GLOBAL ECONOMIC SITUATION

The global economy performed surprisingly well in 1988. Growth remained buoyant despite the October 1987 global stock market correction; growth in the Summit countries accelerated above the pace set in 1987. Also, progress was made towards improved international economic policy coordination, and a significant improvement in external imbalances among the major industrial countries was evident. More recently, however, rising rates of inflation and a stalling of progress in reducing external imbalances suggests that 1989 will pose more difficult challenges for policy coordination.

The Summit economies experienced strong growth last year. Output growth in real terms expanded by 4.2 per cent according to the International Monetary Fund (IMF). Even more encouraging than the pace of growth was its composition. Investment spending provides a foundation for continued economic expansion, and was a principal contributor to rapid output growth. World trade expanded at its fastest pace since 1984, serving to ease some of the difficulties faced by many heavily indebted developing countries.

Conditions in global financial markets were relatively stable in 1988, compared to the turbulence of the previous year. A number of factors were responsible for the greater stability. First, the large external deficit of the United States declined through the first part of 1988. Second, monetary authorities tightened their policies in response to increased inflationary pressures. This reassured financial markets of the commitment to fight inflation. Third, internationally coordinated intervention, along with changes in underlying policies, helped produce relatively stable exchange rates.

Most major forecasts anticipate that the tightening of monetary policies in 1988 will be successful in preventing a further acceleration of inflation by reducing domestic demand growth to a pace compatible with supply constraints. The reduction in the average rate of unemployment for the Summit countries over recent years is expected to continue in 1989, although unemployment is expected to remain high in a number of European countries. On the basis of current policies and exchange rates, external imbalances are likely to remain large into the 1990s.

Recently, some uncertainties have arisen, making the outlook less optimistic. It is not certain that the monetary tightening over the second half of 1988 and early 1989 has been sufficient to contain inflation. Signs of slowing demand have emerged in a number of Summit countries, although further evidence will be required to determine the exent of the slowdown. Monetary policy authorities must then remain vigilant, as there is a continued danger of an overheating of Summit economies giving rise to a further acceleration of inflation.

A second major risk is the prospect of a widening of the large external imbalances between the United States, Japan and the Federal Republic of Germany (F.R.G.). Large current account deficits in the United States and resulting heavy foreign financing requirements increase the threat of disruptive financial market reactions. Furthermore, if large trade imbalances continue, deficit countries may resort to protectionist measures as a means of attempting to restore balance.

The "soft landing" for the world economy implied in most forecasts will depend importantly on policy actions in a number of key areas and continued commitment to the process of international economic policy coordination. Controlling inflation must continue to be a top priority of monetary policy. However, fiscal policies, particularly in North America, must also provide greater support to monetary authorities. Achieving tighter fiscal policy through reducing domestic demand will help not only to contain inflation but also contribute to the reduction of external deficits.

Actions to reinforce the pace of structural reform will be important, especially in countries with large external surpluses such as Japan and the F.R.G. By ensuring that the price system sends the right signals and by removing restrictions on the private sector, such measures can enhance productivity and the growth potential of Summit economies.