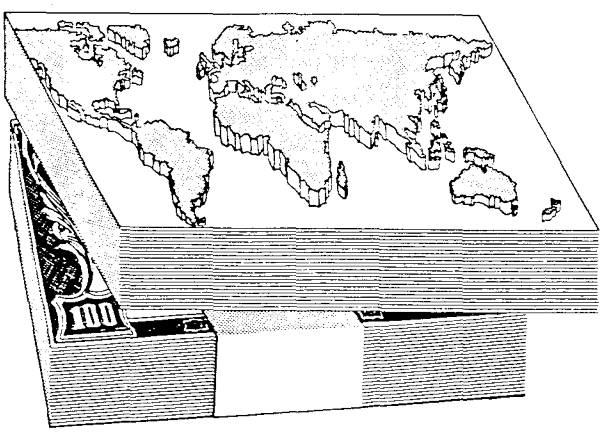
THE WORLD ECONOMY



MACROECONOMIC TRENDS

In the calendar year 1990, GDP growth in the G7 countries was 2.3%, compared with 2.8% in the year to June 1990. As has been the pattern for over a year, growth was sluggish in all the main industrialised countries with the exception of West Germany and Japan. The English-speaking countries have been particularly slow in terms of economic growth, with the United States, Canada and UK all exhibiting annual growth of no more than 1%. Individual country growth rates are as follows: Canada 0.9%; US 1.0%; Japan 5.6%; France 2.8%; Germany 4.6%; Italy 1.8%; UK 0.8%.

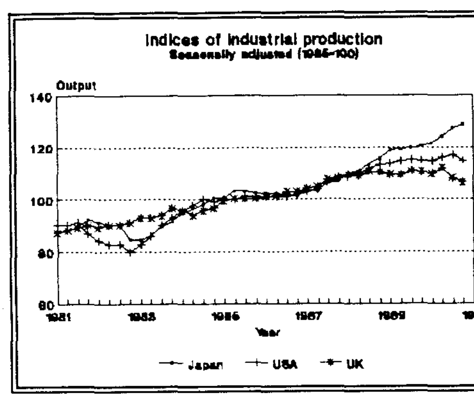
The rapid slowing of many economies is most evident in terms of industrial production. In the final quarter of 1990 there was a marked slump in OECD industrial production, which achieved just 0.3% growth for the year, compared with 2.6% during the year to September. The G7 countries achieved industrial production growth of just 0.1% in 1990, with rapid declines in the US, UK, Canada and Italy, but steady growth in Germany and Japan. Individual growth rates are as follows: US -2.6%; Japan 7.4%; Germany 6.0% (all year to February); Canada -4.8%; France 0.7%; UK -3.8% (all year to January); Italy -4.4% (year to December).

There was some easing of inflationary pressure in the last quarter of 1990 and the early months of 1991. Annual inflation in the OECD averaged 6.5% in February, and 5.2% for the G7 countries. Only Canada and Italy experienced rises in consumer price inflation since last September. Inflation rates for the G7 countries are as follows: Canada 6.2%; US 5.3%; Japan 3.9%; France 3.5%; Germany 2.7%; Italy 6.7%; UK 8.9%.

OECD unemployment averaged 6.6% in February, with the G7 countries averaging 6.1%. All the major industrialised countries exhibited increases in unemployment from last November with the exception of Germany and Japan where there was a slight decrease. Individual countries' rates of unemployment for February were as follows: Canada 10.2%; US 6.4%; Japan 2.0%; France 9.2%; Germany 4.5%; Italy 9.8% (October); UK 8.1%.

United States

The United States economy continues to show most of the signs of recession, despite a short-lived surge in consumer confidence following the end of the Gulf war. Revised figures for industrial production in March show a fall of 0.6%, comparable to the decline experienced in January and February, and representing an annual rate of -9% over the first quarter. Provisional figures for April show a slight rise in industrial production of 0.1%, but these figures have in the past been subject to considerable downward revision. GNP fell at an annual rate of 2.8% in the first quarter compared with a fall of 1.6% in the last quarter of 1990, a much steeper decline than had been forecast by the White House.



There is, however, some better news which may indicate that recovery will not be long delayed. Retail sales show some signs of picking up once again; revised figures show a 2% increase in February, and the March figures were revised from a fall of 0.8% to a rise of 0.4%. Provisional figures for April show a slight fall of 0.1%, which may also be subject to considerable revision. The first faint signs of relief in the housing market are also evident, with a rise in April starts of 6.2% over the March figure. This should not necessarily be taken as recovery, however; housing starts are still 21% below the level of April 1990, and applications for building permits remain very sluggish.

Clearly the Federal Reserve has become concerned at the failure of the recession to bottom out as quickly as was hoped, and, under pressure from the White House, the Fed's discount rate was cut by 0.5 percentage points at the beginning of May. This was the third half-point cut since December, and was apparently prompted mainly by concerns about the manufacturing and capital goods sectors; orders for manufactured goods fell by 2.8% in March, the fifth successive monthly fall.

Reluctance to ease monetary policy too far springs from the desire to keep inflation in check, but the short-term dangers from this source do not look great. In March the producer price index fell by 0.3%, the fourth successive monthly fall, which reduced the annual rate to 2.9%. In the same month the consumer price index excluding food and energy - the "core" rate of inflation - rose by only 0.1% following fairly sharp rises earlier in the year. In addition, wage increases are fairly subdued at present, and the recent rapid strengthening of the dollar has prevented inflationary pressure from imports becoming a problem. It therefore seems likely that in the short term recession rather than inflation will continue to be the major concern.

Japan

With annual GNP growth of around 5% and industrial production growth of over 7% per annum Japan is the fastest-growing member of the G7 countries. It may therefore seem surprising that there have been recent calls, including one from the Miti minister, for a cut in interest rates. This may seem all the more surprising because in recent months the Japanese authorities have been more concerned about inflation than the prospect of slower economic growth. The pressure for an easing of monetary pressure comes from the belief that growth may decline sharply in the next few months due to a combination of factors. Much of the current economic expansion has sprung from capital investment which will begin to slacken in the face of high real interest rate, as will housebuilding; housing starts fell in January by 4.7% over the figure of one year previously, and a further 12.5% fall occurred in February. Corporate earnings have also begun to decline, particularly among the large banks.

Any decision on an easing of monetary policy will depend on the outlook for inflation, which is still uncertain. In February the annual rate of consumer price inflation was 3.9%, compared with an annual rate of 3.5% in 1990 and 2.3% in 1989. This is uncomfortably high by Japanese standards, and, coupled with a continuing tight labour market (2.0% unemployment), suggests a very marked degree of caution with regard to interest rates.

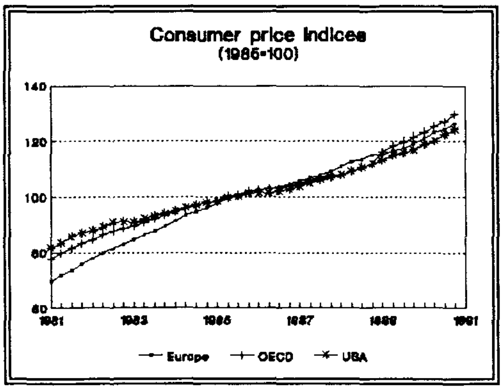
Meanwhile, an old problem has now reasserted itself; that of Japan's trade surplus. In the March Commentary it was argued that the steady decline in the surplus would be reversed as the slowing domestic economy began to import less and Japanese exports began to take off again, and this appears to have happened. In March the trade surplus rose to $8.7 billion, and in April it grew by a further $6.3 billion, almost 80% higher than the level for one year previously. The fall in the price of oil following the ending of the Gulf war is likely to make matters worse for a few months, as will the slowing of the domestic economy.

Between 1986 and 1990 the annual trade surplus fell by 40% from a peak of $90 billion, but it is now expected to rise to over $66 billion in 1991-92. Relative to GDP the surplus may keep falling, however. In 1986 Japan's trade surplus was 4.5% of GDP, falling to 1.2% by 1990; by the mid 1990s this may be down to 0.5% of GDP. Nevertheless, the absolute size of Japan's trade surplus is causing some friction with her trading partners, with the United States (as usual) the principal complainer. However, it may be Europe rather than America which has most to lose from Japan's export drive and cutting of imports. In 1990 Japan's trading surplus with the US fell by over 10%, while that with Europe grew by over 10%. One of the main reasons for this has been a sharp slowdown in the imports of luxury goods from Europe, one of the areas hardest hit by the consumer spending decline in Japan. Even this pales into insignificance compared with exports to Asia. In 1990 Japan's trade surplus with Asia rose by 47%, and some forecasters now believe that within ten years Asia will account for almost half of total Japanese exports.

Germany

Anyone believing that Britain has problems with a North-South divide can take some cold comfort from the size of Germany's East-West divide. While output grows at near unsustainable levels in the west, the east faces an almost total collapse of its industry and massive unemployment. In April, for example, unemployment in the east rose to 837,000 (9.5% of the labour force), with a further two million on short-time working. Companies close virtually daily as the Treuhand fails to find buyers for them and they are totally uncompetitive following monetary union at virtual parity levels, precisely the warnings from the (retiring) Bundesbank president which were ignored at the time.

The Treuhand now estimates that it requires DM400 billion by the year 2000 to carry out its job of restructuring the east's economy rather than merely closing down ailing firms. By April around 100 of the east's 8000 large companies had been privatised, and the hope remains that at least 5000 of these companies can be successfully integrated into the private sector. However, the west clearly underestimated the size of the job both in terms of manpower for the Treuhand and, more importantly, the amount of money which would be required to prepare many of the east's businesses for the rigours of competition. Already the Treuhand has granted short-term loan guarantees of DM28 billion, but 400 firms have nevertheless been compulsorily closed down.



At the same time the west booms. West German industrial production rose by 5.2% in 1990 and by April unemployment had fallen to 4.5%. In the third quarter of last year retail sales grew by 13.3% compared with the corresponding period in 1989. Since the turn of the year industrial production has begun to falter somewhat, but looks likely to resume its upward course in the near future. The west continues to show a remarkable capacity for absorbing new workers; employment rose by 680,000 in the year to April.

One consequence of this rate of growth has been the emergence of a deficit in the west German current account of the balance of payments, the first time such a thing has happened for six years. In the first two months of the year imports rose by 19% while exports fell by 3%, giving a current account deficit of DM3.8 billion. This has occurred for three reasons; the surge in consumer demand following unification which has led to a switch away from exports to domestic markets; a fall in exports because of sluggish world trade; and a marked deterioration in West German international competitveness following the appreciation of the D-Mark.

The difficulty for the unified Germany is that the economic situations of east and west demand different policies. The boom in the west coupled with a tight labour market and increasing wage demands (now running at 7% per annum on average) suggest a continuing tightness in monetary policy, despite the problems of the east which would appear to favour a more liberal approach. Although consumer price inflation is still low at 2.5% it is rising, and the Germans traditionally show great zeal in squeezing inflation out of the system as sson as it shows any signs of increasing, none of which augurs well for the east.

Prognosis

The outlook for the industrialised countries is if anything more uncertain than was the case before the Gulf war. The US, Canada and the UK are all now firmly into recession with growth slowing rapidly in the other G7 countries, including Germany and Japan which have been the main growth economies for several years. The latest IMF forecasts project real GDP growth in the industrialised countries of 1.3% this year, about half the level of 1990, rising to 2.8% in 1992. This is based on the assumption that world trade picks up from a modest growth rate of 2.4% this year to 5.5% in 1992, and that inflationary pressures do not get out of hand.

Herein may lie the difficulty. The major industrialised countries are now finding it difficult to co-ordinate their macroeconomic policies because of different interpretations of where the balance of risks lies. One group, led by the US but also comprising France and Italy, is keen to see a move towards more growth-oriented policies, believing that on balance there is more to fear from stagnation than from inflation. Germany, the UK and Canada take precisely the opposite view, arguing that the only way to guarantee long-run sustainable growth is through the firm control of inflation. This group of countries is concerned that the US wants to see more growth for political reasons, because of the 1992 presidential election.

Policy co-ordination is always difficult when economies approach turning points at different times, but unless some degree of agreement can be reached on the way forward the orderly slowdown in the economies of the G7 countries of the last eighteen months will soon become no more than a pleasant memory.