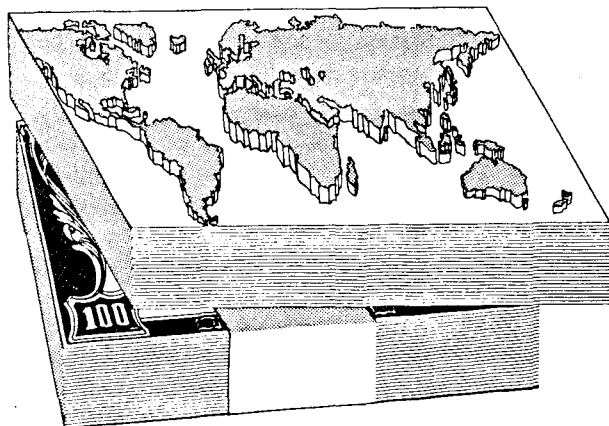


The World Economy



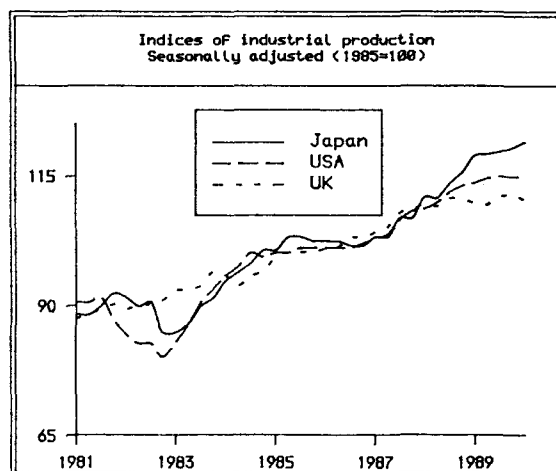
MACROECONOMIC TRENDS

The early part of 1990 saw continued slowing of economic growth in the major industrialised countries. GDP growth in the top seven industrialised nations (the G7) was just 0.5% in the first quarter, the same as the final quarter of 1989. For the year to March G7 GDP growth slowed to 2.4% compared with 3.3% for calendar year 1989. The most rapid slowdown occurred in the US where 3.0% growth in 1989 fell to 2.1% in the year to March. Overall G7 growth would have been considerably lower had it not been for increases in the growth rates of West Germany (4.3%) and Japan (5.5%). Growth rates for the remaining G7 countries (excluding Italy) were as follows: Canada 2.2%; France 2.5%; UK 1.8%.

Industrial production also continued to slow steadily during the first quarter of this year. For the OECD as a whole industrial production rose by just 2.0% in the year to March, down from 1989's rise of 2.6%. As has been the case for some time, the G7 countries have led the slowdown, and G7 industrial production growth in the year to April was a mere 1%. Two of the seven largest countries had declines in industrial production during this period; Canada (-2.2%) and, rather surprisingly, France (-0.3%). The remaining countries performed as follows: US 1.3%; Japan 3.4%; West Germany 2.1%; Italy 1.8%; UK 0.5%.

Although inflationary pressures have begun to build up strongly during 1990, the rate of consumer price increases fell slightly during the year to May in both the G7 countries (4.3%) and the OECD as a whole (5.9%). The price surge which was so noticeable in Japan in the latter part of 1989 and early this year subsided considerably during March and April, although there is now some evidence of a re-emergence of this problem (see Japan below). In fact, in the year to May consumer price inflation moderated in six of the seven G7 countries - the exception, which will surprise no-one, was the UK.

Consumer price inflation in the year to May was as follows: Canada 4.5%; US 4.4%; Japan 2.5% (year to April); France 3.0%; West Germany 2.3%; Italy 5.7%; UK 9.7%.



Labour Market

The steady falls in unemployment which were evident during 1989 have now clearly levelled off. Average OECD unemployment in April was 6.0%, unchanged from January. The G7 countries fared slightly better with an unemployment rate of 5.5%, also unchanged from January. Within individual G7 countries there were few changes in the rate of unemployment between February and May. Unemployment rates (in May unless otherwise stated) were as follows: Canada 7.6%; US 5.3%; Japan 2.1% (April); France 9.3%; West Germany 5.1%

(April); Italy 10.2% (April); UK 6.2%

United States

During the past four months there has been a barrage of conflicting statistical evidence on the performance of the US economy, with opinion divided on whether inflation or recession is the greater threat. An example of this is the monthly index of the National Association of Purchasing Managers, a survey-based index indicating the strength of the (mainly manufacturing) industrial sector of the economy. The index rose steadily between April and June, indicating a stronger manufacturing sector, and was backed up by a 2.1% increase in manufacturing new orders in May. The NAPM's index then promptly slumped in July, once again raising fears in some quarters of recession, fears which were strengthened by the Gulf crisis and higher oil prices in August.

Partly as a result of this type of contradictory evidence the Bush administration and the Federal Reserve have differed somewhat over monetary policy. The administration has been keen to see an early cut in interest rates, arguing that the Federal Reserve is overly cautious with respect to inflation while being too sanguine on the possibility of recession. The Reserve, on the other hand, has consistently taken the view that there is little real prospect of recession, forecasting real GNP growth of 1.5-2.0% this year albeit with a very sluggish second half-growth. Federal Reserve Chairman Alan Greenspan has been consistent in the view that a cut in interest rates will be forthcoming, but only when the administration and Congress agree a package to reduce the budget deficit, of which agreement there is little sign at the time of writing.

At first sight the Federal Reserve's caution on inflation appears justified; consumer prices rose 0.5% in June, giving an annual rate of increase of 5.9% compared with 4.5% for calendar year 1989. The administration takes the view that this will rapidly stabilise around the 5.5% mark before falling in 1991, and is concerned that interest rate reductions take place in order to offset likely cuts in government spending and higher taxes introduced to help reduce the budget deficit.

Probably correctly, the administration takes a fairly relaxed view about the effect higher oil prices will have on the US economy, trimming

growth a little and adding less than one percentage point to the rate of inflation, unless the Gulf crisis worsens substantially. Although domestic demand is shaky, export growth remains fairly strong - an increase of over 8% in the first five months of 1990 compared with the same period last year. The main problem for the US may stem from a crisis not in the Gulf but one of confidence in the domestic economy.

Japan

At first sight Japan is the industrialised economy which has most to lose from higher oil prices and prolonged uncertainty in the Gulf. Japan is dependent on imports for 99% of its oil, and further inflationary and potentially recessionary pressure from this source would appear to be very unwelcome for a country which recently underwent a 'triple fall' - declines in the yen, share prices and bond prices. However, in recent years the Japanese economy has proved to be remarkably resilient to even quite severe exogenous shocks, and this is likely to be the case once again.

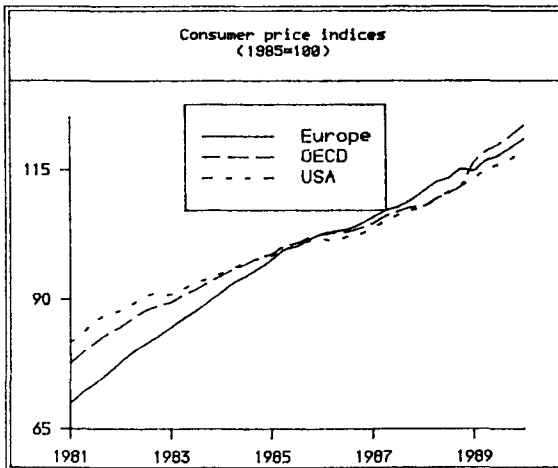
The last Commentary mentioned the rapid depreciation of the yen and recent turmoil in Japanese financial markets, sufficient, perhaps, to end Japan's remarkable recent record of economic growth. In the last three months, however, the economy has recovered to such an extent that it was as if the 'crisis' had never occurred, and forecasts of GNP growth are once again being adjusted upwards. In the first quarter of 1990 real GNP grew by 2.5% over the previous quarter, an annual rate of over 10%. By June the Japanese economy had achieved its 44th consecutive month of growth, a feat which has not been accomplished even in Japan since the 1960s. Industrial production also remains very buoyant, and GNP growth of between 4% and 5% is now being forecast both officially and unofficially.

The recovery in the value of the yen, coupled with a further rise in the official discount rate to 6%, will help the fight against inflation which has begun to emerge as a serious threat in Japan - although at less than 3% consumer price inflation looks low by recent UK standards. Nevertheless, very low unemployment (2.1%) and emerging labour shortages are now putting upward pressure on wages.

But what of the effect of higher oil prices? Despite Japan's dependence on imports, oil is now

much less important than it was in the 1970s. According to one recent estimate, in 1974 a rise of 10% in the price of oil meant a 1.0 percentage point rise in inflation and a 0.5 percentage point reduction in economic growth; the equivalent figures today are nearer 0.1 percentage point on inflation and a reduction in economic growth of 0.1 percentage point. Even if oil prices were to stick in the \$30 pb range this would imply a degree of difficulty for Japan, but very far from a catastrophe.

But just as it appears that Japan can cope with the threat of higher oil prices an older problem ones again moves into view. After falling steadily for some time, Japan's trade surplus widened substantially in June to \$6.7 billion. Despite official statements about this being the effect of the recent weakness of the yen and unexpected single items of exports, there does appear to be some concern that this may signal the beginning of larger Japanese trade surpluses with all the friction with the US and other Western countries which that has entailed in the past. As before, this may be the price which has to be paid for Japan being one of the principal G7 growth economies.



Germany

With German unification now scheduled for 3 October it seems appropriate to drop the prefix 'West' from this section. Unfortunately, the problems inherent in combining two very different economies are not so easily dealt with, and it is on these problems that this section concentrates.

Although the legal and constitutional niceties of a united Germany must wait for October, unification occurred in practice on 2 July with monetary union. Almost immediately, both East and West began to experience the pains of rapid economic adjustment, with most of the difficulties being experienced in the East. One of the problems here is that hard data on the East German economy is very scarce, but it does now seem to be the case that the situation was much worse than had been thought; already some East Germans are accusing the West of failing to provide the necessary capital to prevent a complete collapse of East German industry, and of being too eager to pick up the profitable parts on the cheap.

East Germany's 8,000 state-controlled companies - which account for nearly all of the country's industry - have now been placed in the hands of a 'treuhand' (trust) whose job it is to oversee their successful transition into the private sector. The trust guaranteed the first tranche of liquidity credits (valued at DM10 billion) to these companies in July, in the hope that West German banks would follow close behind with their own money. In fact this has been slow to occur, with banks tending to insist on 100% guarantees from the trust. Chancellor Kohl was forced to make a personal appeal to West German bankers to be less cautious in their lending policies.

Even if the necessary finance for speedy restructuring can be forthcoming rapidly, it is far from clear how much of East German industry can survive in the free market. Pessimists take the view that little over half of these enterprises will survive, with East German unemployment rising to 4 million; even optimists expect unemployment to rise above 1 million, out of a total workforce of less than 9 million. Already unemployment is rising more quickly than was expected by Bonn, because of the rapid collapse of the East's industry. In July alone unemployment doubled to 280,000, and seems likely to be double the estimate of 450,000 for the second half of the year on which budget estimates were made. Partly for this reason East Germany's budget deficit is expected to be 30% above the forecast level of DM32 billion, and financing this deficit must ultimately fall at the door of West Germany.

Germany should, however, be able to take even these problems in its stride. Shortly before that plans for early constitutional merger were

announced, the Bonn Government forecast 3.5% growth for West Germany in 1991, with almost one-third of this coming from demand stimulus from the East. While both East and West will continue to grumble about opportunism on one side and economic incompetence on the other, the united Germany should weather the short-term storms successfully and continue to be one of the main driving forces for growth in the G7.

PROGNOSIS

Until the Iraqi invasion of Kuwait in early August it seemed that the major industrialised countries were, in the main, continuing their steady path towards economic slowdown without entering recession. Financial storms had been weathered in Japan, and while the transition to a market economy in East Germany is proving to be more costly than was anticipated, the evidence still suggested that this could be dealt with in a reasonably orderly fashion. Admittedly there was still a threat of recession in both the US and UK, but on balance the overall picture still looked bright until the end of July.

Whether the situation in the Gulf changes all this very much depends on whether there are outright hostilities and what effect there is on the price of oil. Much, but by no means all, of the shortfall in Iraqi/Kuwaiti production can be made

up by oil producers from both inside and outside OPEC. Nevertheless, there will inevitably be higher oil prices and a degree of pain attached to them; but unless the situation in the Gulf worsens considerably this need not be too severe.

Economies like Japan and West Germany, although heavily dependent on imports of oil, are growing sufficiently quickly to be able to weather an oil price in the \$25-30 pb range without too much difficulty, although at the risk of some inflationary pressure. The US may, however, be at much greater risk. As was indicated in the United States section above, there is already a crisis of confidence with regard to the American economy which will not be helped by rising oil prices. Unlike most other industrialised countries, the US has done relatively little to reduce its dependence on oil following the price hikes of 1973 and 1979, and this may make it more vulnerable to problems in the Gulf than many other countries.

Even allowing for possible US difficulties, the likely outcome for industrialised countries in the West is some discomfort but not disaster, unless the position in the Gulf worsens markedly. It is worth bearing in mind that in real terms oil halved in price between mid-1980 and mid-1990, and we have some way to go before we experience the dislocations of 1979-80.