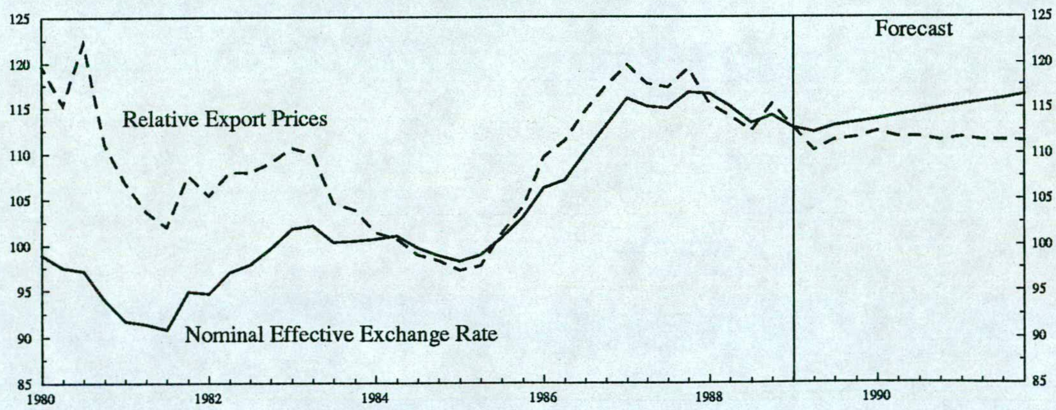
United States



Japan



German



actual cuts. Since the FSBR forecast there have been two main developments on the Budget front.

(a) Revenues have been running well ahead of expectations. This had led to the forecast deficit for FY1989 being revised down. This may also influence the Gramm-Rudman calculations, by enabling a higher forecast of revenue to be carried forward into 1990.

(b) Against this, recent reports indicate that the Administration may have less favourable assumptions on GNP and interest rates for use in the Gramm-Rudman calculations than had previously been thought.

10. The forecast is for a Federal deficit for FY1990 to be in the range of $130-150 bn, representing a fall compared with FY1989 equivalent to about ¼ per cent of GDP. The prospects for major action on the budget deficit are better in FY1991. The forecast assumes significant increases in taxes and further limited expenditure restraint.

Table 4: General Government Financial Balances

Per cent of GDP	**1988**	**1989**	**1990**	**1991**
United States	-2.0	-1.9	-1.5	-1.3
Japan	1.3	1.8	2.0	2.2
W. Germany	-2.0	-0.5	-1.2	-0.7
France	-1.6	-1.3	-1.2	-1.1
Italy	-10.2	-10.2	-10.2	-10.2
Canada	-3.1	-3.4	-3.5	-3.1
G7 (- UK)	-2.0	-1.6	-1.5	-1.3

11. Among other G7 countries, there is a tightening of the fiscal stance to a greater or lesser extent, and the general government deficit of G7 countries as a whole is expected to fall by about ¾ per cent of GDP between 1988 and 1991. Only in Italy is there no progress on fiscal consolidation over the forecast period. The general government accounts in <u>Japan</u> moved into surplus in 1987/

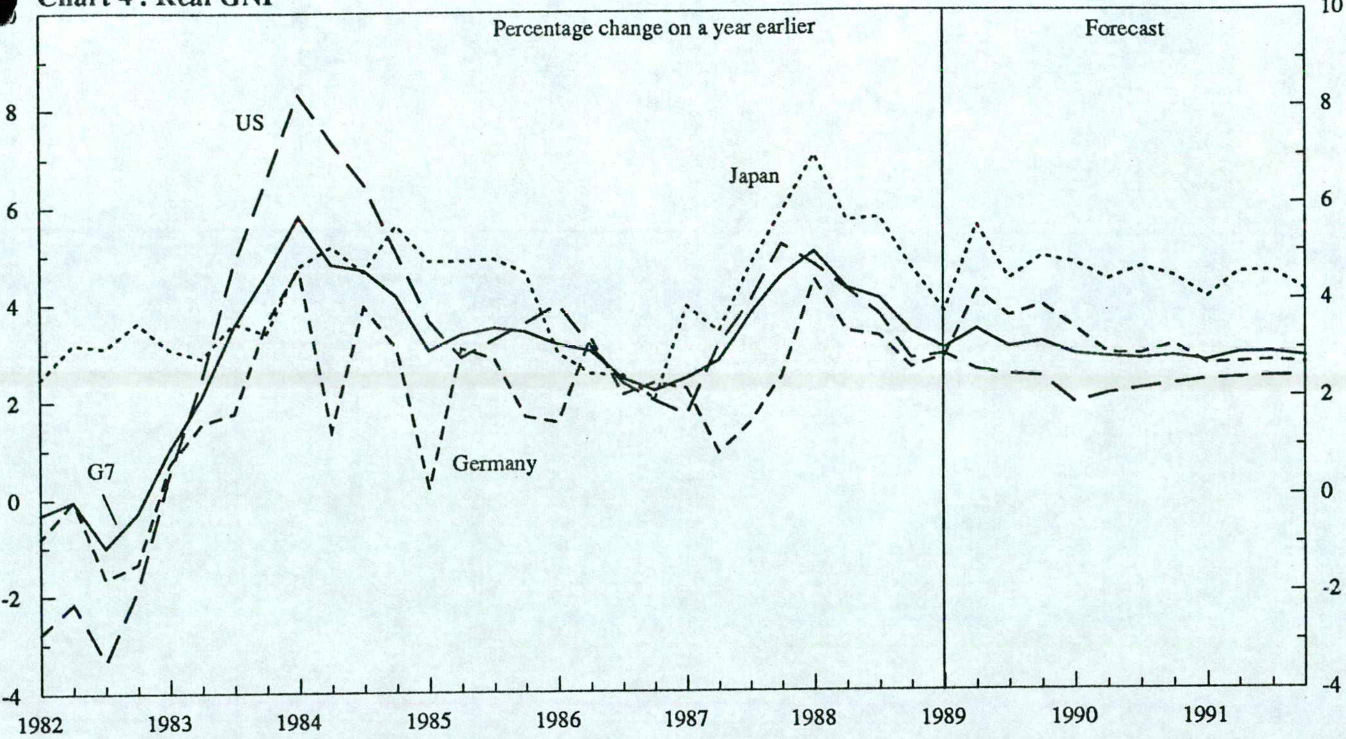
88. The rise in the surplus shown in both 1989/90 and 1990/91 is the result of an assumed tight restraint on both current expenditure and net lending at a time when revenues continue to expand with economic activity. A tax reform package introduced in April involves the introduction of value added tax, and reduction in income, inheritance, and corporation tax rates. It is expected to reduce net revenues in a full year by about ½ per cent of GDP.

12. In Germany the Federal budget deficit is expected to decline this year by about DM 8 billion, almost ½ per cent of GDP, mainly as a result of a rise in expenditure taxes associated with the three stage fiscal reform package. In 1990 the Federal deficit is expected to widen by about DM 20 billion (¾ per cent of GDP) as a further stage of the medium term fiscal strategy, involving reductions in direct tax rates, takes effect.

ECONOMIC ACTIVITY IN MAJOR COUNTRIES

13. For the major countries as a whole only a slight easing of growth is expected to occur during this year compared with 1988Q4. But the slowdown is concentrated in the US, Canada and the UK. In Germany and Japan GNP growth is expected to remain at or above recent rates for the remainder of 1989. In 1990 GDP growth in the G7 countries continues at only a slightly lower rate, mainly as a result of further slowing in the US and a reduction in growth in Germany as the effects of tighter monetary policy bite and the pace of growth of investment slackens. Thus the pattern of a high degree of synchronization of the cycle which has prevailed since the beginning of 1986 is expected to diminish (see chart 4 and table 5). In 1991 growth is expected to continue little changed at around the rate of growth of productive potential.

Chart 4 : Real GNP



14. Industrial production in G7 countries grew by almost 5 per cent in Q1, a little slower than the 6 per cent growth in 1988. The forecast is for a further deceleration to the beginning of next year, when growth is forecast to stabilize at about 3 per cent, about the same as GNP growth. As chart 5 shows, previous slowdowns have seen industrial production growth dip below that of GNP, but this is not now expected to occur, mainly because of the relatively strong performance of investment and exports.

Chart 5 : Real GNP and Industrial Production

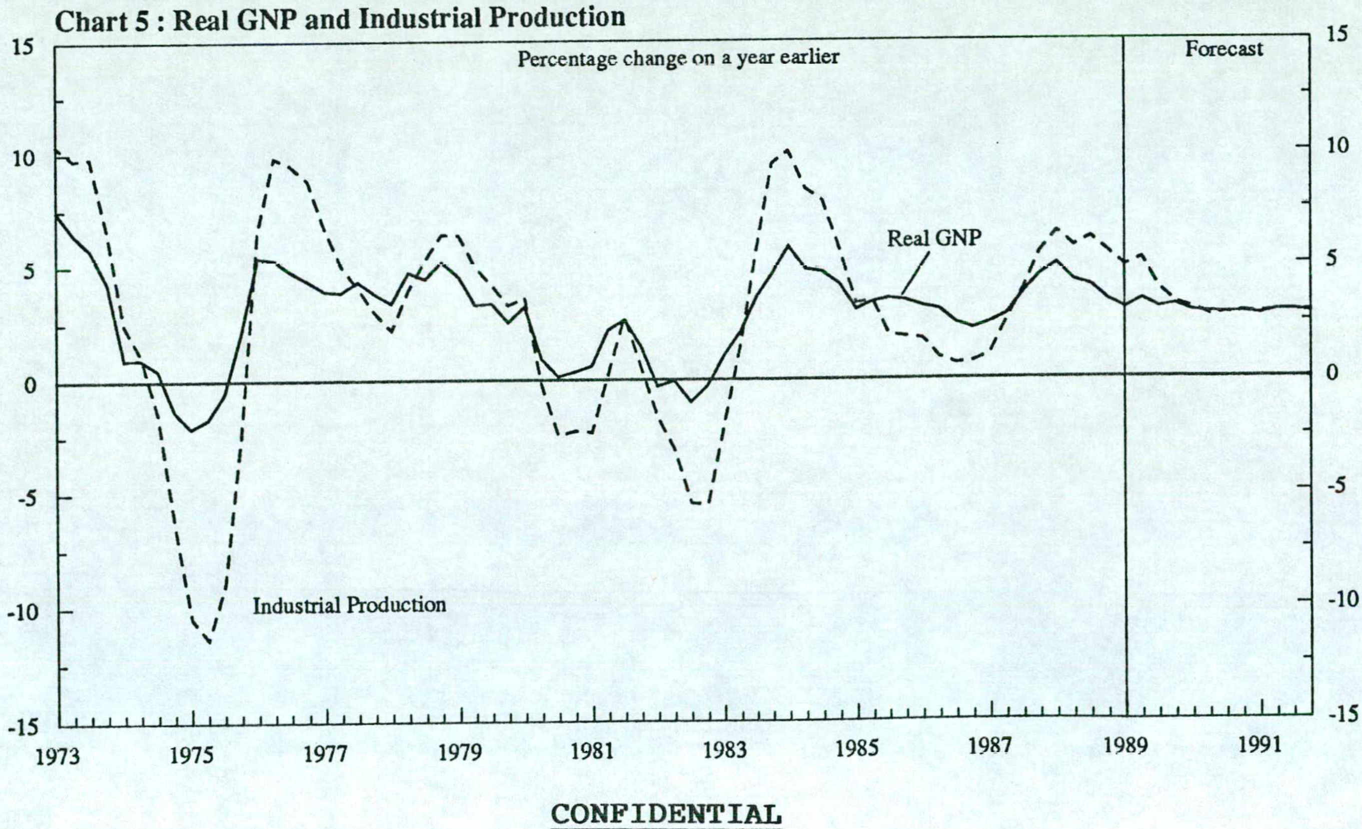


Table 5: Growth of Real GDP and Domestic Demand

Percent change on year earlier

	Average 1983-88	**1988**	**1989**	**1990**	**1991**	**Estimates of productive potential***
GDP						
US	4.1	3.9	2.6	2.1	2.4	2½-3
Japan	4.5	5.8	4.7	4.6	4.3	3¾-4½
Germany	2.5	3.4	3.7	3.1	2.7	2 -2½
France	2.2	3.4	2.8	2.6	2.5	2¼-2¾
Italy	3.2	3.8	3.6	3.4	3.3	2½-3
Canada	4.5	4.5	2.7	2.9	2.1	2¾-3½
UK	3.5	4.4	2.2	2.5	2.7	2½-3
Major 7	3.7	4.2	3.2	2.8	2.8	
Domestic Demand						
US	4.4	3.0	2.5	2.4	2.8	
Japan	4.9	8.1	5.3	4.7	4.5	
Germany	2.6	3.5	2.7	3.0	2.8	
France	2.7	3.6	2.8	2.3	2.4	
Italy	3.8	3.9	3.7	3.2	3.0	
Canada	5.0	5.6	3.4	2.9	1.1	
UK	4.3	6.4	3.0	1.6	2.2	
Major 7	4.1	4.4	3.2	2.8	2.9	

* Derived from OECD and IMF estimates.

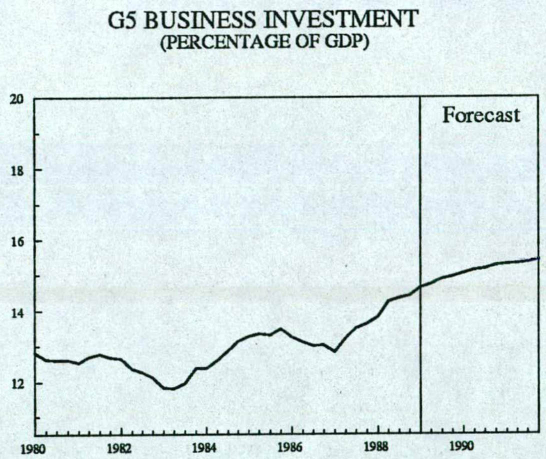
15. Over the forecast period the growth of business investment slackens from the very fast pace seen last year (table 6 and chart 6). Forecast growth over the period 1987 to 1991 would represent the largest expansion of investment since the 1960's. This is justified by continuing high capacity utilization (chart 1), the high levels of profitability that currently prevail, and current and prospective interest rates.

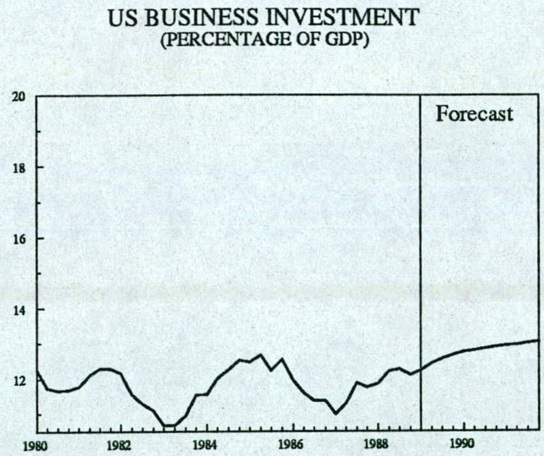
Table 6: Growth of Real Expenditure in G7

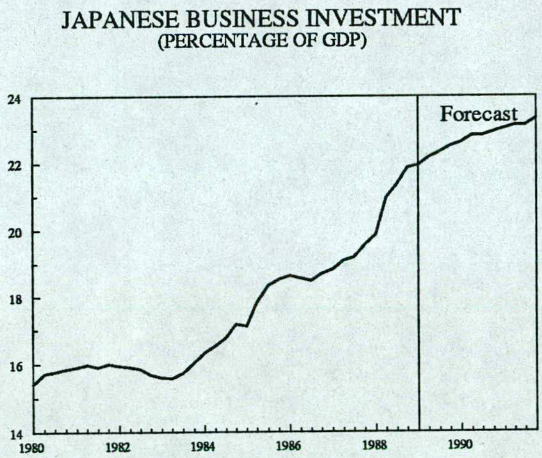
(Percentage change on a year earlier

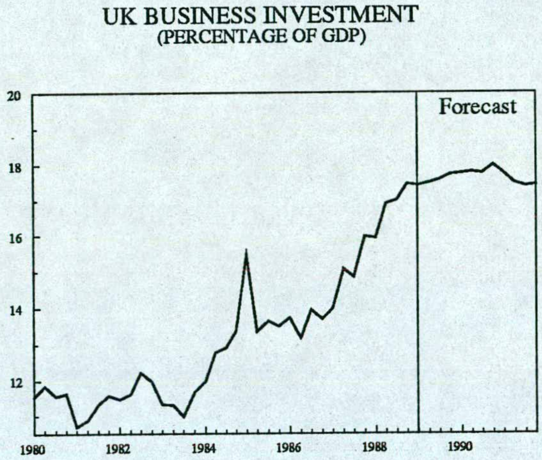
	Private Consumption	**Total Private Investment**	**Government**	**Domestic Demand**	**Exports**	**Imports**	**GNP**
1987	3.4	5.5	2.4	3.6	4.8	6.8	3.4
1988	3.7	9.3	1.3	4.4	9.8	10.0	4.2
1989	2.7	5.9	1.9	3.2	8.2	7.0	3.2
1990	2.8	4.2	1.2	2.8	5.2	5.0	2.8
1991	2.9	4.4	1.3	2.9	5.0	4.8	2.8

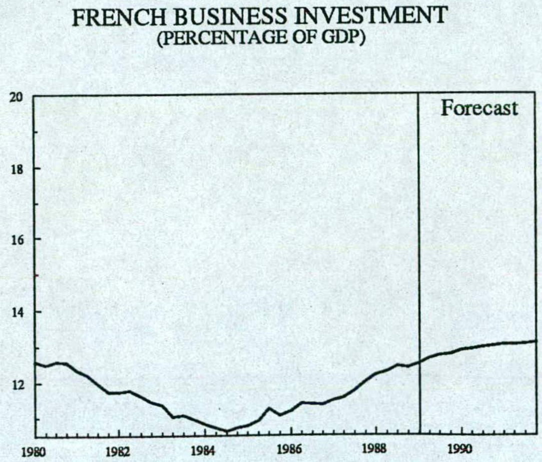
Chart 6 : Business Investment/Output Ratio





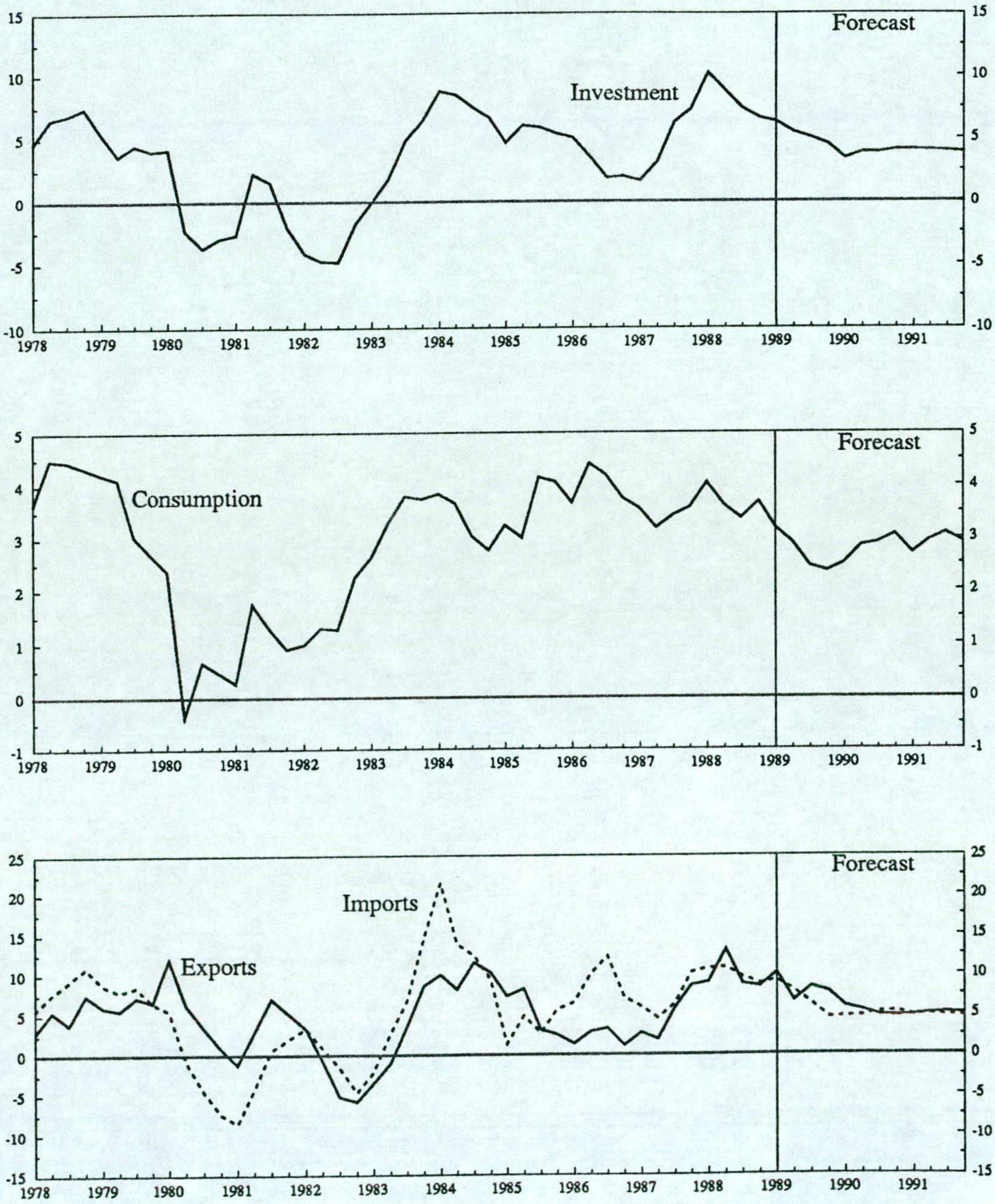






16. Consumers expenditure also slows, mainly because of the effects of the monetary tightening in the US and the effects of fiscal policy in Germany. Over the last two years the net trade balance of the G7 countries has made a negative contribution to growth equivalent to about ¼ per cent of GDP. From 1989 onwards the growth of major 7 exports is expected to be ½ to 1 per cent faster than imports. As explained below the main counterpart to this is the relatively fast growth of imports into non-oil developing countries, largely accounted for by the NIEs. Chart 7 shows the growth rates of the main components of GDP.

Chart 7 : Components of Major Seven Growth

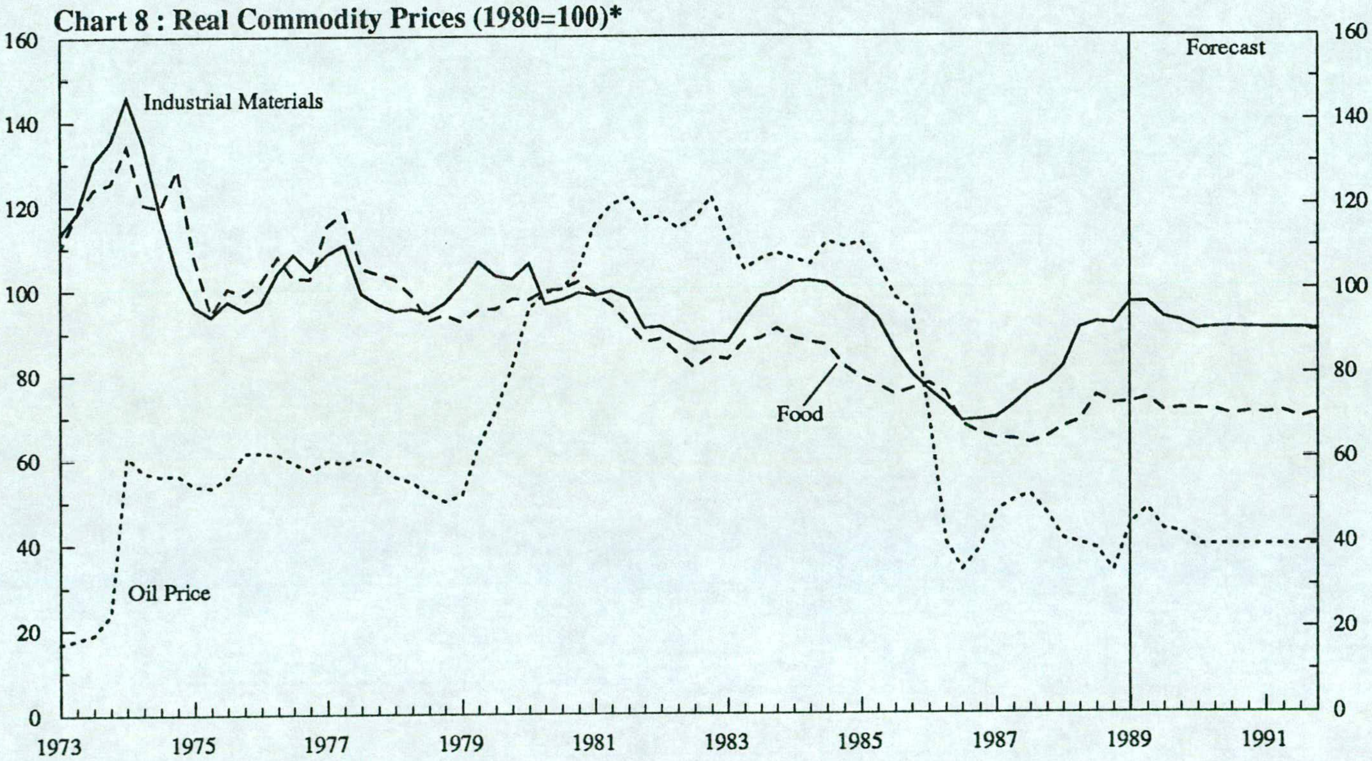


17. In accordance with the fiscal stance growth of government expenditure is expected to remain subdued in all major countries.

INFLATION

18. In the first quarter of the year the Economist all items index of non-oil commodity prices in SDRs showed some strength, being only a little below the peak levels reached in June and July of last year. Since then prices have fallen back a little, with metals being weak as a result of higher stock levels. Metal ores have showed the greatest volatility in recent months: food and non-food agricultural products have been relatively stable, despite the influence of the US drought. The forecast is for real non-oil commodity prices to change little from now on, remaining at or a little above average 1988 levels, see chart 8. This is consistent with the level of world demand.

Chart 8 : Real Commodity Prices (1980=100)*



* in relation to prices of manufactures

19. The forecast is for oil prices (average of Brent and Dubai) to average $16 per barrel in the second half of the year. This figure is slightly above the most recent level and may be compared with an average of $17.5 for 1989Q2 and a low of just over $10 during October-November 1988. Although the outcome of the recent

OPEC meeting - a quota increase of 1 mbd to 19.5 mbd with the likelihood of continued Kuwaiti and UAE cheating - had been widely expected, the confirmation of the lack of cohesion within the cartel led prices to drop by about \$1.5. Even before the meeting prices had been falling back from the high levels of the beginning of the quarter.

20. The forecast has a fall of \$1 per barrel in 1990Q1 and constant real prices thereafter. The fall is justified by two factors. First, tension within OPEC will be exacerbated by increased Iraqi potential production with the opening of a new pipeline to carry 1.5 mbd. Second, the forecast does not have a repetition of the exceptional demand growth at the turn of last year, only part of which can be attributed to special factors.

Table 7: The oil market

Million of Barrels per day	**1986**	**1987**	**1988**	**1989**	**1990**	**1991**
Total Demand	48.2	48.6	51.0	52.4	52.2	53.2
Supply Non-OPEC	28.7	29.3	29.7	30.6	30.0	30.2
OPEC*	19.5	19.3	21.2	21.8	22.2	23.0
Oil Price \$p.b	14.3	17.2	14.2	16.5	15.3	16.1

* includes c1.7 mbd of products outside quota definitions.

21. <u>Consumer Price Inflation</u> has picked up significantly since the beginning of the year in all major countries and is now, at 4½ per cent, about 1½ per cent higher than in the summer of last year. <u>Producer price inflation</u> is about 2½ per cent higher, with most of this increase occurring since the beginning of the year. Inflation rates in Germany and Japan have increased by more than the average. The upturn in inflation can partly be attributed to special factors such as the rise in indirect taxes effective in Q1 in Germany and Q2 in Japan, the rise in world oil prices and the weak Deutschemark and Yen. But the underlying strength of demand has probably also been an influence.

22. The special factors are expected to have their maximum impact on consumer prices during the remainder of this year. By the beginning of 1990 they will start to drop out of the annual rate of increase. The pressure of demand falls back slightly compared with current levels as tighter monetary policy bites. However some effects on wages are likely both from the high pressure of demand and from the effect on price expectations of the recent acceleration in inflation. Consumer price inflation is expected to reach a peak in G7 countries in 1989Q3 of 4¾ per cent. In 1990 it falls back to about 3¾ per cent, reaching a low point of about 3½ per cent in Q4. Table 8 shows the details for each country.

Table 8: Consumer Prices

Percentage change on year earlier	**1987**	**1988**	**1989**	**1990**	**1991**
US	3.7	4.1	5.0	4.3	3.8
Japan	-0.2	0.5	2.8	3.1	2.8
Germany	0.3	1.2	3.1	2.0	2.3
France	3.3	2.7	3.7	3.2	2.9
Italy	4.6	5.0	6.2	5.8	6.3
Canada	4.4	4.0	4.6	4.7	7.0
UK	4.1	4.9	7.5	6.0	5.0
Major 7	2.7	3.1	4.5	3.9	3.7

The greater effect of the monetary tightening on German inflation is a notable feature of the forecast, implying the re-emergence of the inflation differential between Germany and France after its recent narrowing. Also noteworthy is the fact that inflation in the US remains above the G7 average until the end of 1991.

23. There are no indications that the upsurge in inflation is being led from the <u>labour market</u> side. In the US the growth of employment has been erratic since the beginning of the year, but the average increase over the three months to May was 160,000, about half the average increase in the middle of last year. Productivity growth has slowed. Average earnings have increased by about ½ per cent since the middle of last year but earnings

inflation remains significantly below price inflation. Unit labour costs are now rising much more quickly, at about 5 per cent, than at the same period last year. This and the dollar appreciation suggest that profit margins are being squeezed, but not by earnings. Labour markets have also tightened slightly in Japan and Germany. In Germany unemployment fell by almost 1 percentage point in the six months to March and is now at its lowest level since 1982. As yet there appear to be few signs of a significant effect on earnings. In Japan this year's pay award is ¾ per cent higher than last year's. No recent data are available on earnings growth in Germany, although there was a noticeable acceleration in 1988Q4. The emerging picture is therefore one in which the pick up in wage inflation is muted given the low levels of unemployment.

WORLD TRADE

24. Latest estimates suggest that growth in 1987 and 1988 was somewhat more rapid than previously expected. The forecast suggests that the period 1987-1990 will see the strongest and most sustained period of growth in world trade since the 1960s. Although the growth of world trade has not, in any one year, exceeded that in 1984, the earlier year was neither preceded nor followed by a significant period of above trend growth.

Chart 9 : World Trade and G7 GNP

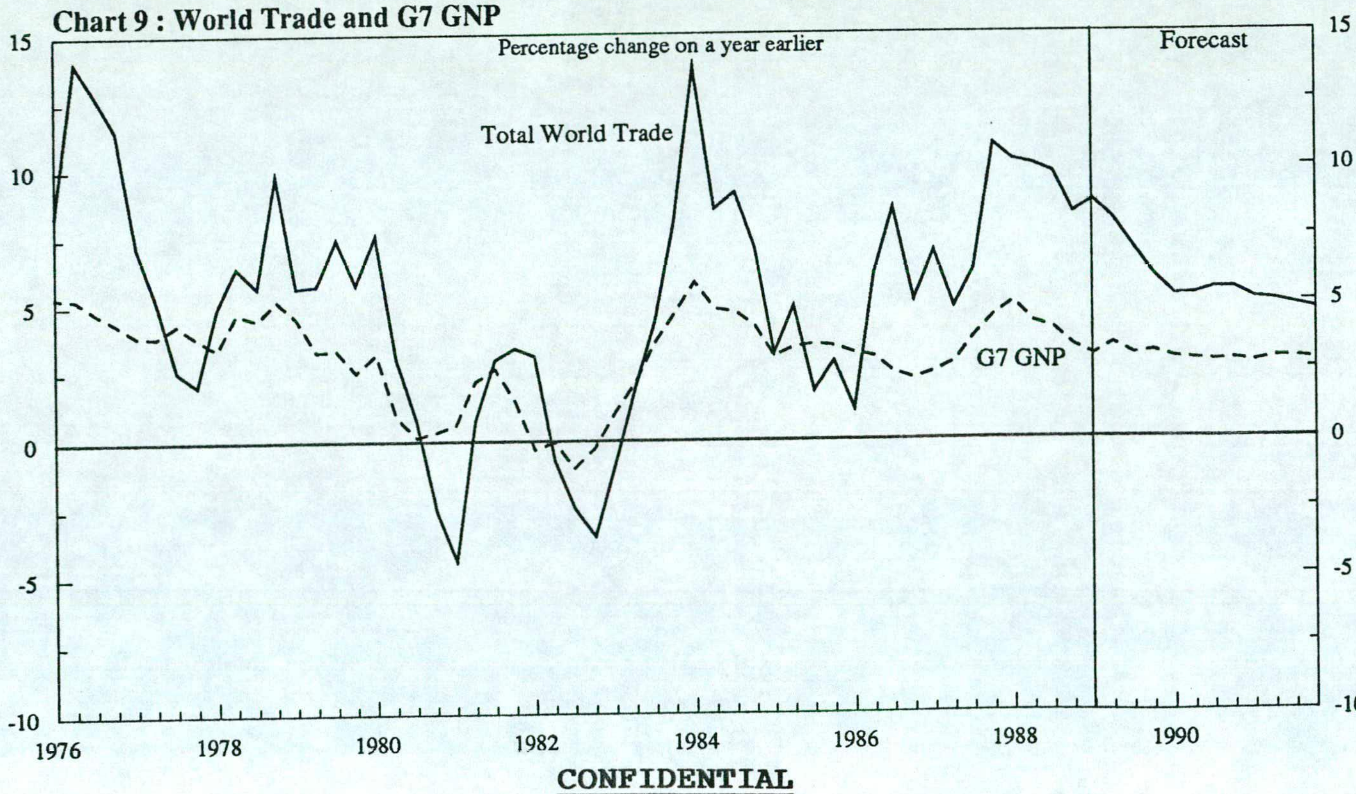


Table 9: World Import Growth

Percentage change on year earlier	**(Share of 1986 imports)**	**1987**	**1988**	**1989**	**1990**	**1991**
Total Developed Economies* of which	(70)	8¼	9	6¾	4¾	4½
US	(13)	5¼	7	6¾	6½	7
Japan	(7)	9	16½	8	5½	4¼
EC(6)**	(35)	7	8¾	6½	4	4
OPEC	(7)	-13½	-1¼	0	1	1
NIEs	(6)	25	23	17	14	11
Other NODCs	(11)	1	11	6	5	4
Total World Imports* **	**(100)**	**7**	**9¼**	**7¼**	**5¼**	**4¾**
World trade in Manufactures		8	10½	8½	6½	5½

* OECD plus South Africa

** Belgium, France, Germany, Italy, Netherlands and UK

*** Includes net imports by centrally planned economies.

25. The dominant factor behind the growth in world trade has been the rapid growth in GNP witnessed across the OECD. Chart 9 illustrates how world trade has grown relative to G7 GNP. It should be noted that the relationship between these variables will have shifted as a result of the emergence of the NIEs as a major force in world trade.

CURRENT BALANCES

26. The pattern of import and export volume growth by country in 1987 and 1988 was dominated by the effects of the fall in the dollar. Thus Japanese import volumes grew by 17 per cent in 1988, while US export volumes grew by 23 per cent. There are probably few further gains from the lagged competitiveness effects of this to come.

27. By the beginning of this year it had become clear that the process of reducing the surpluses and deficits in the US, Japan and Germany had slowed or stopped. But figures for March and April showed a lower trade surplus in Japan and the April figure showed a smaller deficit in the US. These recent figures partly reflect the effects of dollar strength and the associated terms of trade effect. This is the main reason why the US current account is forecast to fall in 1989, see table 10.

Table 10: External Balances and Trade Ratios

	1987	**1988**	**1989**	**1990**	**1991**
Current Balance ($bn)					
US	-154	-135	-121	-131	-153
Japan	87	80	74	84	92
Germany	45	48	52	62	69
NODCs	7	-4	-15	-28	-34
OPEC	-8	-21	-4	-17	-15
Current balance (% GNP)					
US	-3.4	-2.8	-2.3	-2.3	-2.6
Japan	3.7	2.8	2.5	2.5	2.5
Germany	4.0	4.0	4.4	4.8	4.9
UK	-0.7	-3.2	-3.2	-2.5	-1.8
Trade balance ($bn)					
US	-160	-127	-110	-119	-138
Japan	96	94	90	101	108
Germany	65	74	76	85	91
Trade Ratios (exports/imports, volumes 1980 prices)					
US	60	69	71	70	69
Japan	96	86	85	85	84
Germany	110	111	114	113	112

28. A small reduction in the current account surplus of Japan is also expected this year. A terms of trade effect - adverse in this case - contributes to this, but also imports continue to grow

faster than exports in volume terms, although the gap is much less than in 1988.

29. In the US and Japan the current account surplus and deficits are projected to remain about constant as a proportion of GDP in 1990, rising slightly in 1991.

30. In Germany the Deutschemark weakness over the last year has reversed about three-quarters of the real appreciation that took place between October 1985 and February 1987. Despite this, only a small adverse movement in the terms of trade is expected in 1989, and this is more than outweighed by the relative volume movements. The current account surplus is forecast to increase by about $4bn in 1989, almost ½ per cent of GDP, compared with 1988. Thereafter, partly as a result of the gain in competitiveness, the German current account surplus is expected to increase further, reaching almost 5 per cent of GDP in 1991. The counterpart to this is the increasing deficits expected elsewhere in Europe.

31. In 1988 the imports of the four Asian NIEs outstripped their exports and their trade surplus was reduced by about $4bn. This trend is liable to continue over the medium term in the face of further nominal exchange rate appreciation, wage inflation and rising domestic demand. Despite some improvement in the invisibles balance, due to increased IPD inflows, the current account is also expected to decline significantly.

Table 11: NIEs Trade and Current Account

Percentage change on year earlier	**1988**	**1989**	**1990**	**1991**
Export volumes	17	11	10	9
Import volumes	23	17	14	11
Terms of Trade	0	-1	0	0
Current Account $bn	29	21	15	11

32. The prospects for the 130 non-OPEC non-NIE developing countries are very mixed. Non-NIEs Asia is the region that has benefitted most from the recent strength of world demand, with

export growth above 10 per cent. At the same time other countries have been hit by weaknesses in certain agricultural prices and rising oil prices. Major debtors have also suffered from higher interest rates. In aggregate though, export growth should average about 6 per cent up to 1991, with import growth at similar levels.

Table 12: Non-Oil Developing Countries excluding NIEs

Percentage change on year earlier	**1988**	**1989**	**1990**	**1991**
Export volumes	11	6	5	4
Import volumes	11	8	6	4
Terms of Trade	0	-1	-1	-2
Current Balance $bn	-25	-36	-43	-45

IF2 Division
H M Treasury
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ANNEX

RECENT DEVELOPMENTS AND PROSPECTS IN THE GERMAN ECONOMY

Introduction

1. The performance of the German economy in the post-war period has often been described as an 'economic miracle'. In the 1980s, however, the performance of the economy has been poor both by comparison with previous years and other countries. Growth rates declined, investment fell and business confidence weakened. Inflation remained low. Since mid-1987, however, the German economy has shaken off the lethargy that had characterised its performance earlier in the 1980s. The current forecast envisages that Germany will enjoy a sustained period of strong growth with moderate inflation.

Table 1: Historical Comparisons

Average annual growth rates	**1960-1970**	**1970-1980**	**1980-1987**
REAL GNP			
Germany	4.5	2.7	1.4
Major Seven	5.3	3.2	2.6
EC Twelve	4.8	2.9	1.8
TOTAL INVESTMENT			
Germany	4.4	1.4	-0.2
Major Seven	6.6	2.4	2.4
EC Twelve	5.9	1.4	0.6
CONSUMERS EXPENDITURE DEFLATOR			
Germany	2.7	5.1	2.7
Major Seven	3.4	8.3	4.7
EC Twelve	3.6	9.6	7.4

Recent Developments

2. Part of the explanation for the turnaround in the performance of the German economy since mid-1987 is a favourable external environment - strong world trade growth and the decline in the effective exchange rate in 1988 and early 1989 partly reversing the earlier appreciation. Fiscal and monetary policies through 1987 and 1988 helped to boost domestic demand. The recovery does not appear to be due only to these factors. Growth in the first quarter of 1989 was over 4 per cent despite a tightening of policy this year. Recent indicators of business confidence, new orders and investment intentions all suggest that demand continues to be strong.

Table 2: Leading Indicators

	Percentage change on a year earlier					
	1988Q3	**1988Q4**	**Jan 89**	**Feb 89**	**Mar 89**	**Apr 89**
Business Confidence*	113.4	116.4	115.0	115.4	114.5	115.2
Domestic Orders	5.8	6.0	5.9	6.8	11.7	9.7
Foreign Orders	5.8	6.0	5.4	8.3	9.7	13.4
Industrial Prod.+	4.7	4.2	5.2	4.2	4.9	7.2

* Index, 100 = normal level of confidence.
\+ Excluding construction.

3. The recent surge in growth has been driven by investment and exports. Business investment was the strongest component of domestic demand in 1988 stimulated by rising profits, high levels of capacity utilisation, partly the result of low investment over the decade to 1987. Housing investment was also strong, though this was in large part a reflection of the mild winter. For the first time since 1985 net exports were not a drag on growth in 1988. This was due primarily to increased exports which benefitted from strong growth in other industrialised countries and the 5 per cent fall in the effective value of the Deutschemark.

4. The pick-up in growth has, however, coincided with a downturn in consumption. The rate of growth of consumption declined by one percentage point in 1988, despite tax cuts at the start of the year.

Future Prospects

5. After a period of relatively lax monetary policy during 1987 and early 1988 the Bundesbank moved to tighten monetary conditions. Money market interest rates have risen from 3.4 per cent in April 1988 to 7 per cent in May this year. Despite this, M3 growth continues to overshoot its target of 5 per cent. The forecast assumes that two further increases in interest rates will occur, each of ½ percentage point, in the second half of the year. This would take nominal interest rates to 8 per cent, the highest level since 1982.

6. German fiscal policy is based on a medium term strategy to reduce the fiscal deficit and reform the tax system. The pursuit of these dual aims has, however, led to it following a 'zig-zag' path as explained in paragraph 12 of the main paper. These year-to-year changes in fiscal stance have not led to sharp swings in activity.

7. The main issue considered in preparation of the forecast was whether the recent surge in activity could be maintained. The consensus view of forecasters earlier this year was for a sharp slowdown in 1989 followed by some pick up in 1990. This view was based on the belief that this year's expenditure tax increases would cut the growth of consumption and that the pace of investment would also slacken. In 1990 personal tax cuts were expected to push up consumption sharply whilst investment would increase at much the same rate as in 1989. (The IMF forecast shown in table 3 was typical of this view.)

Table 3: Forecast Comparisons

Percentage change on year earlier	1988	1989 IMF	1989 OECD	1989 WEP	1990 IMF	1990 OECD	1990 WEP
Domestic Demand	3.5	2.2	2.5	2.7	3.3	2.8	3.0
GNP	3.4	2.4	3.0	3.7	2.9	2.8	3.0
Consumer Prices	1.2	2.8	3.0	3.1	2.4	2.8	2.0
Current Account ($bn)	49	50	48	52	51	53	62

8. The current forecast is summarized in table 4. It is now clear that the strength of demand in Germany was previously underestimated. Although part of the strong growth in 1989Q1 was due to a mild winter, other influences have also been important. Despite the slowdown in consumption, GNP growth this year is expected to surpass that of 1988, with investment and exports providing the main impetus. The onset of 1992 and the tax cuts of 1990 should also ensure that although growth starts to slow in 1990 it remains rapid by recent standards.

9. German inflation in 1989 is likely to reach its highest level for six years at about 3¼ per cent. Rising import prices and higher expenditure introduced at the start of 1989 contribute to this. Domestic costs remain largely under control, unit labour costs fell in 1988. The next major pay round is not until 1990, as a result of three year wage settlements in 1987, so the danger of a wage price spiral is low.

10. At the beginning of 1990 the expenditure tax increase will drop out of the consumer price index. Monetary policy tightening will begin to bite. The assumption of constant real exchange rates also implies that the nominal effective value of the Deutschemark will rise in 1990 and 1991. For these reasons, and the low core rate of inflation, the forecast is for a quite rapid deceleration in inflation to below 2 per cent.

Table 4: Forecast

Per cent change on a year earlier	1979-88 average	1988	1989	1990	1991
Private consumption	1.5	2.5	2.0	3.4	2.5
Govt. consumption	1.6	1.8	1.2	2.1	1.6
Investment:	0.8	5.8	9.7	4.5	6.4
Public	-1.3	6.1	7.0	3.5	4.5
Private residential	-0.2	5.7	6.1	-4.3	0.9
Business investment	1.4	5.8	9.7	4.5	6.4
Stocks	0.0	0.4	-0.4	0.2	0.0
Domestic Demand	1.3	3.5	2.7	3.0	2.8
Exports	4.1	7.2	10.2	4.8	4.2
Imports	3.0	6.4	7.5	6.0	5.1
GNP	1.6	3.4	3.7	3.1	2.7
Memo					
Unemployment rate		8.7	8.7	8.7	8.5
Consumer prices		1.2	3.1	2.0	2.3
Effective exchange rate (1985=100)		114.8	112.9	114.3	115.8
Current Account ($bn)		49	52	62	69
% of GNP		(4.0)	(4.4)	(4.8)	(4.9)

11. The process of external adjustment stalled in Germany in 1988, with an end to the decline in the current account as a percentage of GDP. The proximate cause of this was the rise in exports after two years of stagnation. The fundamental cause of the persistent surplus is the imbalance between savings and investment. The decline in public sector saving in 1988 was more than offset by the rise in private sector saving.

12. The German current account surplus seems set to continue to rise over the medium term. This is due mainly to the expected strength of exports. The weakness of the Deutschemark has continued well into 1989 and this is reflected in very robust figures for export orders. As the world's largest exporter Germany is in a strong position to take advantage of the removal of non-tariff barriers in the run up to 1992. The deficit on the invisibles balance should also start to diminish. IPD flows are set to benefit from the large exports of capital that took place after the introduction of the withholding tax was announced in late 1987.

13. To summarize, the forecast is one in which the German economy, with its strength in the production of tradeable goods, particularly manufactures, is able to benefit significantly from the prolonged growth in world trade. In this respect the improvement in the German economy compared with earlier years may seen as the result of demand factors rather than of an improvement in supply performance. Against a background of subdued growth in domestic demand this year the current account surplus rises through the forecast period. The forecast is for the inflationary pressures that have emerged this year to be reversed next year through monetary tightening and the low underlying rate of inflation.