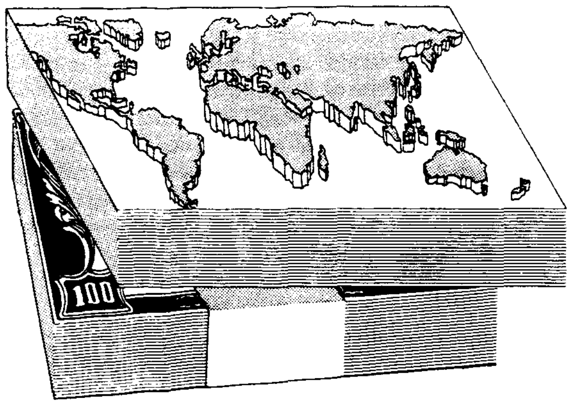
THE WORLD ECONOMY



MACROECONOMIC TRENDS

In the final quarter of 1991 GDP growth in the major industrialised countries actually picked up slightly on an annual basis. Comparing the final quarter with the corresponding period in the previous year, average G7 growth was 0.9% compared with an annual rate of 0.5% for the previous period. Much of this was due to the United States returning to marginally positive growth following substantial decline. Moving in the opposite direction, however, is (west) Germany, which suffered three successive quarters of declining GDP until the end of last year. Individual country growth rates (Q4 1991 on Q4 1990) were as follows: Canada -0.3%; US 0.3%; Japan 3.1%; France 1.8%; Germany 0.9%; Italy 1.2%; UK -1.1%.

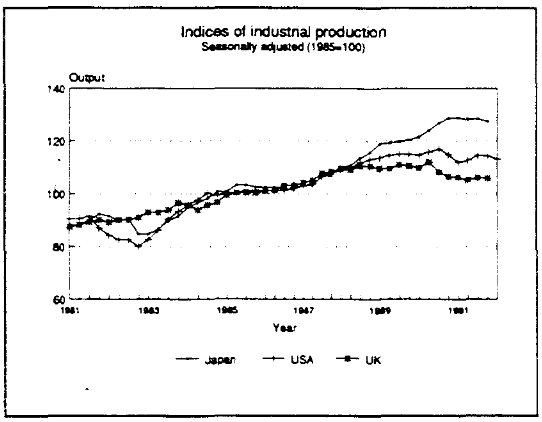
Following a slight upward blip in the third quarter of last year, industrial production in the industrialised countries feel sharply in the final quarter of last year and early 1992. In the year to January G7 industrial production declined by 0.7%, with the OECD as a whole exhibiting a decline of 0.8%. The most remarkable element of this performance is that it is almost totally accounted for by a fall of 3.6% in Japanese industrial production (year to February), an indication of the extent to which the economy of that country has gone into decline. Other G7 countries performed as follows (year to January unless indicated): Canada -1.2%; US 1.4% (February); France 0.4%; Germany 1.5% (February); Italy -0.1%; UK -1.1%.

Consumer price inflation has continued its steady decline. In the year to February consumer prices rose by 4.3% in the OECD as a whole, and by 3.1% in the G7 countries. Of the G7 countries only Germany showed a rise in inflation over the last three months, to an annual rate of 4.3% (the second highest of the major industrialised countries). Individual countries were as follows: Canada 1.7%; US 2.8%; Japan 2.0%; France 3.0%; Italy 5.3%; UK 4.1%.

Following a fairly lengthy period of stagnation, standardised unemployment rates in the OECD have begun to rise again. The OECD average is now 7.2%, and the average for the G7 countries is 6.7% (both February). Canada, the United States, France and the UK all experienced rising unemployment rates between November and February. Individual country rates were as follows: Canada 10.5%; US 7.2%; Japan 2.0%; France 9.9%; Germany 4.3%; Italy 9.9% (October); UK 10.2%.

United States

In the last Commentary the persistence of the recession in the US economy was the principal issue of discussion - nothing has changed in this respect. In April fresh doubts about the prospects for recovery began to be voiced when the retail sales figures for March were announced as a (nominal) decline of 0.4%, later revised to a decline of 1.0%. This was the first fall since October, and was accompanied by a slowing in the rate of growth of industrial output to 0.2% in March following growth of 0.5% in February. So concerned did the Federal Reserve become about the sluggish nature of the recovery that short-term interest rates were reduced by a further quarter point to 3.75%.



GDP growth at an annual rate of 2% in the first quarter of this year was better than had been anticipated, but was tempered by warnings of still hesitant personal consumption and residential investment spending. The Commerce Department's index of leading indicators rose by only 0.2% in March following much larger increases in the previous two months, and the coincident indicator appears to have flattened out. Finally, after showing signs of growing rapidly for several months, housing starts fell unexpectedly in April. It was not only the fact of the fall but its size (17% in a single months) which once again produced calls for a further easing of interest rates despite the fears being voiced in some quarters that retail price inflation could rise from its present level of 2.8% to over 4%.

There is no doubt that this recovery is unusually slow by American standards. Typically the US economy grows at an annual rate of 5-6% during the early part of the upward stage of the economic cycle, but on this occasion it is unlikely that an annual growth rate of above 3% will be achieved in any single quarter before the end of this year. Consumer spending growth is little over half of the rate of previous recoveries, and the decline in investment spending has been particularly heavy. Indeed, so sluggish is the domestic economy and so slow has been the rise in real incomes in recent years that it is difficult at first sight to see why there should have been any economic growth at all in the US economy.

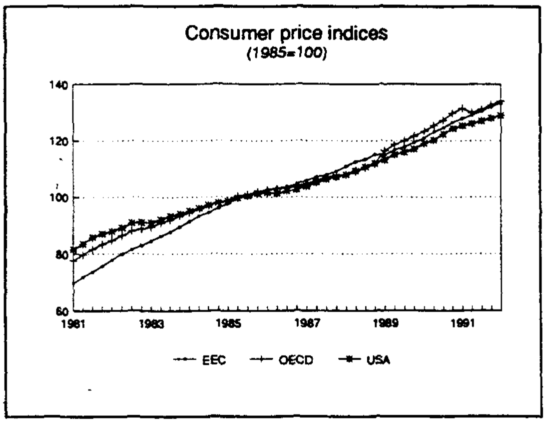
At least part of the reason for this has been America's ability to maintain its export base during a recession which is not only domestic but which has affected most of the country's major trading partners. Part of this has, of course, been due to an undervalued currency, a situation which, in principle, should not persist in the long run. But there is now evidence of domestic upturn again, with significant employment growth in the early part of this year, and provisional retail sales figures for April indicating a rise of 0.9%. The difficult trick for the American authorities is to send the correct signals to encourage consumer spending and business investment, but without appearing to be soft on the threat of inflation. To that end, it is unclear to what extent both monetary and fiscal policy can be further relaxed.

Japan

While industrialists in Japan insist that the outlook is bleak, the Japanese authorities remain convinced that the country's economic problems are more psychological than real. All that is required, it is argued, are measures that will prevent further economic pessimism and help restore orderly growth to the economy.

To that end a package of 'emergency' measures was announced by the Economic Planning Agency at the beginning of April, designed to stimulate the domestic economy in the short term. Among the announced measures were an increase of 15.7% in government spending in the first half of this fiscal year compared with its equivalent six-month period in 1991. In fact, very little of this represents new money; three-quarters of the increase comes as a result of front-loading public works programmes in the early part of the year, precisely the sort of measure discussed above designed to prevent the decline in (mainly industrial) output becoming a full-blown recession.

At the same time the official discount rate was lowered once again, this time by 0.75 percentage points to 3.75%. A clear signal was given that this was to be regarded as the last in the series of ODR cuts, and official sources indicated that it was perfectly adequate for the needs of the domestic economy; the 'speculative bubble' of the late 1980s is now over, it was stated, but there is no need for this to be followed by a real recession. Despite a very rapid fall in industrial production (it has fallen for the last six successive months), there is indeed little real sign of an economic slowdown of American or UK proportions. Much of the fall in industrial production has resulted from a much-needed downward adjustment in inventories, which rose sharply during 1991. The Economic Planning Agency's forecast of 3.5% GNP growth this year may be rather optimistic, but even pessimists believe that Japan can achieve growth of over 1.5% this year.



However, the stronger spur towards taking measures designed to boost the domestic economy derives from external rather than internal sources. Japan's trading partners, especially the US, continue to be frustrated by the rapidly rising trade surplus in Japan, reflecting the tendency of Japanese consumers to reduce rapidly purchases of imported goods in times of (relative) hardship. In March the trade surplus grew by 29.3% in a single month to stand at $10.98 billion. For the fiscal year the trade surplus stood at $88.35 billion, 63% higher than the previous twelve month period, and very close to the 1986 record surplus of $89.7 billion. Fiscal and monetary stimuli to the domestic economy will be welcomed by Japan's major trading partners, but whether the steps taken so far will be enough to mollify the American protectionist lobby is less certain.

Germany

As often happens when an economy approaches a turning point, there is considerable disagreement in Germany about which is the greater threat - recession or inflation. In a review of the economic prospects for both east and west Germany, the country's five leading economics institutes halved their growth forecasts for 1992 to 1% for the west, and concluded that the country as a whole would experience GDP growth of 1.5% this year. This, incidentally, assumes GDP growth of 10.5% in the east, a far cry from the 30% fall experienced in 1991. The institutes predicated their forecasts on the assumption of moderate (i.e. below 6%) wage settlements, and urged the Bundesbank to lower interest rates in order to stimulate the domestic economy, which they believe has not yet clearly bottomed out.

The Bundesbank takes a very different point of view, regarding the threat of inflation as more important than the prospect of continuing recession. When inflation rose to 4% in December the Bundesbank raised interest rates regardless of the difficulties which this posed for Germany's ERM partners. Inflation reached 4.8% in March, and while it is expected to fall by the end of the year, this is still too high for comfort as far as the bank is concerned. Money supply M3 rose at an annual rate of 9.75% in March, well above its target range of 3.5-5.5%. This led the finance minister to promise four years of clampdown on government spending, with effectively no new spending at all, and cuts in some areas. With the public sector strike in early May it looked at one time as if the whole economic strategy might be blown off course. However, the strike ended after ten days with a settlement which will add 5.12% to federal and state wage bills this year; higher than the Bundesbank would have liked, but within the limits assumed by the economics institutes.

Despite the problems being faced by German exporters in world markets, in March the federal trade surplus widened markedly to DM4.9 billion, compared with DM2.8 billion for the same month last year. The current account deficit also fell sharply to DM300 million compared with DM6.4 billion in March 1991. This was partly due to industry completing orders early because of the threat of expected strikes; in the event, the anticipated strike by metal workers was averted at the last moment, and it may be the case that the current account deficit will reassert itself in the next quarter unless there is a very rapid recovery in the domestic economy.

PROGNOSIS

The consensus among major forecasters is that GDP growth among the major industrialised countries will remain sluggish throughout this year but will pick up in 1993. The IMF and OECD have very similar forecasts; the former indicates industrial countries' growth of 1.8% this year followed by 3.3% next, while the OECD forecasts growth for member countries of 1.8% this year and 3.0% in 1993.

Both organisations have reasonably optimistic assumptions on world trade underlying their forecasts, with world trade growth expected to rise by at least 5% this year and by around 6.5% in 1993. As discussed in previous Commentaries, this is in turn highly dependent on agreement being reached on some fundamental issues in the much-postponed Uruguay round of Gatt. Now, however, there is much more optimism with regard to world trade liberalisation following the agreement by the EC to engage in far-reaching reforms of the Common Agricultural Policy. The CAP has been a major sticking point in the Gatt negotiations, with America insistent that further progress could not be made until the EC showed a willingness to cut the subsidies paid to the farmers of member states. Agreement has now been reached in principle for this to be achieved.

The agreement should virtually eliminate export subsidies by 1997, thereby bringing internal farm prices within the EC closer to world market prices. With luck, this will provide the breakthrough necessary to get the Gatt talks moving again, in which case the more optimistic forecasts of world trade and overall economic growth will be a lot closer to being realised.