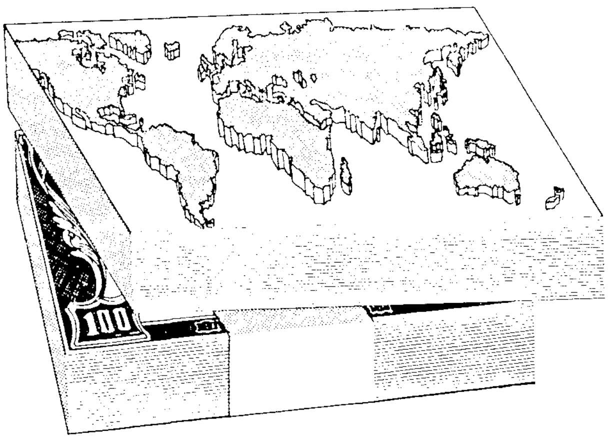
THE WORLD ECONOMY



MACROECONOMIC TRENDS

The rate of GDP decline among the leading industrialised countries increased sharply during the first quarter of 1991, with only Japan and West Germany showing clear signs of growth. Comparing the first quarter of 1991 with the corresponding period in 1990, average growth in the G7 countries fell to 1.1%; this compares with growth of 2.3% for 1990 as a whole. Canada, the United States and Britain all experienced declining GDP in the first quarter, with economic growth falling sharply in France. Individual country growth rates comparing the first quarter with the first quarter of last year were as follows: Canada -2.8%; US -0.6%; Japan 5.9%; France 0.9%; Germany 5.2%; Italy 1.8% (year to September 1990); UK -2.5%.

As usual, the decline is most marked in industrial production. In the year to April, OECD countries as a whole experienced a decline in industrial production of 1.3%, with the G7 countries experiencing a decline of 1.0%. For the leading industrialised countries this compares with a slight rise during 1990 as a whole of 0.3%. As can be seen from the following data, all countries except Japan and West Germany are now experiencing a decline in industrial production (in the year to April unless otherwise stated): Canada -5.0%; US -3.3% (May); Japan 4.0% (May); France -0.3%; Germany 6.6%; Italy -6.2%; UK -6.8%.

As one would expect under such circumstances, there is clear evidence of declining inflationary pressure in the G7 countries with the exception of Germany and to a lesser extent Japan. Annual consumer price inflation for the OECD as a whole in May was 6.2%, and 4.7% for the G7 countries (down from 5.2% in February). The rates for individual countries were as follows: Canada 6.2%; US 5.0%; Japan 3.4%; France 3.2%; Germany 3.0%; Italy 6.8%; UK 5.8%.

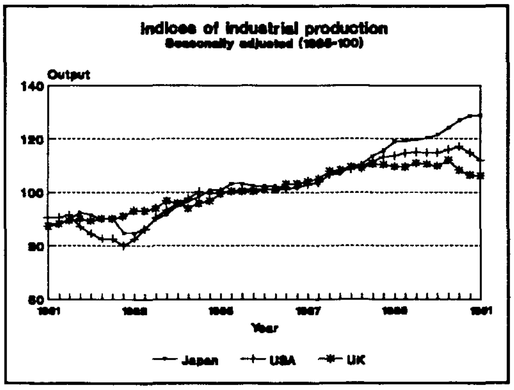
By contrast, every G7 country except Germany and Canada experienced falls in the rate of unemployment in the early part of this year. Canada's rate in May remained at 10.2%, unchanged since February, while West Germany's rate of unemployment fell slightly from 4.5% in February to 4.4% in April. Both the G7 countries and the OECD as a whole experienced slight rises in the unemployment rate to 6.7% and 6.3% respectively. The rates for the remaining G7 countries were: US 6.8%; Japan 2.1%; France 9.5%; Italy 10% (January); UK 9.2%.

United States

Having only just convinced themselves that the US economy really did begin to recover in the second quarter, American economic commentators are now wondering whether the modest recovery can be sustained into the third quarter. The fear is that if this is not the case, especially if consumer confidence continues to be fragile, the result will be not merely sluggish growth but a 'double dip' recession with sustained recovery much further off than had been hoped. As is often the case around a turning point in the economic cycle there continues to be a mixture of apparently conflicting signals. Pessimists tend to base their case on several disappointing indicators which were released in late July and early August. Orders for durable goods in June were expected to show a modest increase, but instead showed a fall during the month of 1.6%, representing an annual decline of 7.7%.

These figures have a habit of being revised downwards, and indeed the provisional increase in durable goods orders in May of 3.4% was subsequently revised to 2%. In addition, annual GDP growth in June was 2.1%; this is at least a positive figure, but the pessimists point out that it is much weaker than the very rapid GDP growth which the United States economy usually exhibits in the early part of an upturn. Although never entirely discounting the 'double dip' hypothesis, the official line has always been that recovery would be slow but steady. On balance, more recent data tends to suggest that this more optimistic outlook may prevail.

Provisional figures for retail sales in July showed a rise of 0.5%, rather higher than had been expected. This is all the more encouraging because, in contrast to durable goods orders, the retail sales figures are generally revised upwards, as was the case in both April and May. In addition to this, housing starts rose by 3.7% in July, at last suggesting that there may be some real recovery in the housing market, although commercial construction remains extremely sluggish.



Finally, the Purchasing Managers' Index - regarded as one of the more reliable indicators of the industrial 'feel-good factor' - rose in July for the sixth successive month, suggesting a continuing rise in industrial production in the third quarter. Nevertheless, the Federal Reserve has been sufficiently concerned about the fragility of the recovery and the possibility of its petering out in the third quarter to make an unexpected cut in interest rates once more. In early August the Federal funds rate was reduced by one-quarter of one percentage point - a modest enough cut, but one which took the financial markets rather by surprise. This was the first cut in interest rates since April, but the fourth since December, and indicates the Fed's desire to prevent the recovery petering out through an over-tight monetary policy.

Japan

In August Japan experienced its 57th month of consecutive economic growth, equalling the post-war record for uninterrupted growth which occurred between 1965 and 1970. Despite this, the interest rate cut which was discussed in the last Commentary did indeed take place. On 1 July the official discount rate (ODR) was reduced by one-half of a percentage point to 5.5%, the first cut in over four years. Given that the government expects continued growth in the year to March of 3.8% and that there is still underlying inflationary pressure in the Japanese economy, the interest rate cut may appear surprising; but it is not unjustified.

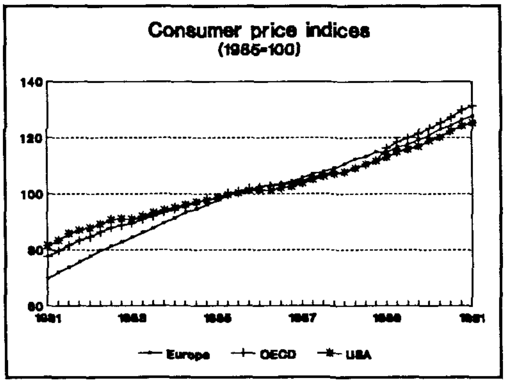
The simplest explanation appears to be a desire to strengthen the stock market following a sharp fall in the wake of financial scandals, resignations and recriminations. There are, however, deeper reasons, one of which is the Japanese desire to be seen to do their bit for international economic policy co-ordination, in which interest rates play a key role. But domestic considerations play an even more important part in the decision to cut interest rates. There are now clear signs that the Japanese economy is slowing down, with a cutback in investment expenditure leading the way. Capital spending is unusually high in Japan by Western standards, and has been particularly buoyant in recent years when the cost of capital has been extremely low; private capital expenditure accounted for 22% of GNP in 1990, and grew by 13% during that year.

Recent rises in interest rate and the tightened lending rules now being enforced by Japanese banks and financial institutions have reduced investment spending, which is nevertheless forecast by the central bank to rise by 7% in 1991. However, in recent months there have been noticeable and sharp declines in capital investment; in June machinery orders fell by 19% compared with the previous month, and were 9.3% below the corresponding month in 1990. The authorities are keen to maintain capital spending at a healthy rate to prevent the economy slowing down too quickly, and now feel that a slight reduction in the ODR can be safely made without refuelling the speculative 'bubble' of the mid-1980s which was based on rocketing property prices and dubious lending practices among financial institutions. There is little doubt that Japanese firms will continue to invest heavily if funds are available at reasonable rates; there is a desire to invest in labour-saving technology in the face of severe labour shortages and persistent cuts in average working hours, and both domestic and export demand for Japanese goods remains strong.

However, this very strength brings its own problems in terms of Japan's current account surplus which has continued to grow during the last few months. Japan's trading surplus grew by 25% in July, the seventh successive monthly increase. The trade surplus with the United States has stabilised somewhat, although there is evidence that exports to America are now increasing again as the US economy comes out of recession. By contrast, the trade surplus with the EC grows ever wider, rising by over 60% in the first half of this year compared with the same period in 1990 to reach a level of $14.4 billion. Worryingly from the European perspective is the fact that Japanese imports of EC goods fell by 3.2% in the first half of this year, and in July imports were a further 12.7% below the 1990 level as Japanese consumers cut back on the purchase of 'luxury' imported items in the face of a slowing economy.

Germany

In the last Commentary some mention was made of the East-West split which is now becoming evident in the economy of the unified Germany. More recent data has now confirmed the extent of this divide. The Bundesbank now estimates that industrial production in the east fell by almost 70% between January 1990 and February 1991, at a time of fairly steady increase in the west. Latest forecasts indicate unemployment in the east rising to 14% (1.2 million people unemployed) by the end of this year with a further 1.5 million engaged on short-term working; and this is an optimistic forecast, based on the assumption of people being removed from the unemployment register and placed on government training and job-creation schemes. By contrast, unemployment in the west has been falling steadily, and is expected by the OECD to average around 4.9% both in 1991 and in 1992. Certainly, GNP growth in the west is now forecast to slow to 2.8% this year and 2.2% in 1992, but this compares with GNP declines in the east of 15-20% in both years.



Virtually the only area in which the two halves of the country are coming together is in wages, precisely the aspect of the economy in which this should not be the case. Since unification wages in the east have risen to around two-thirds of the UK level, and continue to rise rapidly. Labour costs per hour worked rose by 73% in the second half of 1990 alone, which, when coupled with an obsolete capital stock which is scarcely worth replacing at these wage levels, goes a long way to explaining the slump in industrial production and GNP mentioned above. Apart from the political strains which this inevitably encourages, there continues to be concern about the west's ability to absorb and correct the economic problems of the east. Previous Commentaries have considered the issue of the growing budget deficit; here, some attention is directed to the growing external deficit.

Traditionally, West Germany has been thought of as a country with a virtually permanent current account surplus on its balance of payments. The new Germany is already running a current account deficit. The surplus peaked early in 1990 at 5% of GNP, but by the first quarter of 1991 had moved into a deficit of 1.5% of GNP. Much of this has resulted from falling exports, which declined by 3.5% in the first five months of this year compared withe the corresponding period in 1990. The slump in confidence resulting from the immediate aftermath of the Gulf war, recession in the United States and Britain, and the weakness of the dollar relative to the D-Mark have all played their part in this. The completely new factor, however, has been the massive surge in demand for consumer goods from the former East Germany following unification, which has encouraged many western German companies to concentrate their efforts at home rather than fight in the more competitive international markets.

Meanwhile, the Bundesbank has acted to deal with a more immediate problem; increasing inflationary pressure. In the middle of the year consumer price inflation rose to above 4%, leading to the decision in August to raise the discount rate by a full point to 7.5%, but to raise the Lombard rate by just one-quarter of a percentage point to 9.25%. The message from the Bundesbank is clearly that a wage-price spiral must be avoided at all costs, and the limited rise in the Lombard rate has been widely interpreted as leaving some further room for manoeuvre should a further small rise be needed later in the autumn.

Prognosis

Over the last eighteen months to two years the economic cycles of the major industrialised countries have become markedly out of synchronisation. The major English-speaking economies have experienced pronounced recessions, while the economies of Japan and (West) Germany grow rapidly. While most of the G7 economies will bottom out this year and recover in 1992 the situation is rather different in Germany, where the year of lowest - but still positive - growth in the cycle is expected to be 1992.

It now seems likely that next year will see the resumption of modest growth overall in the industrialised economies, with cyclical differences reduced. This does, however, depend on a number of factors. The first is for the G7 countries to continue with clear policy co-ordination, especially in monetary policy, without letting domestic considerations get too much in the way. Linked to this is the need for clear recovery in both the UK and US economies towards the end of this year and especially into 1992; in particular, a double-dip recession in the US must be avoided. Finally, the apparently never-ending Gatt talks cannot be allowed to fail. It is difficult to overstress the importance of world trade in the recovery and growth of the industrialised economies, and the reasonably optimistic picture which has been painted for the next year depends crucially on agreement being reached on a variety of issues in the Uruguay round.