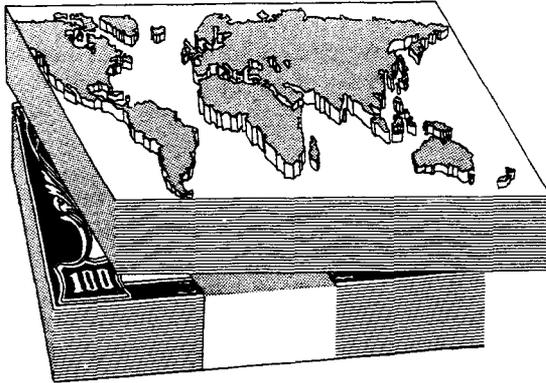


THE WORLD ECONOMY



MACROECONOMIC TRENDS

In the third quarter of 1992 quarterly GDP/GNP growth averaged -0.1% in the main four world economies. The position of the USA improved but growth slowed dramatically in Japan and Germany. Table 1 sets out growth rates for each country and provides a provisional estimate for the USA and the UK in the fourth quarter. Growth rates for these two are the normally quoted annualized quarterly growth rates.

	91q1	92q2	92q3	92q4
United States	1.7%	1.3%	2.1%	4.8% ^P
Japan	1.1%	0.0%	-0.4%	
Germany	-2.0%	-0.2%	-1.3%	
France	0.9%	0.2%	0.5%	
Italy	0.6%	0.2%	-0.8%	
UK	-1.1%	-0.4%	-0.4%	0.1% ^P

Industrial production grew strongly in the United States and slightly in the UK. A dramatic slowdown was observed in Japan, Germany and France. The extent of the problem in Japan and Germany can be seen in table 2.

Table 2 Growth of Industrial Production

	92q1	92q2	92q3	92q4
United States	1.3%	2.0%	0.9%	2.0%
Japan	-4.6%	-6.2%	-6.1%	-7.7%
Germany	1.2%	-1.3%	-1.6%	-4.6%
France	1.0%	0.4%	-0.2%	-2.3%
Italy	-0.3%	-0.3%	-1.1%	-2.8%
U.K.	-1.2%	-0.2%	-0.4%	0.5%

Consumer Price inflation remained reasonably stable over 1992, see table 3.

Consumer Price Inflation

	92q1	92q2	92q3	92q4
United States	2.9%	3.1%	3.1%	3.1%
Japan	1.9%	2.3%	1.8%	1.0%
Germany	4.3%	4.5%	3.5%	3.7%
France	3.1%	3.1%	2.7%	2.2%
Italy	5.6%	5.6%	5.3%	4.9%
U.K.	5.7%	5.3%	4.2%	3.7%

The unemployment position in Italy, France and the United Kingdom remains acute, especially in the latter two. US labour market worries have receded in the last few months, but the European Community's labour market is going through a frightening period of stagnation.

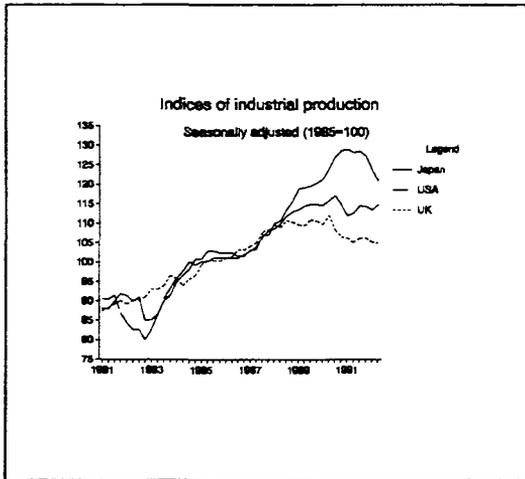
Table 4 OECD Unemployment Rates

	92q1	92q2	92q3	92q4
United States	7.1%	7.4%	7.5%	7.2%
Japan	2.0%	2.1%	2.2%	2.1%
Germany	4.4%	4.7%	4.8%	5.1%
France	10.1%	10.3%	10.3%	10.5%
Italy	9.9%	9.9%	9.9%	n/a
U.K.	9.5%	9.7%	10.2%	10.5%

The United States

The long awaited recovery in the United States seems to have finally arrived. Gross Domestic Product grew strongly in the second half of 1992 and, after revisions, should total around 2.0% for

the year as a whole. The main contributors to the renewed growth were consumption and investment, spurred on by the Clinton victory, and the appreciation of the dollar against most currencies. Both business and consumer confidence indicators are currently showing an upturn in optimism, although this has backed off slightly since the full implications of the proposed fiscal package have been subjected to full public debate.



Consumption expenditure rose toward year end as a result of falling savings ratio rather than any significant rise in personal disposable incomes. Investment has been spurred on by a very low real rate of interest, the product of cheap money since 1990 and a successful anti-inflationary campaign. Export growth contributed little to performance, rising by only 0.9% in 1992q4 compared with 2.5% in 1992q3, since the rest of the world economy is suffering from a protracted slowdown in growth.

The US labour market, which not so long ago aroused concern, has turned around and has seen unemployment fall from a peak of 7.7% in August 1992 to its current level of 7.3%. In addition, the acceleration in growth has increased productivity and served to restrain any potential rise in unit labour costs which may follow from the reported small increase in wage inflation.

The short term future of the infamous budget deficit, currently standing at a gargantuan \$290bn, seems under the control of Congress rather than President Clinton's economic package. His own plan to reduce the deficit to under \$200bn by 1997 primarily through the implementation of higher

direct taxation and various corporate and environmental schemes have been over-ruled and Congress has indicated an intention to cut public expenditure by \$63bn rather than the originally intended \$55bn. Overall the package may inhibit growth a little in the short run but we hope that the face of fiscal determination currently seen in Washington will regain some of the credibility lost by the former administration and manifest itself in a shallower yield curve. The resulting lower yields at the long end should stimulate an upward revision of investment intentions in both the business and residential sectors of the economy.

Japan

In 1992 the growth of GNP slowed considerably and actually fell in the final quarter. This was the first quarter of negative growth in Japan since 1975 and reveals the extent of Japan's problems.

The major contraction in the final quarter occurred in the corporate sector where the adverse effects of asset price deflation are still evident in high net debt ratios. Industrial production, shown in table 2, collapsed during 1992 and interest rate reductions have failed to stimulate sustained investment expenditure and many business still consider de-stocking a necessity, hardly signs of a turnaround in fortunes.

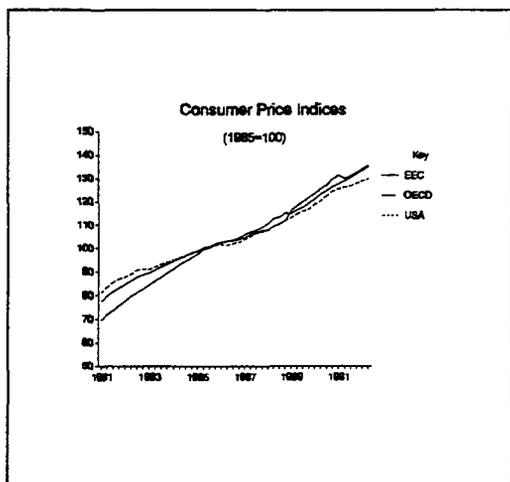
Consumer spending has proved highly volatile over the last four quarters although it provided a stimulus in the final quarter after falling heavily in the third. The slowdown in spending has reduced the demand for imports and pushed the trade balance above \$100bn for the first time. Undoubtedly, the US administration will be seeking assurances that the Japanese authorities will be taking steps to produce an upturn in import demand.

The main success in the economy has been the fight against inflation. The 'underlying' inflation rate is thought to lie around an annualized 2%, reflecting falls in earnings and manufacturing prices growth.

Japan's short term prospects are unlikely to be helped by the fiscal stimuli announced in the December budget which is now considered fairly neutral. The Bank of England has opined that the strongest growth will come from the Public Sector. Furthermore, monetary aggregates, which have followed a flat to declining trend for sometime suggest that a recovery in Japan from this growth recession is still some way off.

THE EUROPEAN ECONOMY

The situation in Europe deteriorated heavily in the final quarter of 1992. Activity is very weak in the majority of countries and unemployment has become the dominant focus of macroeconomic policy making.



Germany

The German economy experienced a severe contraction of industrial production in the final quarter and GNP growth - which includes net factor income from abroad - of only 1% is expected for 1992. The main problem facing the German economy continues to revolve around the effects of a real interest rate of 5% which is the result of the Bundesbank's attempts to suppress broad money growth and the post-unification government deficit.

The downturn in GNP growth has been caused by a contraction in both consumption and investment expenditure as a result of high interest rates. Total demand was buoyed up a little increased government consumption and renewed stockbuilding. It had been hoped that the withdrawal of the 'Solidarity tax' and the harmonisation of EC VAT rates would have boosted consumption. Alas this has failed to materialise and many economists point, not to GDP but industrial production as evidence that Germany is undergoing a severe and worrying downturn. The industrial output figures would imply the word recession and not downturn. This picture is given a sharper definition by new survey evidence which reported large falls in business optimism and manufacturing orders.

The short term future for Germany, to a large extent, depends on renewed altruism in Frankfurt and the success of the Solidarity Pact.

France

The French economy has recorded positive growth throughout the current EC interest rate and exchange rate turbulence. However, like its UK trading partner, the government's credibility depends on strict ERM membership. The decisions taken in Frankfurt have resulted in maintained high real interest rates and a collapse in business and consumer confidence.

France's inflation performance is impressive. Since joining the ERM in 1979 its anti-inflationary policy has become highly credible and consumer price inflation fell to 2.2% in 1992q4. Manufacturing price inflation was negative throughout 1992.

France's short term future depends on how long the real economy can survive under the present weight of ERM membership and competitive devaluations elsewhere within the European Community.

The rest of Europe

Both Italy and Spain have benefitted from ERM membership and have seen their inflation rates fall although Spain has some way to go before it makes inroads into underlying inflation which sits at around 7% at present.

However both countries fiscal and labour market records are less impressive. In Spain, adult unemployment stands at 20% and Italy's rate is shown in table 4. In terms of fiscal policy Italy and Spain are suffering from large budget deficits which are holding up long interest rates and strangling investment expenditure.

The way out for both countries seems to rest on the success of the post Black Wednesday devaluations. Both hope to receive a boost to net exports and should be looking towards the USA for increased export opportunities.

The rest of the European continent has also been struggling under high real interest rate and growth has slowed in most countries of the EC and EFTA. Ireland, whose main trading partner is the UK, has contracted sharply as its export prospects deteriorate and its budget deficit is beginning to put further upward pressure on interest rates.

THE EXCHANGE RATE MECHANISM

The period of turbulence following September 16, 1992 continued into the new year with severe pressure on the Franc, the Irish Punt and the Danish Krone. This has only been resolved by massive intervention by the Bundesbank and the uncertainty of the French political situation.

Following the year-end turbulence the Irish Punt was devalued and rendered a severe blow to credibility. Speculative activity against the mechanism has been low ever since because of German interest rate reductions and the interlude before the French election. Analysts expect a resurgence of speculative attack against the France and other weak ERM currencies in the event of a tight election decision.

THE MEDIUM TERM OUTLOOK

The outlook remains hazy in the short run. The world's largest economy, the USA, seems to be accelerating out of stagnation, albeit at a smaller rate than has been historically recorded at this point in the business cycle. The European countries of the EC and EFTA remain subdued and await lower real interest rates and deficit reductions. The Japanese economy continues to nosedive after the hedonism of the late 1980s and fears grow daily that its banking system is on the verge of disaster.

Our view is that Scotland's main export markets, the USA and the European continent, will start to grow again by the middle of this year as German interest rates tumble in response to excessive deflationary pressure. We do not expect to see any significant recovery in Japan this year although it is felt by many analysts that the Far East will escape with a growth recession and continue to introduce inward investment programmes in Scotland.