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HER MAJESTY'S TREASURY

WORKING PARTY ON
WORLD ECONOMIC PROSPECTS

I attach a report on the Summer WEP exercise. Detailed background tables can be obtained from Mr Hennebry on 233 3829.

Stephen Matthews

S W MATTHEWS

WORLD ECONOMIC PROSPECTS

JUNE 1986 REPORT

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WORLD ECONOMIC PROSPECTS: SUMMER 1986

SUMMARY

1. The forecast covers the period to 1989, but the numbers beyond 1987 are particularly speculative. The main features are summarised below.

(a) Growth in world output and trade volumes has been disappointingly slow over the past six months, but we expect low oil prices to give a significant boost to activity over the next two years.

(b) Real GNP in the major industrialised countries grows at an average annual rate of 3 per cent over the rest of the decade, rather faster in 1987 and 1988.

(c) Trade volumes are expected to rise by only 4-5 per cent per annum because of depressed levels of imports into oil-producing countries.

(d) Inflation in the major seven OECD economies is already down to 2 per cent and should remain low throughout next year. After the once-and-for-all benefits of low oil prices, inflation may rise to 3 per cent in 1988, and further if inflationary fears in the US are realised.

(e) We assume that world oil prices average \$15 from now until the end of 1987, the same assumption that was used in the FSBR.

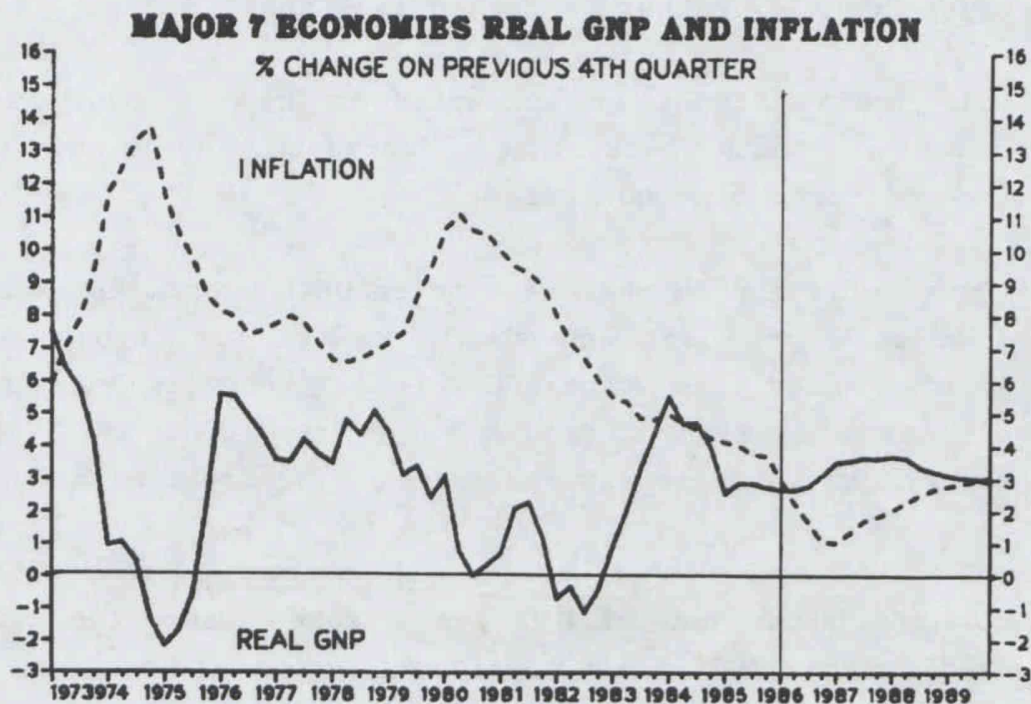
(f) Non-oil commodity prices have continued to weaken in real terms. We expect some recovery from current extremely depressed levels as world activity grows strongly in 1987 and 1988.

(g) Despite the depreciation of the dollar the US continues to run large current account deficits, albeit falling slightly as a proportion of GNP. Little reduction in the Japanese surplus is expected.

Table 1: Output, inflation and trade

Percentage change on year earlier	1984	1985	1986*	1987*	1988
Major 7 real GNP	4½	3	3 (3½)	3½ (4)	3½
Major 7 consumer's expenditure deflator	4½	3½	2 (2½)	1½ (1½)	2
UK export markets (manufactures)	8½	5	3 (5)	4½ (5)	5

* Figures in brackets were those in FSBR; for 1987 they are for first half only.

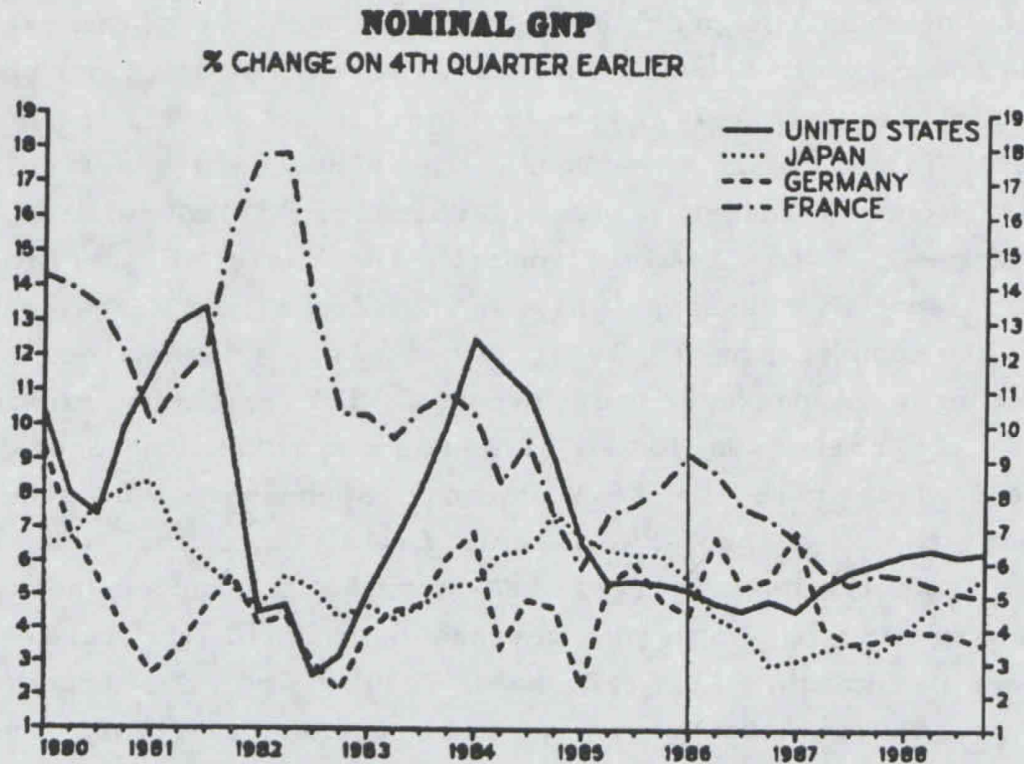
Chart 1:

2. This report focuses on a "central" case only. A major source of uncertainty is the reaction of the world economy to the unprecedented fall in oil prices. Experience of the increases in oil prices in 1973 and 1979 indicates that such shocks can create conditions under which major forecasting errors may be made, e.g. the strength of inflationary forces in 1974 and the

depth of the recession in 1975 were underestimated. Moreover the response to a fall in oil prices may not mirror the effects of the rises of 1973 and 1979, e.g. because the propensity of OPEC to consume its revenues has increased. While there is some consensus between forecasters on the short-run effects on output, there has been little discussion of the supply-side mechanisms and the factors which may increase the long-run growth rates of productive potential.

3. Another source of uncertainty is the ability of the equations in our model to handle the response to the dramatic fall in the dollar's foreign exchange value over the past fifteen months. The conjunction of this and the oil price fall means that our forecasts of trade volumes and trade prices necessarily rely more on our own judgement, and less on the equations, than usual.

Chart 2:



FISCAL POLICYTable 2: General Government Deficits

General Government Financial Balances as % of GNP	1968-73	1974-79	1980-84	1985	1986	1987	1988
US	- $\frac{1}{2}$	-1 $\frac{1}{4}$	-2 $\frac{1}{2}$	-3 $\frac{1}{2}$	-3	-2	-1 $\frac{1}{2}$
Japan	1	-3 $\frac{1}{2}$	-3 $\frac{1}{2}$	-1 $\frac{1}{4}$	-1 $\frac{1}{4}$	-1	- $\frac{1}{2}$
Germany	0	-3	-2 $\frac{1}{2}$	-1	- $\frac{3}{4}$	- $\frac{1}{2}$	- $\frac{3}{4}$
France	$\frac{1}{2}$	-1	-2	-2 $\frac{1}{2}$	-2 $\frac{1}{2}$	-2 $\frac{1}{2}$	-2 $\frac{1}{4}$
Italy	-5	-9	-11 $\frac{1}{2}$	-14	-13	-12 $\frac{3}{4}$	-12 $\frac{1}{4}$
Canada	1	-1 $\frac{1}{2}$	-4 $\frac{1}{2}$	-6	-6 $\frac{1}{4}$	-6	-5 $\frac{1}{2}$
Major 7	- $\frac{1}{2}$	-2 $\frac{1}{2}$	-3 $\frac{1}{2}$	-3 $\frac{1}{2}$	-3	-2 $\frac{1}{4}$	-2

4. Although the Supreme Court in the United States may find the role of the Comptroller-General under the Gramm-Rudman Balanced Budget Act unconstitutional, the mood of Congress is such that there is likely to be a significant deficit reduction in the 1987 fiscal year. The House, the Senate and the President have, all produced budget proposals which yield Federal deficits in the range \$137 to \$144 billion (on the basis of some fairly optimistic economic assumptions). The House and Senate have now gone to conference on their proposals. It remains to be seen whether the package they produce will persuade President Reagan to compromise on his desire to avoid tax increases and to prevent deep cuts in real defence spending. Nevertheless we expect that, helped by recent falls in interest rates, optimistic assumptions on real GNP growth, the added bonus of a likely \$10 billion extra tax revenue because of the tax reform bill (see paragraph 14), and some fudging on the proportion of defence budget authority actually spent, a FY1987 budget broadly consistent with the Gramm-Rudman deficit ceiling of \$144 billion will eventually be agreed. The out-turn, though, is likely to turn out somewhat higher at around \$160 billion.

5. For FY1988 and beyond, the probable modification of the Gramm-Rudman procedures from their present stringent form will

make further cuts in the deficit more difficult. Furthermore the gaps between the Gramm-Rudman target and expected outturn deficits are likely to be viewed as insurmountable (especially with rising interest rates) if tax increases are ruled out. We are therefore forecasting Federal deficits to remain around \$150 billion in each of fiscal years 1988 and 1989. This is sufficient to stabilise the debt-GNP ratio at around 43½ per cent.

Table 3: US Federal Budget Deficit

Fiscal Year	CBO baseline (Feb 86) (\$bn)	Gramm- Rudman targets (\$bn)	WEP		Ratio of Federal debt to GNP (%)
			(\$bn)	(% of Nominal GNP)	
1985	210	-	212	5½	38
1986	208	172	210	5	41
1987	181	144	160	3½	42½
1988	165	108	150	3	43½
1989	144	72	150	3	43½
1990	120	36			
1991	104	0			

6. In Japan and Germany, fiscal policy remains tight despite pressure from other countries, notably the US, for easing in the face of negligible inflation rates and falling export growth. In Japan the forecast assumes further small reductions in the central government deficit as a percentage of GDP. The German government continues to show its determination to restrict the budget deficit this year to its target of 1.2 per cent of GNP and there would seem to be little difficulty in continuing fiscal "consolidation", despite the introduction of tax reforms.

7. In France (despite its new government) and Italy the authorities are assumed to have their usual difficulties in reducing their deficits. They will be assisted by the beneficial effects of falling oil prices, but this is not expected to result in major reductions in their structural deficits. Italy, however,

is using the fall in oil prices to reduce government borrowing by raising petrol taxes. Lack of consensus on the deficit problem in Canada is limiting attempts to curb their federal budget deficit, but the markets have shown that they will react unfavourably if no action is taken.

MONETARY POLICY

8. Falling oil prices and currency appreciations outside the US have permitted sharp falls in nominal interest rates in many countries. However these factors create a difficult background for interpreting developments in monetary growth and for setting interest rates. Real interest rates (as measured by nominal rates less the current rate of inflation) have not fallen (perhaps because some of the fall in inflation due to lower oil prices is expected to be reversed), but money supply has been growing above target in several countries. Low nominal interest rates should persist over the next year or so, but rising real demand and the unwinding of the oil price effect on inflation may put upward pressure on interest rates by 1988.

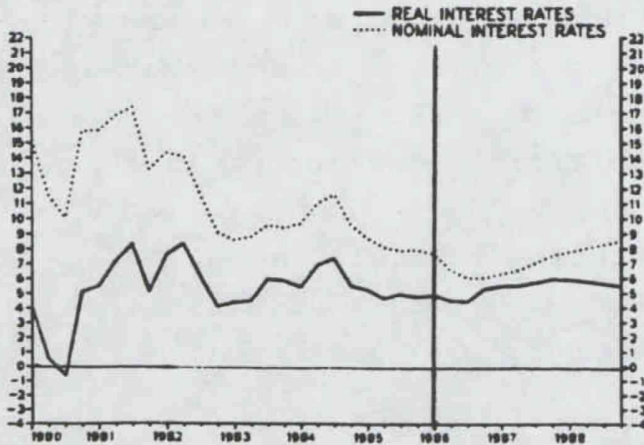
9. In the United States interest rates have fallen considerably over the past 18 months and the yield curve has become almost flat. The declines reflect good news on inflation, largely thanks to oil, and market perceptions of improved prospects for cutbacks in Federal borrowing. In the short-term there could be further interest rate cuts if growth in the second quarter is weak. Thereafter, stronger activity in the second half of the year, accompanied by concern over continued depreciation of the dollar could produce a period of gradually rising rates. There does not however seem much concern at present about the monetary aggregates, which are growing strongly, with M1 and the credit aggregate well above the top of their target ranges.

10. Japan and Germany are both facing international demands for the easing of monetary as well as fiscal policy, reinforced in the Japanese case by home pressures to ease the transition from export to domestic demand-led growth. In Japan, three

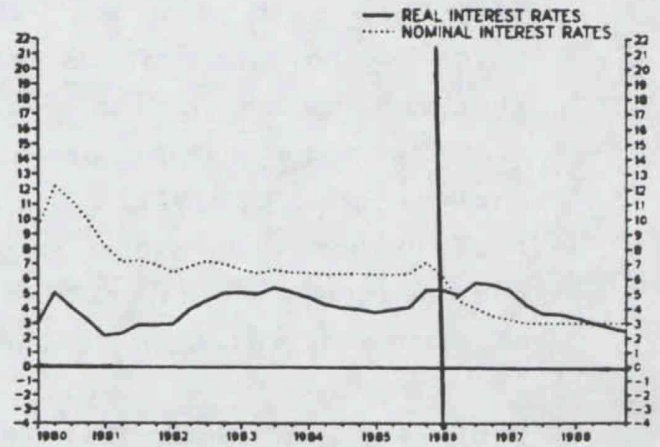
REAL AND NOMINAL 3-MONTH INTEREST RATES

CHART 3:

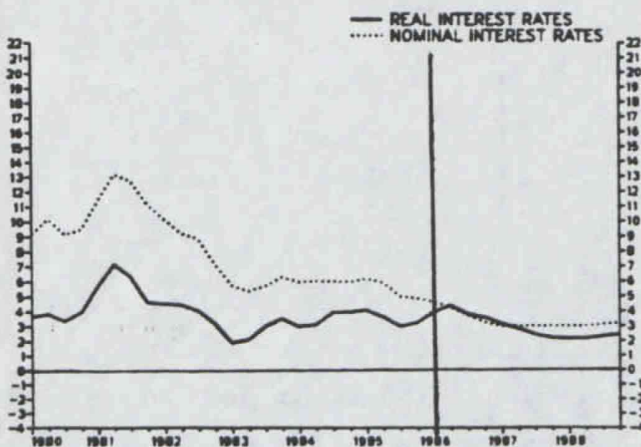
UNITED STATES



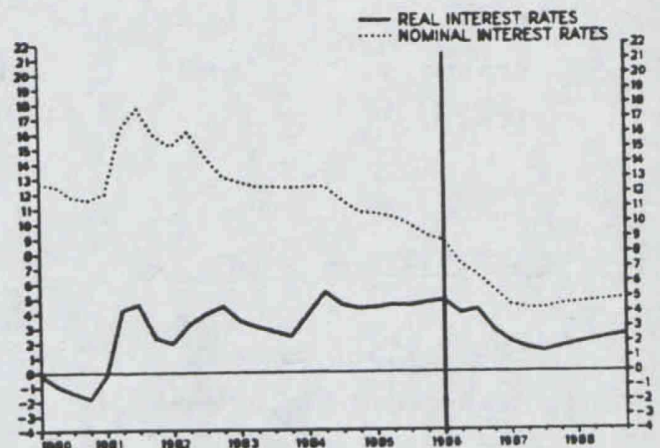
JAPAN



GERMANY



FRANCE



$\frac{1}{2}$ per cent cuts in the discount rate so far this year have brought most short-term interest rates down to levels last experienced in 1978. The monitored monetary aggregate, M2 + CDs, is growing at around $8\frac{1}{2}$ per cent per annum, but further cuts in interest rates are thought likely later in the year. Short-term market rates in Germany have stayed at about $4\frac{1}{2}$ per cent since January, despite a half point cut in the official discount rate in early March. The authorities have been reluctant to reduce rates further because of the weakness of the deutschemark in the EMS and the above target growth in CBM (Central Bank Money) in the early months of 1986. With stable prices there should be scope for further reductions in German interest rates in due course, but here, as in Japan, floors to nominal rates could limit the magnitude of falls in real interest rates in 1987 and 1988.

Table 4: Real Short-Term Interest Rates

Average annual three-month interest rates less annual change in consumer's expenditure deflator.

	1969-73 (ave)	1974-79 (ave)	1980-84 (ave)	1985	1986	1987
US	2	$\frac{1}{4}$	$6\frac{1}{4}$	5	$4\frac{3}{4}$	$5\frac{1}{2}$
Japan	$-\frac{1}{2}$	-1	$4\frac{1}{4}$	$4\frac{1}{4}$	$5\frac{1}{4}$	$4\frac{1}{4}$
Germany	$2\frac{3}{4}$	1	$4\frac{1}{4}$	$3\frac{1}{2}$	4	$2\frac{3}{4}$
France	$1\frac{1}{2}$	-1	$2\frac{1}{2}$	$4\frac{1}{2}$	4	$1\frac{3}{4}$
Italy	$1\frac{1}{2}$	$-4\frac{1}{2}$	$2\frac{1}{2}$	$6\frac{1}{4}$	7	$6\frac{1}{2}$

ACTIVITY

11. Activity in the major industrialised countries has been disappointingly weak in the past six months. There is no single explanation for this slowdown, but a number of factors could have contributed -

(a) cutbacks in oil exploration and investment;

(b) a pause as the major countries alter the balance of domestic and external demand in their economies in

Chart 5:

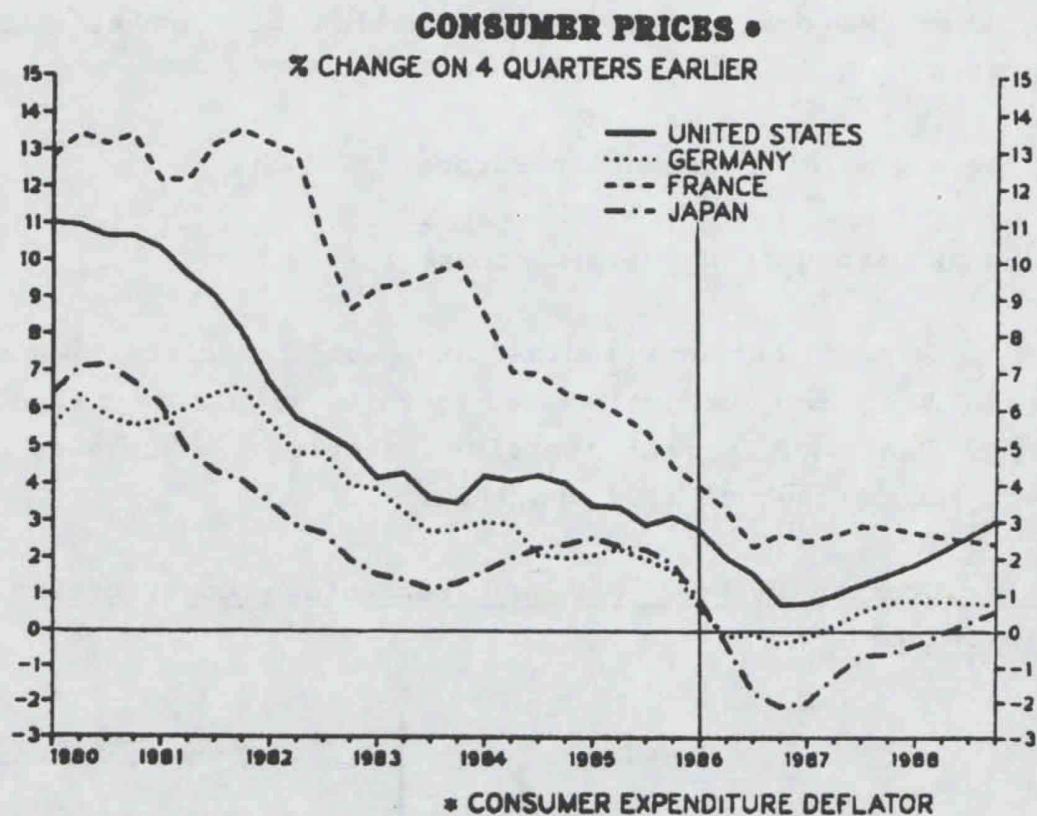


Table 7: Consumer price inflation in the Major 7 countries

% change in the
consumers expenditure
deflator on a year
earlier

	1985	1986	1987
US	3	2	1
Canada	4	3½	2½
Japan	2	-1	1
Germany	2	0	½
France	5½	3	2½
Italy	9	6	4½
Major 7	3½	2	1½

response to a lower dollar and low oil prices;

(c) some destocking in the expectation of further falls in prices;

(d) severe winter weather in Europe;

(e) weak demand in developing countries.

The present poor output figures are not forecast to persist as the fall in oil prices should give a significant boost to activity. Real GNP should therefore accelerate markedly later this year and throughout 1987 and 1988.

Table 5: Growth of Real GNP and Percentage Contribution from Domestic Demand

	GDP/GNP			Domestic Demand		
	1985	1986	1987	1985	1986	1987
US	2.2	2.6	4.1	2.9	3.0	4.0
Japan	4.6	3.2	3.6	3.6	3.9	4.6
Germany	2.4	3.0	3.5	1.4	3.9	4.9
France	1.3	2.7	2.6	1.9	3.4	3.3
Major 7	2.8	2.8	3.6	2.8	3.5	4.5

13. In the United States real GNP grew by an estimated 2.9 per cent (seasonally adjusted at an annual rate) between the fourth quarter of 1985 and the first quarter of 1986. This figure, boosted by strong growth in business inventories (especially cars) and government purchases, looks to be artificially high in relation to other current activity indicators; in particular, industrial production in May was 1 per cent lower than in December, and retail sales have been stagnant over the same period. Oil and gas drilling activity has been cut back, the former to a post-war low, and commercial property development is depressed. The principal bright spot comes from housing starts, with four months of strong figures fuelled by lower mortgage rates.

13. Beyond the very short term, the prospect is for some recovery in domestic demand growth although non-residential investment seems to be slowing (fulfilling the gloomy investment intentions figures). Housing investment looks likely to be strong over the next twelve months. The fall in oil prices is already showing up in lower inflation and higher real incomes and, although the initial effect may appear as higher savings, when consumers adjust their behaviour this will be translated into increased consumption expenditure. The saving ratio has risen from its recent low of $3\frac{1}{2}$ per cent in September 1985 to about $4\frac{1}{4}$ per cent in April, but we continue to expect that a combination of factors (demographic trends, wealth effects from strong bond and equity prices, and low inflation and interest rates) will restrict the saving ratio to an average 5 per cent by the end of 1987 and through 1988, somewhat below its average level over the past 20 years.

14. Development of the US economy in 1987 is further complicated by the likelihood that agreement will be reached on a tax reform package which is acceptable to both Congress and the President. The package assumed in our forecast would transfer \$100-140 billion from businesses to consumers over a period of five years. The net effect on activity may be slightly positive in 1987, with the cut in income tax further boosting consumers' expenditure to grow by nearly 4 per cent.

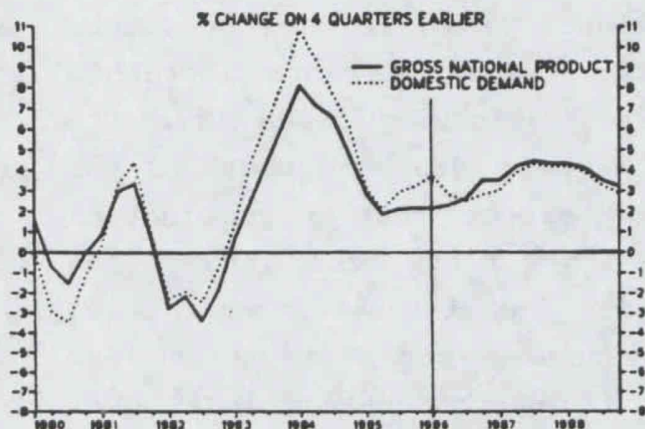
15. The volume of US exports has started to respond to the depreciation of the dollar. The scope for Japanese and other importers to maintain market share by squeezing profit margins must now be fairly limited, but strong domestic demand growth in the US will stimulate imports and limit the extent of the turnaround in trade volumes.

16. Our forecast therefore shows real GNP growth of $2\frac{1}{2}$ per cent in 1986, and 4 per cent in 1987. This is in line with the latest "Blue Chip" consensus forecasts for the current year, but we are more optimistic in 1987. It should be noted however that projections for real GNP growth in 1987 show a wide

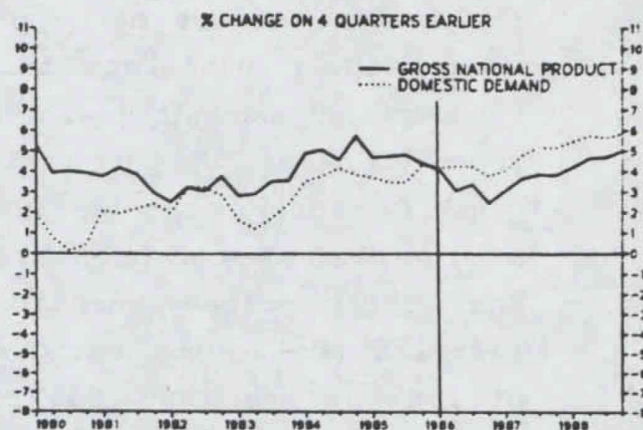
REAL GNP AND DOMESTIC DEMAND

CHART 4:

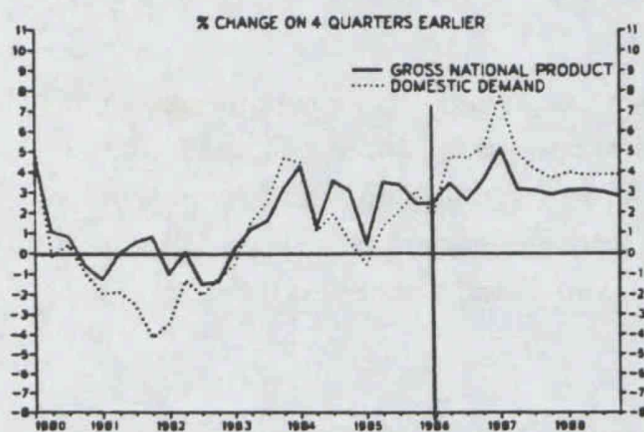
UNITED STATES



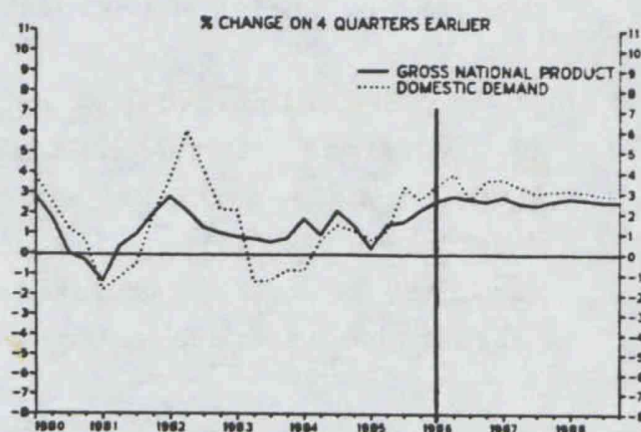
JAPAN



GERMANY



FRANCE



dispersion - several forecasters are expecting growth in the 2 - 3 per cent range while at the opposite extreme there are a few who predict 5½ per cent growth.

17. In Japan real GNP growth in the fourth quarter of 1985 was surprisingly high at 1.8 per cent. All forms of investment grew strongly and there was a 0.3 per cent contribution to growth from external demand. GNP in 1985 was 4½ per cent higher than in 1984, with external demand contributing 1 per cent of the growth.

18. Prospects for the early part of 1986 look much less favourable; figures released subsequent to completion of our forecast show a fall in real GNP in the first quarter of ½ per cent - the first fall in eleven years. In April industrial production was at the same level as in September 1985 and domestic machinery orders were only marginally higher than one year previously. Consumers expenditure continues to grow at a modest rate. Consequently, domestic demand growth is expected to be particularly weak - by Japanese standards - in the first half of 1986, before picking up as a result of increased consumers' expenditure in the latter part of this year and stronger growth of business investment in 1987. Government investment is expected to make a positive contribution to growth in 1986 for the first time since 1981 and housing investment is expected to grow modestly.

19. Provisional figures suggest that the volume of Japanese exports fell by 5 per cent in the first quarter of 1986, reflecting the first effects of the appreciation of the yen and the determination on the part of the Chinese authorities to reduce their trade deficit with Japan. The strength of the yen is expected to keep export growth below the growth of export markets over the next few years.

20. GNP in Germany fell by over 1% in 1986 Q1. The construction industry was once again badly hit by the weather and exports were weak, but consumers' expenditure was relatively buoyant. We expect domestic demand to be strong in 1986; in particular, consumption is expected to increase by nearly 4½%. Wage

settlements next year may be a little lower than in 1986 and no tax cuts have been assumed, but the saving ratio is forecast to decline as consumers adjust to slower inflation and lower interest rates. With a high degree of company profitability and a relatively good outlook, business investment is also forecast to grow rapidly over the forecast period. German exports have fallen in recent months and, with the loss of competitiveness resulting from the appreciation of the DM, exports are likely to remain weak.

21. According to preliminary French GNP data the slight slowdown in growth seen in the fourth quarter of 1985 continued into the first quarter of 1986. Both consumption and fixed investment remained strong, but there was substantial destocking (particularly of energy products) and a negative contribution from trade. With the exception of the destocking, which is likely to prove temporary and may be reversed, this broad pattern characterises our forecast for the year as a whole. Consumption will be boosted by the end-1985 tax cuts and by falling inflation, although the saving ratio may fall less sharply than it did in 1985. Business investment is likely to grow steadily through the year under the influence of increased profitability, while residential investment may start to level off after several years of decline. A similar pattern of growth is forecast for 1987.

Table 6: Unemployment*

%	1974-84 Average	1985	1986	1987
US	7½	7	7	6½
Japan	2¼	2½	2¾	2¾
Germany	4½	8½	8¼	8
France	6	10	10	10

* OECD standardised rates

22. Unemployment is forecast to remain high in most developed countries despite the sustained output growth in the forecast. Growth rates well above potential would be needed to make substantial inroads into unemployment.

INFLATION AND COMMODITY PRICES

23. Recent indicators on price inflation have been better than we were forecasting in January. Consumer prices in April in the major seven OECD countries were less than 2 per cent higher than in April 1985 (only half the inflation rate of a year earlier) and have been virtually static since last December. In Germany prices are actually lower than they were a year ago. Already the fall in oil prices is leading to lower fuel and petrol prices and as these feed into industrial costs there should be further falls in inflation later this year. However, the once-for-all nature of the fall in oil prices and the oil-induced boost to activity will push price inflation back up towards its underlying rate of 2 - 3 per cent by 1988.

24. In Europe and Japan, the forecast continues to show a combination of factors (rising exchange rates, weak oil and other commodity prices, persistently high unemployment and firm monetary policies) which should perpetuate low rates of inflation. We do not expect price levels in Japan and Germany to change very much over the next four years, and French inflation is forecast to settle at around 3 per cent, having been around 12 per cent at the beginning of 1983.

25. The position is rather different in the US. Although consumer prices have fallen in each of the three months to April, there is a marked divergence between the energy and non-energy components - the latter were still rising at an annual rate of nearly 4 per cent in April. There are a number of reasons why the underlying rate of inflation may increase - the fall in the dollar, high rates of monetary growth, and overheating in regional labour markets bidding up real earnings - and the prospect of a significant inflationary spiral in the late 1980s cannot be ruled out.

Chart 5:

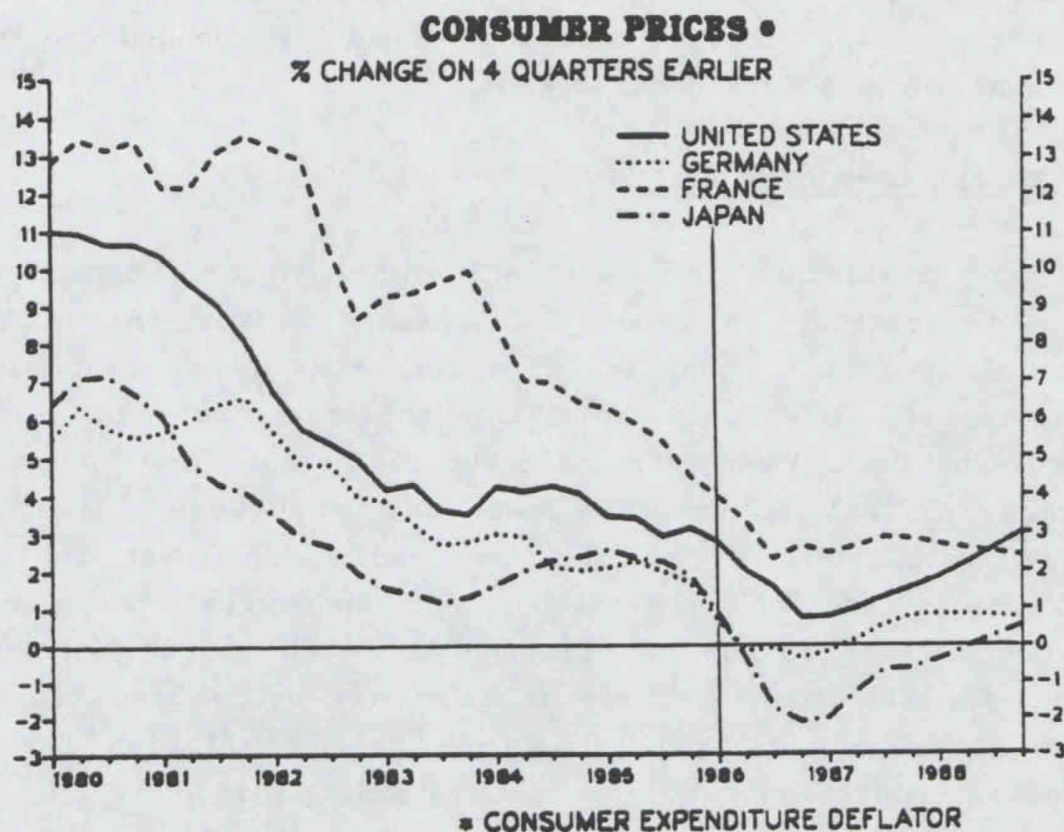


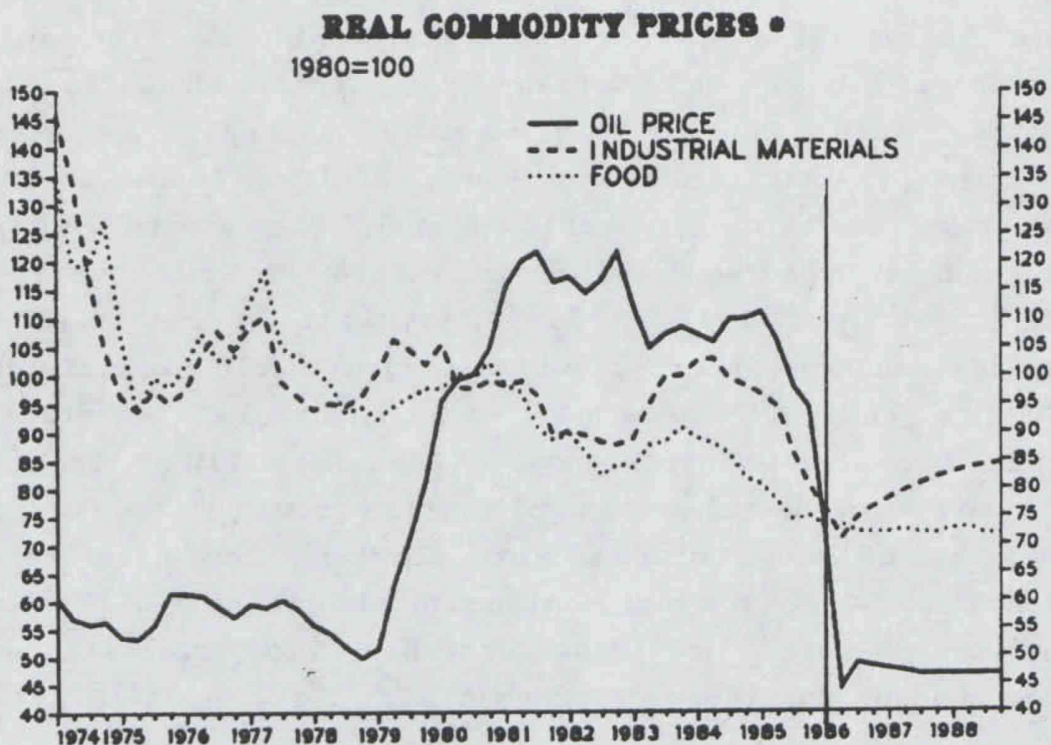
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Germany	2	0	½
France	5½	3	2½
Italy	9	6	4½
Major 7	3½	2	1½

26. Once again commodity prices in recent months have turned out weaker than expected; industrial materials prices are at record low levels in real terms. Abundant supply and healthy world stocks continue to dominate most commodity markets. Nevertheless, we are forecasting some gains in real commodity prices as world activity responds to lower oil prices. Food prices are always liable to be pushed up by bad harvests and extreme weather conditions. This has caused coffee prices to firm considerably since last autumn and our expectation is that they could remain high until early 1987. In general, however, the abundant supply position generated by technological improvements in agriculture and government subsidies should continue to keep world food prices at very low levels.

Chart 6:



* IN RELATION TO PRICES OF MANUFACTURES

WORLD TRADE

27. Along with activity in the major countries, world trade slowed down in 1985 from its exceptional growth of nearly 10 per cent in 1984. Strong growth of imports into North America helped maintain moderate underlying growth of world imports through 1985, offsetting the depressing effect of an estimated fall of nearly 15 per cent in OPEC import volumes. Figures for the first quarter of 1986 are patchy but the indications are that trade may have fallen slightly. The US has recorded a small fall in the volume of imported goods, while exports from most of the major countries (apart from the US) seem to have been weak; in particular there was a large fall in Japanese exports.

28. Expansion of trade may be only moderate for the remainder of this year, reflecting a pause in world activity and the transition of Japan and Germany to greater domestic demand orientation (and the US vice versa) as well as economic difficulties in Australia and South Africa. Once lower oil prices start to stimulate world demand, the growth of import volumes can be expected to pick up. A 20 per cent cut in OPEC imports in each of 1986 and 1987, as well as relatively weak developing country imports, will reduce world import growth relative to real GNP growth in the major OECD countries as compared to the 1970s experience. (See chart 7). Within total world trade growth, trade in oil will grow relatively faster and imports of manufactures more slowly. The UK's relative dependence on OPEC markets, although declining, will depress UK-weighted measures of trade growth. The forecasts assume no major changes in levels of protection.

Chart 7:

MAJOR 9 REAL GNP AND WORLD IMPORTS 1980=100

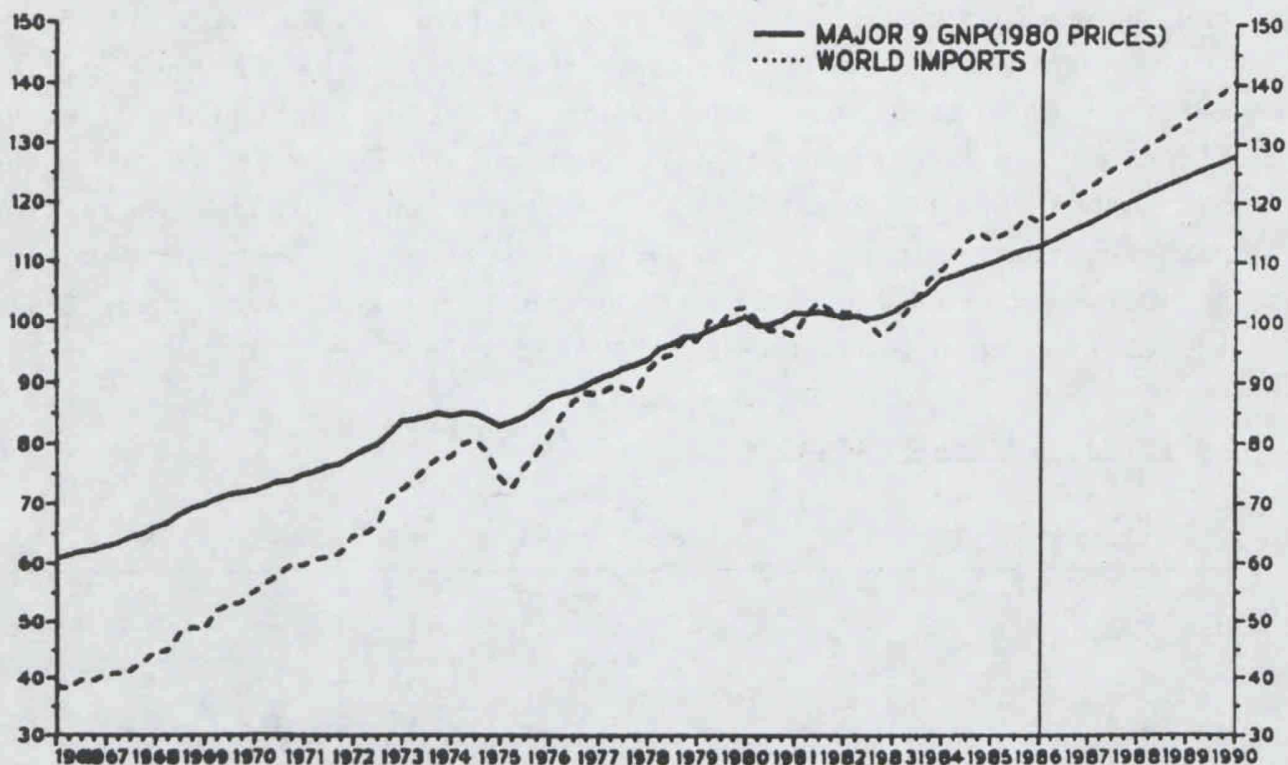


Table 8: World Import Growth

% change on previous year	1984	1985	1986	1987	1988
US	24	4	7	4	3
Japan	11	0	5	9	8
Europe ⁺	6	5	4	8	6
Total Developed* Economies	12	5	6	6	5
OPEC	- 10	- 14	- 20	- 20	- 3
NODCS	8	3	1	6	5
Total	10	3½	3½	5	4½
UK export markets in manufactures	8½	5	3	4½	5
+Germany, France, UK, Italy, Netherlands, Belgium					

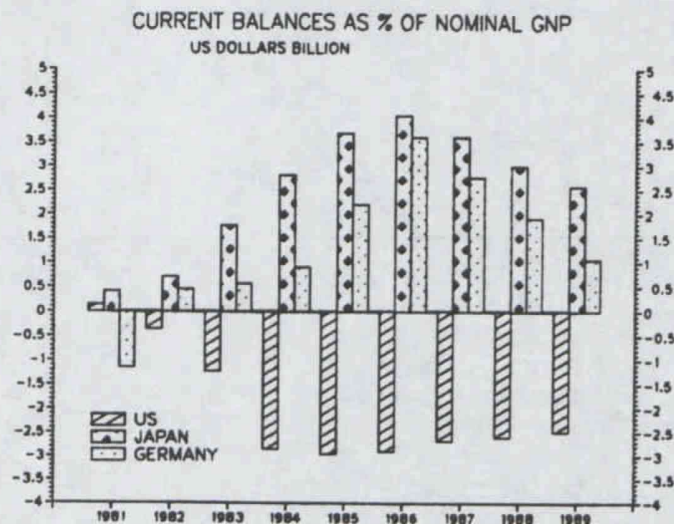
*OECD + South Africa.

CURRENT BALANCES AND EXCHANGE RATES

29. Table 11 shows continued large current account imbalances. The US deficit is expected to fall only slowly in response to the depreciation of the dollar. Although trade volumes react to the gain in competitiveness, the sheer size of the initial deficit increases the importance of the continuing J-curve effects. In addition, the succession of deficits reduces the net stock of US assets held overseas and entails increasing net interest payments. Nevertheless the US current account deficit, and the Japanese and German surpluses, show some falls in relation to nominal GNP in 1987 and 1988.

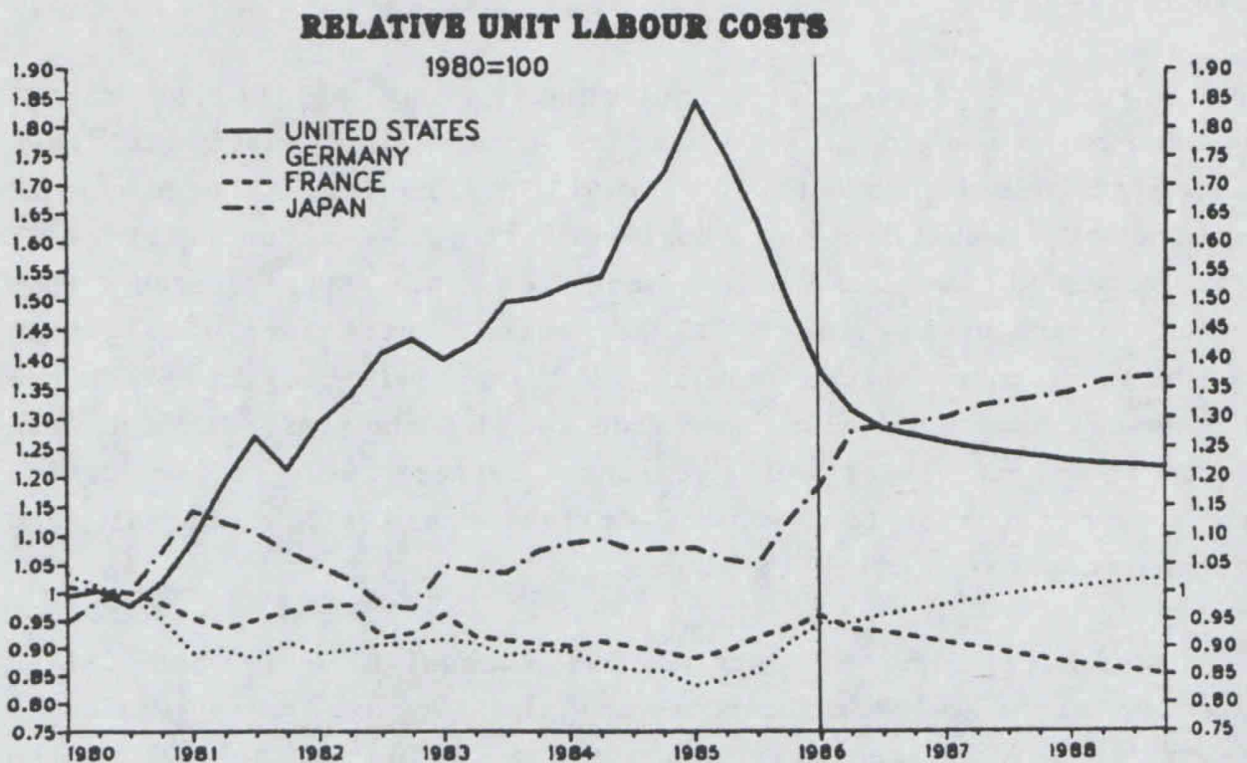
Table 9: Current balances

\$ billion	1982	1983	1984	1985	1986	1987	1988
US	-11	-42	-107	-118	-121	-118	-122
Japan	8	21	35	49	79	81	77
Germany	3	4	6	14	31	27	21
NODCs	-61	-29	-13	-27	-6	-10	-13
OPEC	-16	-17	-9	-5	-54	-30	-16
World Imbalance	-114	-66	-85	-85	-75	-58	-67
as % of GNP							
US	- $\frac{1}{2}$	-1	-3	-3	-3	-2 $\frac{1}{2}$	-2 $\frac{1}{2}$
Japan	$\frac{1}{2}$	2	3	3 $\frac{1}{2}$	4	3 $\frac{1}{2}$	3
Germany	$\frac{1}{2}$	$\frac{1}{2}$	1	2	3 $\frac{1}{2}$	3	2

Chart 8:

30. The dollar seems likely to depreciate further in response to continued US current account deficits and, in the medium term, its relatively high inflation. We have assumed that expectations of continued high real interest rates and confidence in the general strength of the US economy will prevent a further dramatic dollar collapse, and that Japan continues to show a strong desire to build up its external assets by direct and portfolio investment in the US and elsewhere. Even so we are forecasting further appreciation of the Yen by about 6 - 7 per cent per annum. Similarly the Deutschmark is expected to appreciate further against the dollar reflecting Germany's stable price level and large current account surplus. The EMS realignment in April has restored some of the competitiveness which other European economies had lost to Germany over the past three years. Over the forecast period we expect the French Franc and the Italian Lira to depreciate against the DM broadly in line with relative changes in prices.

Chart 9:



THE OIL MARKET, OIL PRICES AND OPECTABLE 10: THE OIL MARKET

Millions of barrels per day	1983	1984	1985	1986	1987	1988
<u>Demand</u> (including stockbuilding) in OECD, OPEC and developing countries.	44.6	45.7	45.4	47.6	49.3	51.3
<u>Production</u>						
OPEC	18.4	18.5	17.2	19.3	20.4	21.9
Non-OPEC	26.1	27.2	28.2	28.3	28.9	29.4
<u>Oil Price</u> ¹ (\$ per barrel)	29.0	28.1	26.9	16.2	15.0	15.7
Real (1980=100) price (relative to world manufactured export prices)	108.2	108.2	102.3	53.2	47.1	46.8

1 average price of oil imported into OECD countries
(f.o.b.)

31. Spot oil prices fell dramatically from \$26-27 per barrel in December to a low of \$10 at the beginning of April and have since fluctuated between \$10 and \$15 per barrel. The prospects for the oil market in the short-term remain very uncertain. We have retained the assumption made for the FSBR forecast that world oil prices remain at \$15 per barrel until late 1987, while recognising that prices could be quite volatile in practice; this assumption has also been adopted by the IMF, EC and OECD staff in their latest projections. After 1987 rising demand and further depreciation of the dollar should allow nominal (and perhaps some real) price increases.

32. World oil demand (outside the Communist area) has fallen steadily since 1979 in response to the two oil price increases in the 1970s, and has only shown signs of flattening off in the last two years with a pick-up in world activity. The Department of Energy's latest assessment, on which our forecast is based, shows OECD energy demand in 1986 and 1987 growing a little faster

than OECD real GNP, with oil's share, nearly 49 per cent in 1980, stabilising at around 42½ per cent of all energy consumption. This is a sharper turnaround in energy demand than other forecasters are expecting, but there is no previous experience by which to assess the effect of a halving of oil prices.

33. The response of oil production is also difficult to forecast. There has been little effect on oil supply in the US or the North Sea. A number of countries, including Mexico, Egypt and Norway, have said that they would be prepared to cooperate with OPEC in restraining production, but only if the OPEC members themselves come up with a realistic and viable agreement. There is, however, no consensus within OPEC on how to share out the production between members. The cartel is clearly in a weak position at present, but the longer prices stay low the stronger the pressure on OPEC to cooperate. Given the Saudis' wish to restore some stability to the market, the likelihood of their reaching an agreement, which would initially stabilise prices and then increase OPEC's market share, will increase over time.

34. Continuing low oil prices pose severe financial difficulties for OPEC and other countries highly dependent on oil exports. Further substantial reductions in import volumes are inevitable. Even Saudi Arabia can only finance two or three years of payments deficits of current magnitude without exhausting its limited reserves of liquid overseas assets and countries like Nigeria, with no foreign exchange reserves and no access to financial markets, are even harder hit.

NON-OIL DEVELOPING COUNTRIES

35. NODC export volumes are estimated to have grown by 4% in 1985, reflecting slower growth in export markets, particularly in the US. Export markets are likely to grow by only 3 per cent in 1986, but to grow faster thereafter as activity in the industrialised countries picks up. The currencies of developing countries have on average depreciated in effective terms, as some are linked to the dollar and others have adopted more realistic exchange rate policies. As a result NODCs should continue to make gains in market share, assuming no increase in protectionist measures by the industrialised countries.

Table 11: NODCs Current Account

	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>
Export volume growth (%)	14½	4	4½	6	6
Export market growth (%)	10	2½	3	5	5
Import volume growth (%)	8	3	1	6	5
Terms of Trade (% change)	½	-3	+1	-1	-1
Current Account (\$bn)	-13	-27	-6	-10	-13
of which:					
trade ¹	13	5	19	17	19
invisibles	-26	-31	-25	-27	-33
<u>MEMO ITEMS</u>					
Change in reserves (\$bn)	11	-10	14	12	12
Reserve/Import Ratio (%)	27	23	27	25	28
Capital Flows (\$bn)	27	16	20	22	25

36. The sharp fall in oil prices will, of course, have different implications for the prospects of individual developing countries; but, on balance, it is unlikely to affect the overall terms of trade greatly. With coffee a temporary exception to generally weak commodity prices, the terms of trade improve marginally in 1986, but deteriorate thereafter. Import volumes appear to have fallen sharply in the second half of 1985 and this probably continued into the early part of 1986. Thus, despite a substantial recovery in the course of the year import volumes are forecast to be only slightly higher than in 1985. Chinese imports, in particular, are expected to fall from their very high 1985 levels. Given our assumptions about capital flows, NODCs should be able to increase import volumes by 5-6% a year from 1987.

Table 12: NODC Debt Indicators

	<u>1977-84 average</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>
Growth in Gross Debt Stock: (% change)					
Nominal	16	6	6	6	6
Real	10	4½	-8	3	1
Gross Debt/Export Ratio	1.2	1.6	1.6	1.5	1.5
Net Debt/Export Ratio	0.9	1.2	1.2	1.2	1.1
Gross Interest Service Ratio	0.10	0.14	0.12	0.12	0.12
Net Interest Service Ratio	0.06	0.10	0.09	0.08	0.08

37. Capital flows in 1985 appear to have been rather weak, although latest figures show that borrowing from banks picked up in the course of the year. There was also an increase in borrowing in the form of bonds, but this was concentrated on a small number of Asian countries. The forecast assumes a slight recovery in capital flows in 1986. IBRD lending is expected to increase in response to the Baker initiative, but commercial bank lending is likely to continue at low levels. Given the adverse effects of the oil price fall on the position of countries like Mexico, the commercial banks will be wary of lending any more to them than is absolutely necessary. Much will depend on the continuing negotiations between Mexico and the IMF.

Table 13: NODC Capital Account

	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>
Current balance	-13	-27	-6	-10	-13
ODA	13	14	16	17	18
Other Official Lending	13	9	11	12	14
o/w IBRD	9	9	10	11	13
Direct Investment	8	8	8	9	10
Bank Borrowing	10	9	9	10	11
Bonds	3	6	5	5	5
Other Capital Flows	-25	-29	-28	-28	-28
Capital Account	22	15	20	25	29
IMF Credit	5	1	0	-3	-4
Change in Reserves	11	-10	14	12	12

