Global Economic Situation

Growth of global economic activity remained robust in 1989, as the world economy expanded by approximately 3 percent, down somewhat from the 4 percent pace of 1988. The slowing of growth over the past year reflected both policy measures and cyclical factors. In particular, monetary policy was tightened in most major industrial countries to combat growing inflationary pressures, as capacity limits were approached. Further progress on reducing external imbalances was achieved in 1989. However, recent exchange rate movements, viewed as inconsistent with continued international adjustment by the G-7 finance ministers and central bank governors, will likely make external imbalances a continuing policy challenge over the period ahead.

The economic expansion in the summit countries continued through its seventh consecutive year, with another solid performance in 1989. According to the IMF, real output growth eased to a still-healthy 3.5 percent rate in 1989, after recording an increase of 4.5 percent in 1988. Slower growth reflects the tightened credit conditions implemented in most industrial countries to deal with pressures on productive capacity and rising inflation. Consumer price inflation rose from 3.1 percent in 1988 to 4.3 percent in 1989, an increase of over 1 percentage point, despite the absence of any significant external price shocks.

Economic activity slowed considerably in the North American economies and the U.K. over the second half of 1989, but remained relatively strong in Japan and continental Europe. World trade continued to expand at a reasonable pace, though more slowly than in 1988, helping to ease some of the difficulties faced by heavily indebted developing countries.

Financial market developments over the past year primarily reflected inflation prospects. Tightening product and labour markets convinced the monetary authorities in most summit countries to implement more restrictive credit policies early in the year. The exception was the U.S., where signs of a significant slowing of growth led the monetary authorities to ease credit conditions. Over the last several months of 1989, inflation rates in most of the summit countries moderated. Nonetheless, long-term interest rates in 1989 were significantly above their 1988 levels in all summit countries, except in the U.S. and Canada, reflecting increased concern on the part of financial markets over a possible resurgence in inflationary pressures.

In exchange rate markets, the U.S. dollar surged during the first half of 1989, and again towards the end of the summer. Concerted exchange rate intervention undertaken by the summit countries in September and October, and an increase in F.R.G. interest rates, led to a significant weakening in the dollar against the Deutsche Mark between September and December.

However, the dollar remained relatively stable against the yen over the same period. The yen started off 1990 on a relatively weak note, depreciating sharply against the dollar between the start of the year and mid-April. After stabilizing in April, the yen has gradually strengthened against the dollar, appreciating by 4 percent in May. Despite uncertainty surrounding the inflationary impact of German currency union, the Deutsche Mark has been relatively stable against the dollar during 1990.

Most major forecasts agree that global economic prospects for 1990 remain quite favourable. The tightening of interest rates over the past year is expected to slow economic growth to a pace more compatible with the capacity to supply, thereby easing inflationary pressures.

Although the prospects for the global economy remain promising, performance in the period ahead could be significantly influenced by two key factors: 1) political and economic reform in Central and Eastern Europe, and 2) the macroeconomic policy mix in the industrial countries.

Managing the impacts of economic reform in Central and Eastern Europe represents a significant policy challenge for the major industrial countries. Long-term interest rates increased significantly over the first part of 1990, reflecting either an increase in inflationary expectations, or an increase in the expected return to investment stemming from economic reform in Central and Eastern Europe.

Financing the development of Eastern Europe is expected to increase global credit demand significantly. There is a risk that, unless global savings are increased, the expected rise in global credit demands over the period ahead could push interest rates higher, and undermine the prospects for continued global growth. The recent developments in Eastern Europe and Germany therefore heighten the need for fiscal consolidation in several summit countries, as a means to increase savings.

While recent economic reform in Central and Eastern Europe presents unique challenges, the opening of new markets also presents opportunities for the world economy. These developments also augur well for the adjustment of large external imbalances between Germany and its Western European trading partners.