THE ECONOMIC BACKGROUND

The upturn in the growth of the world economy, which commenced in 1991, has continued unabated through 1994 and it seems set fair to continue into 1995, and beyond. For example, recent calculations by the International Monetary Fund (in their World Economic Outlook) suggest that the overall growth in world output will be 3 per cent in 1994, while their projections for 1995 are for a growth rate of 3.5 per cent, double the rate of 1990-1993. Furthermore, it is anticipated that the world economy will recover its average 1970-93 growth rate in the final quarter of 1994.

With economics being regarded as the dismal science, economists are usually quick to point out that the benefits of rapid economic growth are bought at a cost of rising inflation. This certainly has been the pattern in previous recoveries. The present recovery seems to be an exception in this regard, since the only major inflationary pressures in the world economy this year have been confined to commodity price inflation (often seen as a good leading indicator of inflationary pressures) and not to any great extent in producer/ consumer price inflation. Thus, the overall US dollar commodity price index exhibited a 37.3 per cent year-on-year change from October 1993 to October 1994, while the corresponding industrial country inflation average was a modest 2 per cent. In large measure this reflects the fact that although 1994 is the year in which industrial country growth again became synchronised across countries, countries are at different stages in their recovery - some like the US reaching full capacity, whilst others like Germany only emerging from recession for the first time in 1994.

The fact that the key industrial countries are at different stages in the upturn has helped prevent inflationary pressures taking off in 1994. Another reason why the current world recovery has not so far been inflationary is the very large debt overhang from the 1980's boom which has helped to curb consumer spending, an important component of aggregate demand. The combination of relatively rapid world economic growth and low inflation seems most desirable. How long though is it sustainable? In this article we argue that it is potentially sustainable through into 1995 and perhaps beyond; however, there are some worrying trends in the world economy and these may need careful monitoring in 1995 if the 'golden combination' of growth and low inflation is to be maintained.

In this last quarter review of the world economy, we take the opportunity to summarise the position of four key players in the world economy during 1994 and how we expect them to perform in 1995. Our main emphasis is on the US economy. This is because although the US trading position does not dominate European trade its impact on world financial markets is still extremely important and, indeed, developments in US financial markets in 1995 could well have an important bearing on the level of interest rates in Europe and hence the stance of European macroeconomic policy.

The United States

The US recovery, one of the earliest industrial country recoveries, is now at, or close to, its peak, this being reflected in the fact that full capacity utilisation has now been achieved. There are now, therefore, very real signs of inflationary pressure building up in the US, and this may be illustrated in at least three ways. First, the recent trend in actual inflation has been upwards. For example, the US producer price index rose from a zero value in June of this year to an annualised rate of 1 per cent in the quarter ending in October; consumer prices rose faster than producer prices to an annualised rate of 2.6 per cent in October 1994. Inflation based on the consumer price index is projected to rise to an annualised rate of 3.3 per cent in 1995.

The second indication of inflationary pressures is to be found in long bond yields, traditionally a good leading indicator of inflationary expectations. The yield on long term government debt is traditionally decomposed into expected real and inflationary components (the idea being that investors have some notional expected real rate and want to be compensated, by a rise in the nominal rate when expected inflation increases). Yields on long term US government stock have risen from around 6 per cent in June 1994 to 8 per cent at the time of writing, thus suggesting a fairly dramatic upward revision in inflationary expectations (although this could, in part, reflect a rise in the real rate of interest due to the relative tightness in the real sector, the depreciation in the external value of the

US dollar during the period suggests otherwise). Subtracting the actual inflation rate from the long bond yield suggests a real rate of interest of 5.4 per cent which is too high by historical standards (it should be around 2 to 3 per cent) and this therefore indicates that it is the expected inflation rate that has risen; indeed, the fall in the external value of the dollar is consistent with this.

A further indicator of potentially higher US inflation may be gleaned from the US fiscal position. Although the US authorities have had some success in reducing the fiscal deficit over the last couple of years, the recent successes that the Republicans have scored in the mid-term elections may result in tax cuts and this, combined with a reluctance to cut government spending, could well result in a budgetary blow-out (prior to these elections the International Monetary Fund, in its World Economic Outlook, had already advocated further controlled reductions in the government debt-GDP ratio). This may therefore be a portent of further inflation with the uncertainty associated with this. An increased fiscal deficit may also further exacerbate the already large US trade deficit which has been one of the key problem areas for the world economy. To the extent that the trade deficit does worsen in the future this will have further important inflationary ramifications for the world economy as the other OECD and, indeed far eastern suppliers, start to reach binding supply constraints.

Given the pivotal role the US plays in the world economy, the upward revision of inflationary expectations, and the interest rate increases associated with it, is worrisome for at least two reasons. First, there is the traditional expenditure reducing effects of higher interest rates which may trip the US economy into recession mode, with the consequences this may have for world trade. Second, an upward revision of the inflation rate imparts increased uncertainty into international financial markets. This is revealed, in particular, by the cat-and-mouse game played by the Federal Reserve in attempting to keep a lid on inflation, and inflationary expectations, and the consequences this has had for world bond and stock markets. Thus the rise in the Fed Funds rate in November resulted in a sharp fall in the US stock market which was rapidly transmitted to other countries through the so-called contagion effect. Such sharp stock market adjustments do not impart a particularly confident air into the business environment and although this stock market correction reduced the bond/equity yield from 2.8 to 2.7 per cent it is still rather high on an historical basis, suggesting that a further correction(s) is in the pipeline in the future (the normal range is 2.4 to 2.6 per cent). Whether short term US interest rates have now risen enough to dispel inflationary worries is doubtful.

Since continued rises in short interest rates seem to be expected by financial markets it is likely that US growth will moderate in 1995 to around 2.5 per cent, from the predicted 3.75 per cent for the overall 1994 position.

Germany

The prediction of Germany's five wise men in 1993, that overall economic growth in 1994 would be zero, has been proved wrong since the country looks like producing a respectable 2.5 per cent growth rate for the current year; thus proving the rule that forecasting is an especially hazardous occupation! This growth led to a slight fall in the jobless total from 8.7 per cent of the work force at the beginning of the year to around 8.0 by October. The expected growth rate for German GDP in 1995 is around 2.7 per cent. The improved German economic growth performance has been generated by a combination of export-led growth, residential construction and stock building. The potential buoyancy of the German economy for the coming year should help to attenuate the effect on world economic growth next year of any relative slowdown in the US economy.

Much of the improved real economic performance has been aided by the fairly dramatic easing of the stance of monetary policy, particularly at the turn of the year when the annualised rate of change of the M3 definition of the money supply was above 20 per cent, an unheard of increase for the recent past. The Bundesbank's clear commitment to achieving its monetary/ low inflation targets (the inflation target for 1995 is 2 per cent) means that short term interest rates have risen during the year and are unlikely to fall any further for the foreseeable future. The Bundesbank's tightening of monetary policy has resulted in the annualised growth of M3 to October being 6.9 per cent, which is only slightly outside the governments target range of 4 to 6 per cent. As the recovery gathers momentum next year, there may in fact be pressures to increase interest rates in much the same way as has occurred in the US.

Part of the German strategy of controlling inflation has been the control of the government deficit as a proportion of GDP, which has fallen to 2.5 per cent of GDP in 1994 and is expected to fall further in

1995 with planned tax rises. However, given that the German recovery seems so strongly rooted, it is unlikely that this will affect economic growth next year.

Japan

Like the German economy, the Japanese economy in 1994 has shown clear signs of an economic turnaround, although this is still rather fragile. The Japanese recovery may be gauged in a variety of ways. For example, the OECD's composite leading indicator, which fell in 1993, has been rising steadily in every quarter of this year (this indicator is reinforced by the upward rise in the Japanese official index of current business conditions). Also, the fall in Japan's external trade surplus, which shrank by 15.2 per cent in October 1994 compared to October 1993, indicates relatively buoyant domestic demand; although the relative strength of the yen and a perhaps more fundamental reorientation of Japan's trading patterns are also likely to be important factors. In contrast to previous quarters, industrial production became positive in the third quarter of 1994 (+1.6 per cent compared to an average of -2.8 over the previous three quarters). Unemployment seems to have levelled of in the third quarter at around 2.7 per cent. The fragility of the recovery may be gauged from the fact that consumer price inflation is almost zero whilst producer price inflation is still around minus 2 per cent.

The fragility of the Japanese recovery has not deterred the Bank of Japan from gradually raising short term interest rates this year (from 2 per cent in July to 2.3 per cent in November), the intention being to ensure that the necessary restructuring of the economy, necessitated by the overexpansion in the 1980s, is maintained. The yield gap between long and short term Japanese government debt is positive at around 2.3 per cent, which is a reflection of US bond market developments (see above) rather than a portent of increased Japanese inflation.

France

French economic growth also became firmly established in 1994 illustrated by the fact that industrial production became marginally positive in the first quarter of 1994 (to 0.4 per cent) and rose to 4.9 per cent by the third quarter. Overall GDP growth is expected to be around 2 per cent in 1994, rising to 3 per cent in 1995. The recovery in real output has led to a stabilisation of the unemployment level at around 12.5 per cent, but the largely structural nature of unemployment means it is unlikely that the expected improved economic performance next year will make much impact on the unemployment total. Inflation is relatively low, expected to be 1.7 per cent in total for 1994, rising to 2 per cent in 1995. Although the recovery in France has been aided by a loosening of monetary policy, interest rate levels have still remained relatively high given the low inflation rate: short term rates are 5.55 and long rates are around 8 per cent, again the latter being driven largely by developments in the US. The relatively high French interest rates will help to ensure that inflation is strictly controlled during 1995.

Concluding Comments

In sum, the world economic recovery became firmly established in 1994 and this will continue through 1995 and beyond. It is likely that the inflationary dragon will remain slain in 1995, although, as we have pointed out, there are some concerns about the implications of certain US developments for international financial markets and international trade. In particular, the fact the US economy is now beginning to overheat will keep US long bond yields relatively high and this, in turn, will feed through into other industrial country bond yields, which will also remain high in 1995. Given the relatively low inflation forecast for next year these relatively high real yields could have a negative effect on expenditure and thereby attenuate the world economic recovery somewhat. A further danger of the relatively high bond yields is that corrections in the bond-equity yield ratio could again spark a decline in world equity markets and corresponding corrections at the short end of the interest rate spectrum. Also there is likely to be further upward pressure in short term interest rates as the recovery takes a firmer grip in the European countries and in Japan.

In terms of exchange rate levels, the fundamentals portrayed in this review suggest that they will be relatively stable. The dollar, for example, is expected to stabilise in 1995 and may even show a modest appreciation. The long term appreciation of the yen will probably continue, although there may well be some short term correction if capital outflows resume. We can expect continued relative stability of the European currencies in the coming year and, perhaps, a slight appreciation of sterling against its European neighbours given the favourable current account/ inflation position.