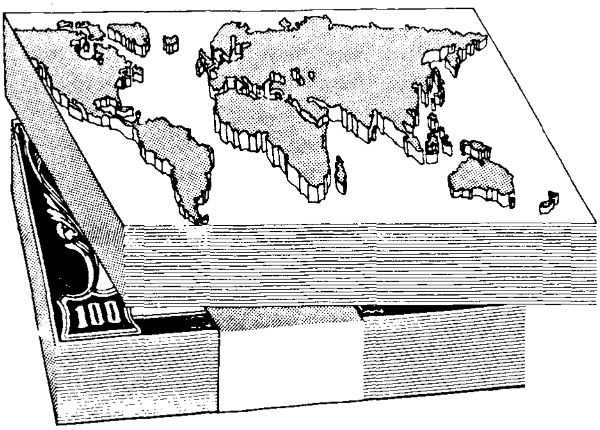
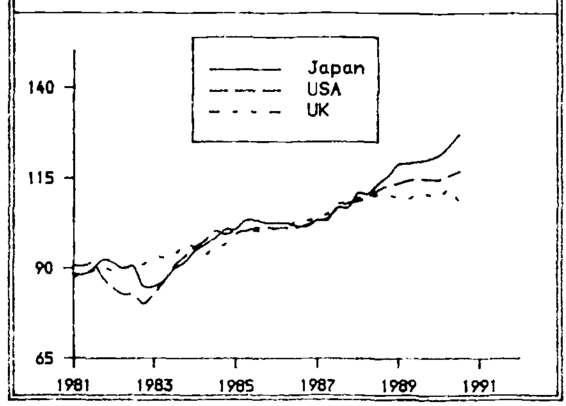
The World Economy



continuing evidence of a build up of inflationary pressure throughout the OECD. Annual inflation in the OECD as a whole rose to 7.3% in September, and 5.7% for the G7 countries, compared with 6.6% and 5.2% respectively in the year to June. Most of the individual countries within the G7 also experienced a rise in the annual rate of inflation of around 0.5 percentage points, with the exception of Italy where the rate of inflation remained virtually unchanged. Consumer price inflation rates for the G7 countries were as follows: Canada 4.8%; United States 6.3%; Japan 3.5%; France 3.9%; Germany 3.3%; Italy 6.2%; United Kingdom 10.9%.



Indices of industrial production
Seasonally adjusted (1985=100)

MACROECONOMIC TRENDS

GDP data on some of the G7 countries for the third quarter of 1990 is not yet available, and so overall comparisons with the last quarter are not possible. In those countries for which data is available the general trend is a fairly sharp decline in growth in the third quarter. Individual growth rates are as follows (year to September); Canada 0.5%; United States 1.1%; Japan 5.4%; France 2.8%; UK 0.6%.

Despite some evidence of a decline in September, year-on-year growth in industrial production continued to be healthy in the third quarter of 1990. In the year to September both the G7 countries and the OECD as a whole experienced 2.6% growth in industrial production. As in previous quarters, the German and Japanese economies continued to provide the bulk of the growth, with increases in industrial production of 6.0% and 7.7% respectively for the year to September (October for Japan). While less spectacular, France (2.4%) and the United States (1.8%) also showed reasonably healthy growth, while the UK went into sharp decline, with annual growth of -2.3% for the year to September. Growth rates of industrial production for the remaining G7 countries were Italy, 0.6% and Canada, -4.2%.

In the three months to September there was

In the OECD as a whole the rate of unemployment has been virtually unchanged throughout 1990. In October the G7 average was 5.6% with the OECD as a whole at 6.1%, both fractionally up on the respective rates for July. This was also the picture for individual countries within the G7, except for Germany where a marginal fall occurred. Individual countries' rates of unemployment in October were as follows: Canada 8.7%; United States 5.6%; Japan 2.2%; France 8.9%; Germany 4.9%; Italy 9.9% (July); UK 6.5%.

United States

The US authorities have finally decided that recession is more of a threat than inflation in the short run, and have now ordered their domestic economic policy with this in mind. The Bush administration now takes the view that the US economy is in recession - but only just, and with high hopes of a robust recovery in the latter part of 1991 and into 1992. The official forecast is for two quarters of declining GDP; the final quarter of 1990 and the first quarter of 1991. But this is expected to be followed by a rapid turnaround in the second half of this year leading to GDP growth for 1991 of 0.9%.

This seems to be rather optimistic, and recently the administration has shown a tendency to be overly optimistic on growth and to underestimate the impact of the budget deficit. In the final quarter of 1990 GNP fell at an annualised rate of 2.1%, which was no worse than might have been expected. Other economic indicators, however, remain stubbornly bleak, most notably retail sales. In nominal terms, retail sales were provisionally estimated to have fallen by 0.4% in December, which was later heavily revised to show a nominal fall of 1.5% for the month. This was followed by a further fall of 0.9% (provisional) for January, leading to a 1.4% fall for the year to January. In addition, the broad money aggregate M3 fell between September and December at an annual rate of 1%, which was part of the reason for the half of one percentage point fall in interest rates which occurred in early February.

In fairness, there are some straws in the wind indicating a relatively short-lived recession. Nominal personal income and expenditure rose by 0.7% in December, the second successive month of increase. and the composite index of leading indicators rose by 0.1% in December after fairly heavy falls in the previous four months. Together with rising inflation (6.1% in 1990 compared with 4.6% in 1989), these sort of indicators suggest that the Federal reserve will continue to be cautious on monetary policy.

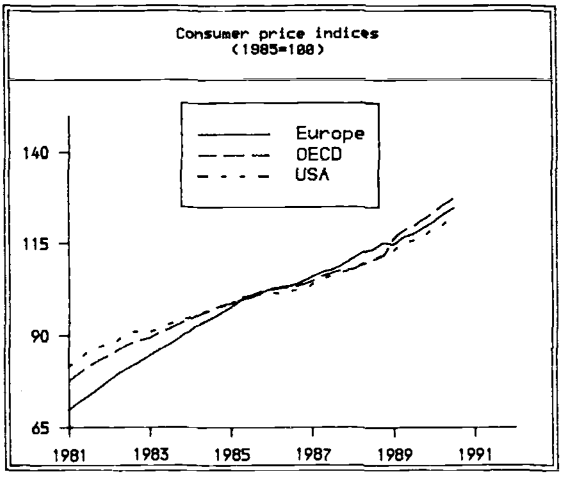
Nevertheless, the United States will do well to achieve positive GDP growth in 1991, and it is still not clear that the budget deficit problem has been fully grasped. Even without the need to finance the war in the Gulf, official estimates of the deficit have now risen to $318 billion for 1991 and $281 billion for 1992, and, as outlined in the last Commentary, plans to eliminate the budget deficit in four years depend on rapid and sustainable growth in 1992 and beyond. As indicated elsewhere in this Commentary, the costs of Desert Shield and Desert Storm could add considerably to the United States' problems in deficit terms, but at least the threat of markedly higher oil prices has not materialised to threaten what growth might be achieved in the latter part of 1991. It remains the case, however, that neither the short-run growth projections nor the medium-run deficit elimination targets seem likely to be achieved.

Japan

Japan continues to be one of the two major growth economies of the G7 nations. In 1990 GNP growth of 6.3% was achieved, with modest (by UK standards) inflation of around 3%. Concerns that inflation might accelerate further led to a continual tightening of monetary policy during 1990, and partly as a result of this the growth of Japanese GNP is forecast to fall to around 4% in 1991. The slowdown in growth is expected to derive principally from decreased investment rather than from a fall off in consumer demand. Both housing and capital investment show signs of tapering off, the former because of the successive bouts of tightening of monetary policy and the latter because of high land prices which may now have peaked. Overall investment growth in 1991 is now forecast to be around 4.6% compared with 10.6% in 1990.

Although 4% GNP growth may seem impressive, the prospect of slackening domestic demand coupled with relaxations in US and UK monetary policy has been enough to prompt rumours that there was a possibility of a reduction of Japanese interest rates. The Bank of Japan was quick to deny this possibility, although there does appear to be some satisfaction in official circles that the rapidly-growing money supply has been brought under control. There was a sharp fall in the growth of the money supply in December; in the calendar year 1990 there was growth of 8.6%, the lowest rate of growth achieved since 1987. Much of this was achieved by a cut-back in bank lending as a result of higher interest rates, and the authorities do not seem to be overly concerned about the prospect of a 'credit crunch' as outlined in the last Commentary. Nevertheless, with evidence of inflation still rising and a persistently tight labour market the Bank of Japan will be very cautious about relaxing its grip on interest rates.

One side effect of the rapidly growing economy has been a substantial fall in Japan's trade surplus with the rest of the world, an issue which has not received much prominence in recent months. In 1990 the trade surplus fell by 18.5% to $52.4 billion; during the year imports increased by 11% while exports rose by 4%. As domestic demand begins to falter there is every likelihood that the trade surplus will widen again, as fewer imports are sucked in. In addition, exports tend to be a key element of Japanese economic growth, a fact illustrated by the rapid increase in the trade surplus for January which resulted from particularly buoyant exports to South East Asia.



Germany

The West German economy has been on a cycle of accelerating growth since 1987, fuelled mainly by rapidly-growing investment and exports, and now appears to have peaked in 1990 when GNP growth exceeded 4%. The Bundesbank now forecasts GNP growth of 3.0% in 1991, somewhat above the consensus forecast of 2.5% by the main German economic institutes. The principal issues which are presently occupying the West German authorities are the fiscal and inflationary consequences of German unification and, to a much lesser extent, the Gulf war.

As indicated in the previous Commentary, West Germany dramatically underestimated the costs of unification with the East. The economy of East Germany has collapsed in rather more spectacular fashion than might have been expected. According to recent forecasts, the expected performance of the East German economy in 1991 is as follows; GNP -16.5%; unemployment and short-term working reaching 42% of the workforce; industrial production -30%; exports -66%; and labour costs rising by 25%. Most of the costs of financing the collapse and reconstruction of the East will fall on the buoyant economy of West Germany. There is no doubt that the West can bear this burden, but at considerable cost to its budget deficit, which is now expected to rise to DM160 billion from the DM70 billion which was achieved in 1990. This does not, of course, include any contributions to the Gulf war.

From a domestic point of view the main problem here is one of inflation, which began rising in 1988 through rapid export-led growth and has been high by German standards (around 3%) since then. Between July and December 1990 the broad measure of money, M3, grew at an annualised rate of 7%, a situation which the authorities would not allow to persist for long. Monetary union and the (virtual) parity agreed between the D-Mark and the OstMark could have resulted in a substantial increase in inflationary pressure, but this has proved to be less than was expected. Nevertheless, the Bundesbank has acted decisively to prevent inflation from rising to uncomfortable levels by raising interest rates. The 0.5 percentage point increase in early February was completely unexpected, and while rational from Germany's domestic perspective, did introduce problems for that country's ERM partners, particularly Britain.

There are now indications that fiscal as well as monetary policy will be employed both to pay for German restructuring and to ensure that inflationary pressures do not build up further. In February a series of tax increases was announced which will yield DM50 billion (1.8% of GNP) in a full year, including higher petrol and income taxes from July. These will inevitably further slow the rate of growth of the German economy, but this is unlikely to depress GNP growth below around 3% per annum in the early 1990s. There is, however, already evidence of a change in Germany's trade surplus with the rest of the world. Against estimated statistics for 1989, the trade surplus of the united Germany is estimated to have fallen by 20% in 1990, with the more accurate figures for West Germany alone indicating a 32% fall from the 1989 position. The West German trade surplus is now running at its lowest level since 1985.

PROGNOSIS

The latter part of 1990 saw the end of an eight-year boom in the economies of the industrialised countries which was brought about not by a further oil shock, but by steadily-tightening monetary policy stemming from rising inflationary pressure. With the major countries' economies now at different stages of their economic cycles this has resulted in a slowdown but not a slump, except for particular economies, most notably in the English-speaking world.

In the last three months the most interesting development has been what has not happened to oil prices. Several factors, including the inability of Iraq to affect Saudi supplies, has resulted in the oil price being closer to that suggested by the underlying determinants of supply and demand than that dictated by war panic; the world oil market is still in a state of basic oversupply. The lack of an oil shock and the steady growth of countries such as Germany and Japan has led to a modestly optimistic outlook for the industrialised world as a whole. While world trade is expected to slow from the rapid growth achieved in 1989 and before, it should still remain relatively healthy throughout 1991 (around 5%), unless there is a complete collapse of the reconvened GATT talks.

As recently as last december the IMF was forecasting an average of 2.4% GNP growth in the G7 countries during 1991, with growth of around 3% during 1992-95. With the recession in the US and UK the 1991 forecast will not now be achieved, but the reasonably upbeat 1992-95 forecast is still possible if all goes well. Within Europe there are particular problems posed by German domestic policy for ERM members. Clearly Germany will continue to use a high D-Mark and tight monetary policy as a defence against inflation, which may mean ERM partners such as the UK deferring further interest rate cuts which may be warranted for reasons of domestic policy. But these problems are not insuperable, and for much of the industrialised world the outlook is by no means gloomy.