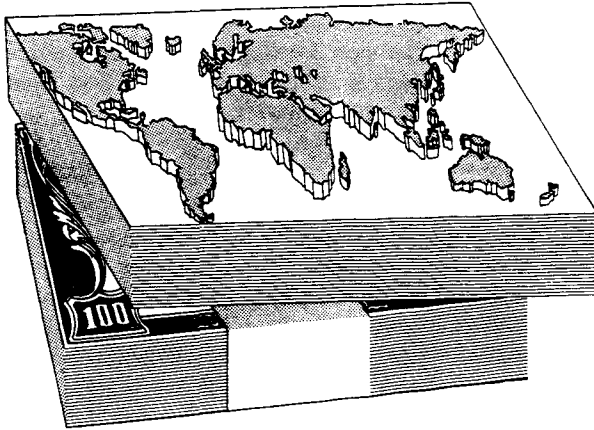


THE WORLD ECONOMY



MACROECONOMIC TRENDS

The recession in the developed world reached a peak in the first quarter 1993. The biggest decline occurred in the European Community and Japan continued to experience a growth recession.

Table 1: Growth of GNP/GDP

Percentage changes on previous year

	92q3	92q4	93q1	93q2
USA	2.1	3.1	2.6	1.6 ^(p)
Japan^(a)	0.9	0.5	0.6	-
W Germany	0.9	0.4	-2.9	-
France	0.9	0.4	-0.6	-
Italy	0.7	-0.3	-0.9	-
UK	-0.4	0.2	0.9	-

Source: Bank of England

(a) GNP (p) Provisional

Table 2 displays the extent of the decline in industrial production in the last six months. The collapse of the German economy is readily apparent from the figures for 1993.

Table 2: Growth of Industrial Production

Percentage changes on previous year

	92q3	92q4	93q1	93q2
USA	1.7	3.2	4.4	3.7
Japan	-6.2	-7.7	-5.1	-4.5
W Germany	-1.3	-4.6	-9.8	-8.4 ^(b)
France	-0.2	-2.3	-3.5	-4.3 ^(b)
Italy	-2.1	-3.8	-4.3	-3.9 ^(b)
UK	-0.3	0.7	1.5	2.4 ^(b)

Source: Financial Times

(b) Average of April & May 1993

Price inflation remains subdued in the six economies in table 3. Strong deflationary pressures are still evident in the UK and France. A slight upturn in inflation occurred in the USA but fears of a resurgence have been allayed in recent months by the world recession. In Western Germany, the increase in VAT from 14% to 15% in January brought about a temporary hike in consumer price inflation.

Table 3: Consumer Price Inflation

Percentage changes on previous year

	92q3	92q4	93q1	93q2
USA	3.1	3.0	3.2	3.2
Japan	2.0	0.9	1.2	1.0
W Germany	3.5	3.7	4.3	4.2
France	2.7	2.2	2.1	2.0
Italy	5.2	4.8	4.3	4.1
UK	3.6	3.0	1.8	1.8

Source: Financial Times

Revisions to the OECD figures revealed that Italian unemployment did not rise from 10.1% in 1992q4 to 12.3% in 1993q1. In fact unemployment fell to 9.3% of the workforce. This leaves France and the UK at the top of the unemployment league.

Table 4: Unemployment

OECD Standardised Rates

	92q3	92q4	93q1
USA	7.5	7.2	6.9
Japan	2.2	2.3	2.3
Germany	4.8	5.1	5.5
France	10.4	10.7	11.0
Italy	10.1	9.3	9.1
UK	10.1	10.4	10.6

Source: Financial Times

The United States

The outbreak of economic growth reported in late 1992 has receded throughout 1993. Output growth fell from an annualized rate of 3.1% in the fourth quarter 1992 to a mere 1.6% in the three months to June. Year on year growth is now a considerable way below its historical average for this stage of the economic cycle.

The generally optimistic climate which followed the election of President Clinton produced an increase in retail spending. Greater confidence and companies paying bonuses early to avoid tax increases encouraged consumers to bring forward spending plans. Consequently, activity boomed and the world economy was shielded from the threat of outright recession.

Now that the political climate has settled down again, the US economy is apparently taking a short breather. Retail sales growth declined in the first quarter - seen by many as a correction for over optimism in the fourth of last year - and in the second was only 3.2% higher than a year earlier. High capital gearing ratios - especially in manufacturing - have led to only meagre employment gains in the last four quarters.

The pursuit of monetary stability in Germany and the subsequent deflationary pressures within the European Community meant that inflationary worries receded in the second quarter. As a result, long bond yields currently stand at an historical low. This should, it is hoped, lead to an acceleration in growth in the second half of 1993.

Since the end of the recession, over two years ago, the US labour market has signally failed to recover. While the rate of increase of wage costs is much

lower¹² than in many competitor countries, firms non-wage costs are high and many expect higher social security taxes in the future. In consequence, any increase in labour demand has produced, not job creation, but increased overtime and a rise in the length of the average working week.

Now that Clinton's deficit reduction plans have been finalised, debated and passed into law³ the US economy can look forward to lower government borrowing and a continuation of low long bond yields. While the overall effects are considered slightly negative in the short run the general feeling is that low interest rates and relief that something positive has finally been done should produce a resurgence in consumer activity and medium term employment growth. This statement therefore implies that the prospects for world trade - with Scottish exports to its third biggest market - are probably better than in the first half of this year.

Japan

The general feeling is that the Japanese economy is over the worst of its late 1980s hangover. Many observers feel that the improving financial and credit conditions imply a medium-term revival, even though the short-term real indicators are still sitting on the fence.

In the first quarter, consumer spending rose for the first time in a year and business confidence did not fall for the first time since 1989. While production remains extremely volatile the manufacturing sector believes that the trough has indeed been passed. While this is not evidence of rampant recovery, it does suggest that domestic demand may begin to pick up in the not too distant future.

Broad money (M2 plus CDs) expanded by 1.5% in May and June after a year in which most movement was downward. Although a large slice of new borrowing is thought to represent debt refinancing, recent Tankan studies have reported an improvement in bank's lending attitudes.

The contentious issue of the Japanese trade balance is still with us and if anything threatens to get worse as growth picks up in the US economy. While recent gains for the dollar have reduced the impact that an appreciating Yen has on the value of the trade balance, the absence of sustained demand can only serve to prolong trade and political imbalances between the two countries. A speedy conclusion to the Uruguay Round would help to

snuff out the now routine calls for protectionism in the US.

THE EUROPEAN COMMUNITY

The last few months saw the death of the Exchange Rate Mechanism - at least in the form that we previously knew it - and the possible bottoming out of the recession in Germany. Given the deepening European recession, and an intransigent reliance on dubious monetary indicators in Frankfurt, it was only a matter of time before speculation would lead to the partial collapse of the Franco-German monetary dream and the introduction of effectively flexible exchange rates.

Before the collapse, the situation in France and Germany had reached breaking point. Scotland's two main trading partners had for some time been suffering under the weight of the high real interest rates imposed by the unification budget deficit in Germany. Domestic inactivity in France and Germany was effectively exporting recession and unnecessary hardship to the rest of the European Community.

Industrial production in Germany contracted by 9.8% in the first quarter 1993 after falling by 4.6% in the final three months of 1992. In France production only fell by some 3.5% in the same period but by then the OECD standardised unemployment rate had edged up to 11% of the workforce. This made France's labour market problem one of the worst in the developed world and fuelled speculation that the *Francfort* policy would only survive if the Bundesbank relaxed their anti-inflationary zeal. Interest rate reductions in France - signalling, perhaps that the real economy had reached the pain threshold - and a series of refusals from the Bundesbank inevitably produced a situation where either ERM rules had to change or the system collapsed. The end result is a combination of both but at least allows the French to lower interest rates without having the prospect of another general election.

In Germany, the large scale collapse in vacancies seems to have come to a halt. In fact it looks increasingly likely that the worst of the recession occurred in the first half of this year. With this and the *Solidarity Pact* in mind, the Bundesbank may see fit to reduce interest rates in an attempt to stimulate the European economy and claw back some of the competitive gains obtained by Britain, France and the United States.

While economic forecasts for the EC have mostly been pretty gloomy this year, and unemployment has moved to the near-centre of the economic debate, the widening of the bands is undoubtedly good news for Scottish exporters. Given the apparently changing manner in which the Bundesbank monitors inflationary pressure, Scottish exporters might find their prospects for world trade a touch more optimistic this quarter than had been expected at the time of the last Commentary.

WORLD TRADE

The far-reaching tariff-cutting deal which was reached by the world's leading industrial nations at the commencement of the 19th G7 economic summit meeting in Tokyo, presented the resumption of Uruguay Round of Trade talks with a much needed fillip, and once more ushered in yet another wave of optimism for its successful completion by the end of this year.

While these tariff cuts on manufactured goods are undoubtedly good news for world trade, and may yet prove to be an important key which unlocks the Uruguay Trade talks, they do not mask the fact that difficult negotiations still lie ahead on such issues as the liberalisation of services, farm trade, and textiles. Thus, several other keys will be needed in order to attain the Uruguay Accord. The task facing the new director-general of GATT Mr Peter Sutherland remains a formidable one.

MEDIUM TERM PROSPECTS

Three factors have made us more optimistic this quarter. Firstly, the US has finally done something about the budget deficit - albeit on a rather smaller scale than had been intended - and we feel that this will lead to renewed growth in the US as long bond yields remain at their current low level. Secondly, Germany, it would appear, is finally coming to terms with the fact that unification, and subsequent monetary policy, has led to an unnecessary recession in the rest of Europe and avoidable political tensions between member states. While we are unlikely to see a rapid drop in interest rates we think that German policy may now be a little more flexible and geared toward growth.

And lastly, the Far East. As China calls in the IMF, Japan looks more healthy than six months ago. Investment in Scotland and revitalised world trade are the perceived benefits of an expanding Japanese

economy with more favourable lending conditions.

NOTES

1. Financial Times - July 21, 1993
2. Bank of England Bulletin - August 1993
3. Financial Times - August 9, 1993