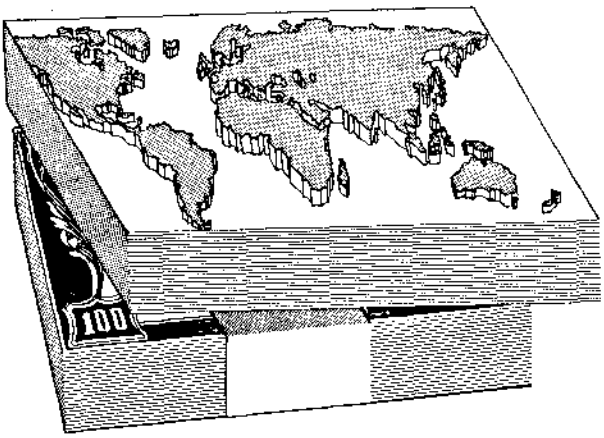
The World Economy



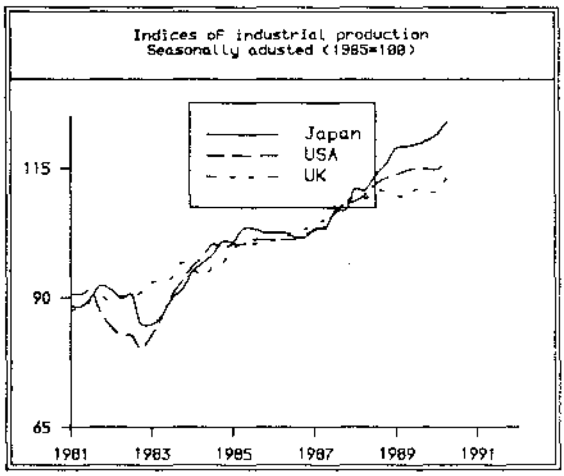
MACROECONOMIC TRENDS

Economic growth continued to decrease for most major industrialised countries in the second quarter of 1990. GDP growth in the G7 countries in the year to June actually accelerated fractionally to 2.8% (from 2.6% in the year to March), but this was almost totally due to the very rapid growth of the Japanese economy; year-on-year growth in Japan stood at 7.5% in June. Most other G7 countries saw growth slow quite sharply in the second quarter. This was especially the case in the US, where annual growth slowed to 1.6%, barely half the level achieved in 1989. Growth rates for the remaining G7 countries (excluding Italy) were as follows: Canada 1.4; France 2.1%; Germany 3.4%; UK 2.6%.

Industrial production in the major industrialised countries showed a fairly sharp rise in the second quarter of 1990, increasing at an annual rate of 2.2% for both the G7 and the OECD as a whole. This was almost entirely attributable to the performance of Japan and Germany, where in the year to July production rose at an annual rate of 6.1% and 5.0% respectively. The US and France also experienced modest rises in production during the second quarter, in contrast to Italy and the UK where industrial output continued to falter. G7 performances were as follows: US 1.5% (year to August); UK 0.2% (year to July); France 1.3%; Italy 0.1% (both year to June); Canada -2.2% (year to May).

Following a slight lull in the early part of the year, inflationary pressures have clearly re-emerged in most OECD countries. In the year to August average OECD inflation was 6.6% and that for G7 countries 5.2%. In the latter case this represents a rise of almost one percentage point from the position in May. All G7 countries, with the exception of Canada, experienced some increase in the rate of consumer price inflation over the year to August, with the largest increases being experienced by the US and the UK. The US situation is particularly interesting given that much of the concern being voiced about that economy relates to the possibility of a recession rather than of inflation.

Consumer price inflation in G7 countries for the year to August was as follows: Canada 4.1%; US 5.6%; Japan 2.9%; France 3.5%; Germany 2.8%; Italy 6.3%; UK 10.6%.



Labour Market

Unemployment in the OECD overall has remained virtually unchanged since the beginning of the year. In July the average OECD figure remained at 6.0%, with G7 countries continuing to fare slightly better with an average of 5.5%. In the three months to July unemployment rose in Canada (sharply), the US, Germany and the UK, and fell in France (sharply) and Italy. Japanese unemployment remained unchanged. Unemployment rates for individual countries were as follows (in August unless otherwise stated): Canada 8.3%; US 5.5%; Japan 2.1% (July); France 8.9%; Germany 5.2% (July); Italy 9.6% (April); UK 6.3%.

United States

After months of wrangling, a budget for the US was finally set during October. This involved the acceptance of the largest deficit-reducing package in US history; the budget deficit should now be reduced by $41 billion during fiscal year 1991, and by a total of $492 billion over five years. The measures adopted to achieve these deficit reductions were accepted reluctantly by President Bush, not least because they involved considerable increases in taxation. The top marginal rate of income tax will be raised from 28% to 31%, excise taxes on petrol, alcohol and tobacco will rise, and a 10% "luxury" tax has been imposed on aircraft, boats, cars, furs and jewellery (items which many Americans would surely regard as necessities). Some spending cuts will also be imposed, and the measures will benefit from reduced debt interest payments due to lower interest rates.

The measures had to be fairly substantial because of the size of the federal budget deficit, standing at $294 billion for fiscal year 1991. Some commentators have argued that the $41 billion reduction in the coming year is no more than a token gesture, which will still leave the deficit running at a high level by the end of 1991-92. It is unlikely that the President sees the budget as a gesture, especially because of the need to raise an extra $137 billion in taxes over the next five years despite the infamous "watch my lips" speech.

More problematic is whether the expected elimination of the deficit in four years can actually be achieved. The deficit reducing package was enacted under the Gramm-Rudman laws which have been around for some time. The first statutory targets under this legislation were introduced in 1985, and were aimed at eliminating the deficit (then $172 billion) by 1990. These targets were first revised in 1987, and the new budget agreement represents a second revision. The whole idea of the Gramm-Rudman legislation was that it should be both firm and inflexible, but the 1990 version is not only less ambitious than its predecessors but considerably more flexible. The targeted reductions can be altered depending on the economic situation, which some see as a guarantee that they will not be achieved. As it is, the targets are based on a very rapid improvement in the economic climate in 1992 and beyond, following officially-forecast growth of 0.7% in 1990 and 1.3% in 1991. In fact, it seems possible that growth will slow to zero or less in 1991, putting the deficit reduction plans into some jeopardy.

The expected (indeed promised) cut in interest rates occurred immediately the budget was set, a slight reduction in the Federal Reserve rate from 8% to 7.75%. This was the first cut since mid-July, and the comments of the Reserve Chairman, Alan Greenspan, indicated that his concerns over inflation would prevent further reductions in the short run despite cries of recession from other quarters. Despite weak consumer demand and a collapsing housing market, Mr Greenspan still takes the view that there will be no recession in the United States. And, at least until war in the Gulf began to appear more likely, he took a relaxed attitude on the impact of higher oil prices on the economy, expecting growth to be cut by one percentage point and inflation to rise by up to two percentage points. Forecasts are not helped, however, by official figures which are subject to heavy revision. GNP estimates of 1.8% annual growth based on provisional third quarter data were met with widespread disbelief, not least because second quarter growth of 1.2% was later revised to just 0.4%.

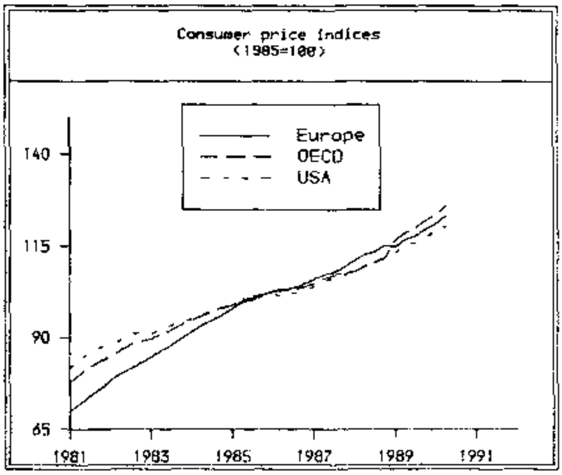
Japan

While the US is undecided about whether inflation or recession is the main area of concern, the Japanese authorities are in no doubt that inflation is the principal problem to be combated. With consumer prices still rising at below 3% per annum this may seem rather extreme, at least by UK standards; but there are good reasons for this attitude. Japan is heavily dependent on oil imports and, despite having an economy which is markedly less energy intensive than was the case in the 1970s, is still one of the G7 countries most exposed to an oil price shock. In addition, the country is experiencing an output boom with very buoyant consumer demand and acute labour shortages in many areas, which has been putting upward pressure on wages. The official reaction to this has been to raise the official discount rate to 6%, the sixth rise in eighteen months, and possibly not the last in the near future.

Unlike America, where there is some fear of higher oil prices engendering recession, the Japanese economy is too buoyant for this to happen. Real GNP grew at an annual rate of 7.5% in the second quarter, an increase from an annual rate of 6.0% in the first quarter. As was shown earlier, industrial output is also growing very rapidly (an increase of 6.0% in the year to August), and consumer demand is steady. Even if war in the Gulf led to much higher oil prices it seems unlikely that Japanese economic growth would fall below 3%, an outcome helped by the recent appreciation of the Yen. During September and October the Yen appreciated by 15% against the dollar, ameliorating the effects of a higher dollar price of oil. The renewed strength of the Yen in turn led to a recovery in equity prices and some semblance of order in the Japanese banking and financial system, which is still going through a crisis of confidence.

In addition, Japan is now much more efficient than it used to be in the use of oil and of energy generally. According to Nomura Securities, oil imports as a percentage of GNP fell from 5.4% in 1980 to 1.1% in 1989, and oil prices now have little effect on consumer prices. A possibly more acute problem faced by Japan is a rapidly tightening labour market. Unemployment continues to be very low at around 2.1%, and the ratio of job offers to applicants continues to be high by recent standards, reaching 1.45 in July. The Bank of Japan quarterly short-term survey of business outlook for August indicated that a net 40% of companies foresaw a labour shortage in the immediate future, a figure which has increased steadily since the beginning of 1988. These factors have coincided with a 12% year-on-year increase in the money supply, indicating that concerns over inflationary pressures are not misplaced.

Despite the rise in equity prices mentioned above, there is still evidence of difficulties in the Japanese banking system. Financial deregulation has led to a rash of mergers between some of the medium and larger banks in Japan, most recently between Kyowa Bank and Saitama Bank to create the eighth largest commercial bank in Japan. Coupled with the uncertainties of deregulation has been the ruling by the Bank for International Settlements that most banks should raise their capital adequacy ratios (setting minimum levels for the ratio of capital to assets) by 1993. While European and American banks have tried to achieve this by reducing their assets, Japanese banks have been raising their assets fairly rapidly in recent years but trying to raise their capital even more quickly. Since much of this activity was equity based, this was made impossible by the collapse in the stock market; Japanese banks now find themselves not only turning away new business but also having to sell off loans, traditionally not done in Japanese banking. These factors have led to the fear that 1991 may see a 'credit crunch' for Japanese borrowers which may jeopardise the rapid rate of economic growth.



Germany

Most of German thinking on the economy is dominated by the costs and benefits of unification between East and West. While there is now nominally a single federal state, it has been made clear that for the foreseeable future there will continue to be an East-West split in economic terms. This will be both practical, as the West booms and the East slumps, and in terms of economic information, as a key problem appears to be obtaining accurate data on the state of the East German economy.

It now seems clear that many aspects of the costs of unification have been considerably underestimated. The credit needs of the Treuhand which was established to oversee the transition of East German industry to the free market (as far as possible) are now thought to be nearer DM35 billion by the end of 1991 than the DM25 billion originally allocated. This is in part because the industry of the East was in even worse shape than had been anticipated, and partly because commercial investment from the West has been slower to materialise than had been hoped. This has not been helped by the need to sack all fifteen Communist-appointed regional directors of the Treuhand and replace them with West German business executives.

In the short run East Germany's economy will suffer badly. Industry has lost most of its Eastern European orders and up to 50% of its domestic consumer goods market; with one-to-one parity between the OstMark and D-Mark East German consumers can afford to buy Western goods. In the year to August the Bundesbank estimates that East German industrial production fell by 51%. Unemployment is now officially above 5% and rising, excluding the 1.72 million people on short-time work, and East German GNP is expected to fall by up to 16% in 1990 and a further 10% in 1991. A recession of this severity is felt necessary to ensure that the economy of the East can compete in world markets in as short a period of time as possible, and the worst of the recession is expected to have passed by the third quarter of next year.

However, economic unification in such a short time scale would not be possible without a strong West German economy. In the year to September West Germany created 700,000 new jobs, more than enough to accommodate all those still coming in from the East. Growth in the West's economy is expected to peak this year at 4% before falling to 2.5% in 1991, which should be sufficient to pay the substantial cost of unification, which is expected to necessitate extra government borrowings of DM70 billion this year and DM90 billion next (excluding the costs of the Treuhand). If accurate, this will lead to a public sector deficit of above DM100 billion in both years, and ideas on how to finance this are already being put forward. Interestingly, these include privatisation of industries in which the West has a large stake, such as Lufthansa and Telekom.

Fortunately, the possible inflationary effects of monetary union have not yet materialised. One possibility was that one-to-one monetary parity would lead to a spending boom by East Germans desperate to run down their savings on Western goods. While increased spending has indeed resulted in a boost in consumer demand, inflation has only just reached 3%, and continued tight monetary policy by the Bundesbank should ensure no major inflationary problems as a result of unification.

PROGNOSIS

The relatively rosy picture of gently slowing growth in the major industrialised countries is overshadowed somewhat by continuing stalemate in the Gulf, and would cloud considerably in the event of war. Such an outcome, and the higher oil prices which would inevitably result, could be enough to push the US into recession, but is unlikely to stifle growth in the leading economies of Germany and Japan.

The main problems of much higher oil prices would actually be borne outside the major industrialised countries, by Eastern Europe, Latin America and the Third World. The first of these would suffer a double blow from an oil price surge, because they are just getting used to the idea of paying the world price for supplies of oil. In addition, Eastern European economies are hampered by being between 1.5 and 2.5 times as energy intensive as the West, which makes their vulnerability all the more acute.

A further rise in the debt burdens of Latin American and Third World countries is unlikely to be to the long-run advantage of anyone, but this is one possible outcome from a sustained rise in the price of oil. And should the credit crunch mentioned in the Japanese section above not only materialise but extend beyond the Pacific rim, the outcome could endanger the orderly progression in industrialised economies which has characterised 1990 so far. Overall, a period of considerable uncertainty.