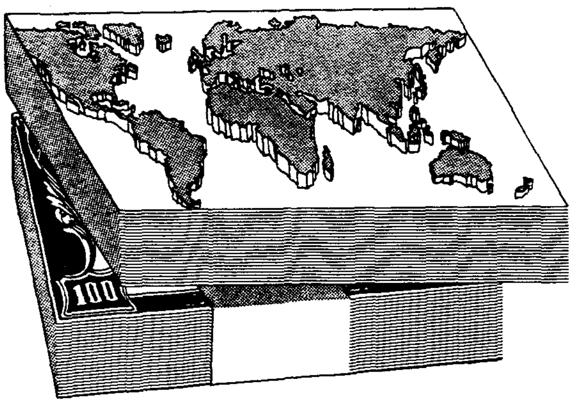
THE WORLD ECONOMY



MACROECONOMIC TRENDS

In the first quarter of 1992 GDP/GNP growth averaged 1.7% in the main four world economies. The position of the U.S.A., Germany and France improved but growth slowed dramatically in Japan. Table 1 sets out growth rates for each country and provides a provisional estimate for the U.S.A. in the second quarter.

Table 1. Growth of GNP/GDP

	1991q4	1992q1	1992q2
United States	-0.5%	2.9%	1.4%
Japan	3.1%	1.0%	n/a
Germany	-0.5%	1.8%	n/a
France	0.1%	1.0%	n/a
Italy	0.4%	0.4%	n/a
U.K.	-1.1%	-0.5%	-0.1%

Industrial production recovered in the first quarter in Germany and in United States. Production has declined in France and collapsed in Japan, as can be seen in table 2.

Table 2. Growth of Industrial Production

	1991q4	1992q1	1992q2
United States	-0.5%	1.3%	2.0%
Japan	-1.6%	-4.6%	-6.2%
Germany	0.1%	1.3%	1.1%
France	1.7%	1.1%	0.1%
Italy	-0.7%	-0.3%	n/a
U.K.	-0.8%	-1.3%	-0.2%

Consumer Price inflation remained reasonably stable over the three quarters. The major inflationary gains were achieved in Japan and Italy.

Table 3. Consumer Price Inflation

	1991q4	1992q1	1992q2
United States	3.0%	2.9%	3.1%
Japan	3.2%	2.1%	2.5%
Germany	4.5%	3.3%	3.5%
France	2.9%	3.1%	3.1%
Italy	6.1%	5.6%	5.5%
U.K.	4.2%	4.1%	4.2%

The unemployment position in Italy, France and the United Kingdom remains acute, especially in the latter. Unemployment has also been rising steadily in the United Stats but not the same levels as these European economies.

Table 4. OECD Unemployment Rates

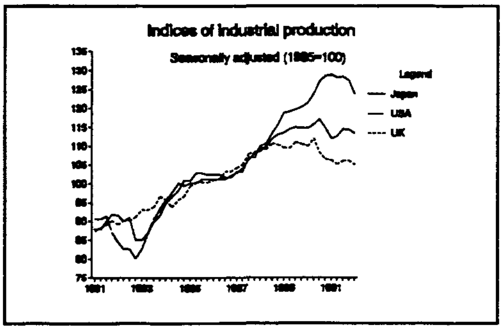
	1991q4	1992q1	1992q2
United States	6.9%	7.1%	7.4%
Japan	2.1%	2.0%	n/a
Germany	4.3%	4.3%	n/a
France	10.0%	10.1%	10.3%
Italy	9.9%	9.9%	n/a
U.K.	9.7%	10.2%	10.5%

The United States

Following the encouraging 2.9% growth of GDP in the first quarter the recovery faltered again and achieved a rise of only 1.4% in the three months to June. The fragility of the U.S. recovery, a symptom of the large debt-income ratio fostered in the Reagan years, is reflected in the trend of Industrial Production. In March and April of this year production growth peaked at 2.5% but has now fallen back to only 0.7% in July. Just like the U.K. economy the U.S.A. depends on consumer confidence to engineer a recovery since the trade deficit is well into the red.

The contribution of the consumer to this uncertainty is evident in two indicators; consumers expenditure and retail sales volume. The first of these grew by some 5.1% in the first quarter and then collapsed in the second, showing growth of only 0.3%. The real volume of retail sales has increased very erratically since growth resumed in December of last year. It rose by 5.0% in January, 1.2% in March, 2.1% in April and then fell back again to 1.4% in May.

Two factors which influence consumers confidence, which fell back from a nine month peak of 72.6 in June to 61.0 in July are the debt-income ratio of consumers and their fear of unemployment. The first of these deters new credit agreements and the second throws doubt on the ability of individuals to use future income as collateral, thereby reducing consumption. Evidence suggests that the increase in unemployment raises the savings ratio, so the faster the rise or more erratic the movement in unemployment the less likely a consumption increase.



The OECD standardised unemployment rate rose sharply between April and June. It rose by 0.6 to 7.7%, the highest rate since 1984. Further weakness in demand can be seen in the trend in broad money. M2 growth peaked in December 1991 at 3.0% but after the FED cut the discount rate to a 29 year low of 3.0% it has failed to inflate to anywhere near its target range of 2.5 - 6.5%. The composite leading indicator stalled in June after growing all year.

Any room for further cuts in interest rates in the run up to the Election is limited because inflation appears to have stuck and is threatening to rise again. Consumer Prices in July rose by 3.2%, up 0.1% on June, producer prices in June rose by 1.7%, up 0.6% on May and unit labour costs rose for the first time since January this year.

On the good side the US Merchandise trade deficit fell 7.7% in June to $6.6bn as exports rose by 7.2%. However more than 40% of the increased exports were due to increased sales of civilian aircraft. For the first six months the trade deficit was only $5bn worse than the $30.5bn deficit for the same period last year. In addition the US corporate banking sector seems to have solved its problems. After the collapse of the property market the US banking sector went into nosedive. It responded quickly by slashing dividend payments, rationalising the workforce and engineering 3 major mergers. The result of these prompt moves is an improvement in earnings, lower loan write offs and stronger capital ratios in the second quarter.

Japan

Fears of a real recession in Japan have resulted from the disappointing first quarter GNP growth and the main economic indicators released in the summer. Gross National Product rose by a mere 1.0% in the first quarter buoyed up by consumers expenditure and the ballooning current account surplus. Industrial Production fell by 6.2% in July, more than the average fall in the first six months, although nearly twice as bad as the fall in June.

The state of demand also leaves room for concern. The real volume of retail sales fell for the second month running in April (-2.8%) but by less than in March (-4.5%). The trend in volume resembles a downward sloping sawtooth and so opens the possibility of further contractions. the composite leading indicator, after two slight increases in March and April has stalled again. In response to the deterioration in the real economy the Bank of Japan reduced the discount rate to 3.25% in late July, but has failed to boost the money supply as yet. Broad Money (M2+Cds) rose by 1.1% in May, 0.9% in June and a mere 0.2% in July. Narrow money (M1) grew by 6.9%, 3.3% and 2.8% in the same period.

The labour market has deteriorated again. The OECD standardised rate of unemployment rose by 0.1 to 2.1% in May. The Vacancy rate indicator fell from 129.8 to 121.2 in May, representing a fall of 6.6% over the month.

The problems facing the Japanese economy centre around the psychologically damaging effects of the collapse share and property prices. Low interest rates in the mid 1980s, coupled with financial liberalisation led to a bubble in asset prices and massive corporate borrowing. As the domestic and world economy overheated the cost of borrowing increased and asset prices collapsed with the obvious inhibitive follow on for investment activity. Housing investment, which makes up one fifth of the total fell by over 8% in 1991. Unfortunately for the authorities, the downward trend in activity has heightened the belief that they are ineffective and unlikely to engineer a recovery. The stock market crash has certainly increased the prospect of an outright real recession. In response to the crisis of confidence the authorities have introduced a package of fiscal measures which could put between Y6,000bn and Y8,000bn into the economy. The Bank of Japan has also introduced a series financial regulations designed to discourage the selling of shares when companies wish to boost profits by realising capital gains.

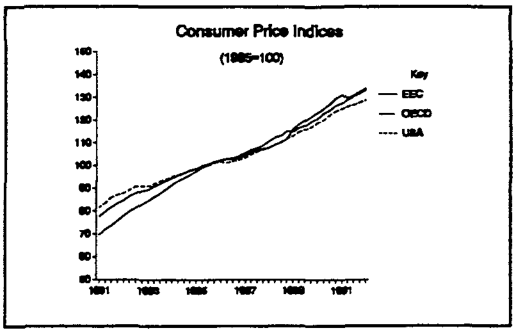
The Current Account surplus for the half year totalled $56.2bn, up 94% on the same period in 1991, a record for any half year. The surge in the current account is the result of three factors. Firstly, the level of competitiveness has improved now that the mid 1980s overvaluation of the yen has been reduced. Secondly, the large increase in the US export market has boost exports and thirdly, very weak domestic demand has reduced import demand substantially.

Inflation does not seem to trouble the Japanese economy at this time. Consumer Price inflation fell from 2.5% in July to 1.9% in August. Producer prices fell by 0.7% in August and have not risen since October 1991.

Germany

Real GNP grew by 2.0% in the first quarter of 1992, following three successive quarters of contraction. Much of the credit for this resurgence stems from a resuscitation of investment, which grew by 8%, and consumer spending.

The period since this good news is much less buoyant. The real value of retail sales fell heavily in the three months to June, showing growth rates of -2.4% in April, -4.3% in May and -6.8% in June. This may, of course, be due to consumers increasingly putting off non-essential purchases until July when the consumption elements of the 'Unification taxes' are withdrawn. Assuming that this is correct we should see a strengthening in consumers expenditure in the latter half of this year, augmented by spending brought forward to avoid the raising of VAT from 14% to 15%. The trend in industrial production has been erratic over the year but contracted heavily in June, by 4.5%, following average positive growth of 0.8% in the first five months of 1992.



The labour market has also deteriorated. In May the OECD standardised unemployment rate stood a t 4.5%, up from 4.3% in February. The vacancy rate indicator has fallen heavily, from 283.5 in February to 266.3 in May, a decline of 6.1%.

The level of the money supply and its effect on interest rate movements is of particular concern given Germany's anchor role within the ERM. Broad money is currently growing at levels well above its 3.5 - 5.5 % annual target level. M3 growth has risen throughout the year and annual growth rates of 7.8%, 8.2% and 8.4% were recorded in May, June and July. The major reason for the expansion in credit has been, one, the demand for private sector credit, which goes into construction and investment in the former East Germany and, two, the demand for credit to buy shares in state firms sold by the Treuhandanstalt. Interest rate policy has reacted primarily to this consideration and in July the Bundesbank raised the discount rate by 0.75% although a slight loosening of policy occurred in the wake of the ERM crisis.

Inflation seems to under control now that the unification tax has dropped out of the calculations. Consumer prices fell from 4.5% in May to 3.3% in July, rising slightly to 3.5% in August. Producer prices were trimmed from 2.0% in May to a slim 1.1% in July. Unit labour costs fell from 5.4% in April to 1.7% in May.

The trade deficit is still a problem for Germany. Now that the import boom following the unification period is over the import pressure has receded. Germany's problem is now focused on weak export demand from its European competitors, following the high interest rate policy followed by the Bundesbank, and from the US where German competitiveness has suffered from the recent fall in the US dollar.

The Public Sector deficit, which resulted from large social security payments and the 'German Unity Fund' which finances public expenditure in the east, is also helping to keep interest rates high. Actual outlays in 1991 were less than expected because of delayed expenditure. The implication of this is that we should expect a higher than forecast deficit in 1992, possibly resulting in interest rates staying high for longer than would have expected.

ERM and Satellites

In recent weeks the ERM protagonists have struggled to maintain their pre-agreed parities as the Deutschmark soared in response to the large interest interest rate differential which separates the Federal Republic of Germany and the United States. The resulting capital flows into the Deutschmark resulted in a strong DM appreciation against the rest of the ERM currencies, causing consternation among the governments of the weaker currencies, i.e. the Italian Lira, the U.K. pound, the Spanish Peseta and the Portuguese Escudo, whose anti-inflation policies were founded on the discipline of ERM credibility.

In mid September the Bundesbank, undoubtedly in reaction to political and economic pressure, lowered short rates by a very disappointing 0.25%, but in subsequent trading, despite denouncements of any realignment, the weaker currencies of the ERM came under what was to be insurmountable speculative attack from currency dealers anxious to maximise profits.

In Scandinavia, Finland and Sweden had been trying to shadow the Deutschmark in separate experiments with ERM discipline. In mid September Finland gave up and allowed the Maarka to float, the first effective devaluation in the ERM since January 1987. The Swedish authorities, worried by the huge flows into the Deutschmark, raised overnight rates from 16% to 500% in the space of one week to protect the Krona.

Within the actual ERM, Italy and the U.K. failed to maintain their parities. Trading in the Lira, clouded by the huge and seemingly irredeemable government overspend, first devalued by 7% and when it became obvious that this was nothing more than a token withdrew entirely. The Bank of England eventually after using intervention, borrowing from the Bundesbank and interest rates increases submitted to the inevitable and also withdrew from the system. The Spanish Peseta then unexpectedly devalued by 5% and the whole system verged on extinction.

The survival of the ERM may depend on the Maastricht referendum in France on September 20. France has benefitted from ERM membership and obtained low inflation but only at the expense of an OECD standardised unemployment rate of 10.3% in June 1992. At the time of writing, Friday September 18, it appears that a Yes vote is the more likely but the overall majority and the resulting signal for European unity may be very small and possibly insufficient for the move to EMU without renegotiation of the Maastricht Treaty.

World Trade

Trade rose sharply in the late 1980s as the world economy expanded and then fell back to its trend level as the slowdown took hold. The contraction in world trade has not been as severe as expected for three reasons; the reconstruction of Kuwait after the Gulf War, the emergence of the Pacific Rim as a industrial force and the collapse of inter Eastern bloc trade. Trade within the OECD has been more bullish than expected given the protracted slowdown. Fortunately for European traders, the G7 slowdown has been unsyncronised, the North American economies reaching the nadir before their Eastern counterparts, and European exporters have been able to divert their efforts to the western edge of the Atlantic.

Oil Price

The current low price of oil, around $17pb, is due to the recovery of Middle Eastern supply following last years conflagration and unaffected output from the Commonwealth of Independent States. The invasion of Kuwait forced the price near $35pb in October 1990 but the price fell when it appeared that the military operation would secure the required future supply.

Prognosis

The world economy is faced with uncertainty as the long term effects of a large debt overhang remain unknown. It seems likely that a slow recovery will begin early next year as world trade resumes and lower German interest rates boost growth in Europe.