The international environment

- Iraq's invasion of Kuwait at the beginning of August caused a steep rise in oil and product prices. Since then, the price has fluctuated as market expectations of imminent conflict advanced or receded.

- Inflation rates and trade flows in the industrial economies have begun to show the effects of higher oil prices. Financial markets reacted to the Gulf crisis with a rise in bond yields.

- The divergence of growth between Japan and Germany on the one hand and the United States on the other has become more marked. The contrast is particularly strong with regard to the growth of domestic demand, which remains weak in the United States.

- The relative strength of domestic demand partly explains the continued reduction of G3 external imbalances. Declining current account surpluses in Japan and Germany and the continued decline of the US current account deficit have also been underpinned by exchange rate movements, with the dollar weakening during 1990.

- The higher oil price has exacerbated the problems facing non-oil developing economies and the new democracies of eastern Europe, which have for the most part not achieved the gains in energy efficiency recorded in the industrial economies in recent years.

The recovery in OPEC supplies during September and October has helped oil prices off their recent peaks

The Iraqi invasion of Kuwait on 2 August and the United Nations embargo that followed removed 4.3 million barrels of oil a day from world supplies (around 20% of OPEC production) as well as substantially reducing available refining capacity. Markets reacted with sharp price increases, both of crude oil and refined products (see the chart), and prices have remained high despite a subsequent increase in oil output of some 3.2 million barrels a day from other OPEC countries, including 1.9 million from Saudi Arabia. The Gulf crisis initially precipitated sharp falls in world equity prices and increased volatility in currency markets, as financial market participants assessed the likely effects of events in the Gulf. However, oil prices remain low in real terms compared with the level prevailing after the 1979 oil shock.

For policy makers, the main concern is to prevent a higher oil price increasing the general rate of inflation through excessive wage and price increases, while acknowledging the dampening effect on activity of higher oil prices. The Group of Seven communiqué issued on 22 September suggested a cautious monetary policy response aimed at maintaining stability. A tight monetary policy stance to contain inflation appears particularly appropriate in Germany and Japan, whose economies are characterised by tight labour markets and strong demand pressures. But such pressures are less in evidence in the United States. A 25 basis point easing of the federal funds target rate in late July was largely prompted by an independent tightening of credit conditions by commercial banks. This suggested that an easing was necessary to maintain unchanged monetary conditions. Following agreement on a programme of reductions in the US federal deficit, the federal funds rate was cut by a further 25 basis points.
Long-term bond yields rose after the start of the Gulf crisis

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<th>Year</th>
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<tr>
<td>France</td>
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</tr>
<tr>
<td>United States</td>
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<tr>
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</tr>
<tr>
<td>Japan</td>
<td>16%</td>
<td>14%</td>
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...but money-market rates have been affected less

<table>
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<th>Year</th>
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<tr>
<td>France</td>
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<tr>
<td>United States</td>
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<tr>
<td>Germany</td>
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<tr>
<td>Japan</td>
<td>10%</td>
<td>8%</td>
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</tbody>
</table>

In Japan, pressure from the labour market has become more apparent this year, with unemployment falling to its lowest level since 1980, and the jobs to applicants ratio rising to its highest level since the early 1970s. The Bank of Japan has expressed concern about such inflationary pressures as well as suggesting a non-accommodating approach to higher oil prices. The strength of the yen since the start of the Gulf crisis may in part reflect the perception in financial markets that of the major industrial economies Japan might suffer one of the lowest increases in inflation from higher oil prices. This in turn has stemmed partly from the view that the Japanese monetary authorities were likely to take a non-accommodating approach to the oil price shock. The rise of the yen itself represents a tightening of monetary conditions, further reinforcing the stance of the Bank of Japan which raised the Official Discount Rate by 0.75% to 6% at the end of August. However, the Ministry of Finance's concern about the weakness of the equity market was demonstrated by the support measures taken in early October, suggesting that the authorities have been concerned about too rapid a decline in equity prices.

Interest rate differentials in Europe have narrowed

The Bundesbank raised the Lombard rate by 0.5% to 8.5% on 1 November, principally reacting to higher market interest rates, raised by apprehension about GEMU, tax cuts and rising real wages. Concern about the direct inflationary impact of monetary union appears to have eased, but buoyant domestic demand still risks putting upward pressure on inflation, particularly through the labour market, where the forthcoming annual pay negotiations come against the background of falling unemployment and continued skill shortages in western Germany. However, the strengthening of the deutschmark has been an important factor in maintaining price stability this year. As higher oil prices feed into price indices, the Bundesbank is keen to ensure that this does not influence the coming pay round, indicating a non-accommodating policy stance.

In France, pay settlements have picked up somewhat this year despite a slowdown (before the Gulf crisis) in consumer price inflation. They nonetheless remain among the lowest in Europe, reducing the need for a tightening of monetary policy in response to external price pressures. In mid-October, the Bank of France reduced commercial banks' compulsory reserve requirements, allowing a slight decline in prime lending rates which was followed by a 25 basis point easing in the intervention rate. In Italy, measures designed to prevent an over-run of targets for the 1991 fiscal deficit (evenly divided between lower expenditure and higher taxes) are projected to cut the deficit to 9.4% of GDP from an expected 10.7% in fiscal 1990. This package, if enacted in full, together with the effect of higher oil prices, should slow domestic demand growth in the coming year. Interest rate differentials narrowed with respect to most other ERM currencies during August and September as the Bank of Italy increased liquidity in advance of large public debt sales. Interest rate differentials have since widened somewhat, possibly reflecting market perceptions of an adverse differential effect on inflation from higher oil prices on the Italian as opposed to other European economies.

The cost of German unification may have played a role in reducing interest rate differentials within the ERM. To the extent that German interest rates are rising to offset domestic inflationary pressure from GEMU, they do not require similar moves in other
Interest differentials have narrowed within the ERM. Spain, Italy, Germany, Denmark, Ireland, and Belgium have seen narrowing interest differentials against the deutschemark. France and the United Kingdom have also experienced narrowing differentials, while Ireland and the Netherlands have seen widening differentials.

Banking conditions have become more difficult in the United States and Japan. The further decline in equity values after the start of the Gulf crisis has focused attention on possible constraints facing Japanese banks. Higher interest rates in Japan have contributed to a series of sharp downward adjustments in equity prices, now partially reversed, and may precipitate a similar realignment in the real estate sector, where yields have fallen to historically low levels. A sharp downturn in property prices could affect the quality of some of the assets of Japan’s banking sector. Moreover, Japanese banks have found it hard to raise new equity to move towards the Basle capital-adequacy standards as a result of the declining equity market, which has also cut the value of their domestic equity portfolios, reducing the unrealised capital gains allowed as tier two capital. This has reduced the speed with which the banks can increase their asset base. In the United States, real estate prices have come under pressure. Difficulties with property loans and anxiety about the general economic environment, as well as capital pressures, have led to concerns that US banks might tighten credit unduly.

Changes in interest rate differentials between the major industrial economies seem to have contributed to an altered pattern of private sector capital flows. US private sector net inflows fell sharply in the first half of 1990, resulting partly from lower Japanese net investment in foreign bonds and a steep fall in foreign direct investment. Japanese banks have been considerably less active in international lending this year, a situation which may continue as they restrain asset growth in order to boost the adequacy of their capital. A rise in OPEC balances available to be recycled in the international financial system, as occurred in previous oil shocks, is possible if OPEC expenditure reacts slowly to the boost in their inflows. However, the ability of international banks to recycle new OPEC funds must be questioned in view of the increased constraint currently imposed by their capital. In the past a substantial share of OPEC capital outflows has gone to the United States, and were this to continue it could compensate for declining flows from Japan.

Some reported statistics, notably trade accounts and inflation, are already exhibiting the effects of higher oil prices. The initial effect will be to worsen the current account position of the industrialised oil importing economies, with a lag likely before higher oil import bills are offset by increased demand for industrial economies’ exports to oil exporting nations. Changes in relative competitiveness brought about by exchange rate and cost changes will also tend to impinge more slowly on relative current account balances. Demand responses in the oil market following conservation measures and a switch to cheaper fuels are also likely to be sluggish. In the medium term, oil producers such as the
United States will benefit from domestic supply responses, further reducing the current account impact of the oil shock.

The United States faces the largest potential trade account deterioration in value terms in the short run, although as a proportion of GNP it is the lowest of the G3. With its oil import bill reaching $50 billion in 1989, the additional cost could be as high as $5 billion per quarter if the oil price were to remain in the $30-35 per barrel range, even allowing for some reduction in demand. This would sharply reverse the trend towards lower current account deficits established over the last three years. That trend appeared to accelerate this year, with the deficit falling to $44 billion in the first half of the year, compared with $56 billion in the same period of 1989, as US domestic demand growth continued to lag that of its major trading partners. This, as well as recent exchange rate movements, has contributed to a continuing decline in G3 external imbalances this year. As a result of improving energy efficiency over the 1980s, Japan is now the least oil dependent of the G3 economies, and faces the lowest trade account deterioration relative to GNP after the United States from the oil price rise. However, the oil shock comes against the background of a falling Japanese current account surplus ($24 billion in the first half of 1990 against $34 billion for the same period of last year). Higher oil prices could add $4 billion a quarter to Japan’s import bill. The German current account may be more strongly influenced by domestic developments. This has been reflected in a narrowing of the current account surplus, which fell to $27 billion in the first half of the year compared with $30 billion in the corresponding period in 1989, despite an improvement in the terms of trade.

... and are likely to depress economic activity ...

The effect on economic activity in the industrial countries depends upon two factors in particular: the extent to which oil exporters’ higher surpluses are channelled into demand for imports, and the policy response to the shock in the industrial economies.

Higher oil prices are likely to depress economic activity in the industrial economies through their impact on consumption and investment. The effect on these two components of demand depends on its effect on various intermediate economic variables—inflation, interest rates and exchange rates in particular. The loss of real income in oil-importing economies may reduce corporate profit margins or real personal sector earnings, the division between the two depending on the reaction of nominal wages and the extent to which companies are able to pass on higher prices. As uncertainty about the future course of the economy increases, individuals may save more and firms may be more cautious about investing. A change in expenditure plans may take time to implement, so temporary movements in the oil price are likely to have little effect on output. The relative price change that a rise in oil prices implies will have structural effects, reducing demand for oil-based products, causing factor unemployment in such sectors. The sectors that benefit, such as oil exploration, may respond more slowly in their spending decisions than those that lose, producing an aggregate reduction in expenditure. These structural effects may be slow to occur so that a permanent change in the oil price can be contrasted with a temporary one, where structural changes may be limited. Wealth effects may depress consumption as asset prices, particularly equity prices, fall in value, although the response to the stock market crash of October 1987
Japanese business investment continues to outstrip that of other major overseas economies. Business investment as a percentage of GNP

The international environment may suggest that such losses have only limited and uncertain effects. However, the absence of the large paper gains of 1987 in the current climate may exacerbate possible wealth effects.

... which is already weak in the United States ...

In the United States, recent indicators suggest continued weakness in the real economy, although third quarter GNP data were stronger than many had expected. Much of the growth was attributable to consumer spending, helped by rising auto sales; however, deteriorating employment conditions suggest that spending is unlikely to have maintained that pace. The rise in final sales was also supported by a recovery in business investment, despite continued poor profitability. Residential investment continues to decline. The strength of the dollar in 1989 reduced export volume growth somewhat but, stripping out movements in oil stocks, the external sector continues to provide support to activity, benefiting from the weakness of US domestic demand relative to that of its main trading partners.

US federal budget negotiations have taken place against a background of rapidly rising estimates of the likely budget shortfall in fiscal year 1991. Congress failed to agree to various proposals earlier in October but finally endorsed a package to cut the federal deficit by $492 billion over the next five years. The latest projection suggests a federal deficit of $250 billion in fiscal 1991, including costs associated with the savings and loan rescue package.

... although not in Japan or Germany

In Japan, domestic demand accelerated in the second quarter, after a strong first quarter performance, with business investment again providing the impetus. There is considerable optimism that the real economy is in good condition to withstand higher oil prices, with the volume of oil imports per unit of GNP falling to 67% of its 1980 level by 1989. While recent surveys suggest that business investment plans have not weakened significantly since the start of the Gulf crisis, the current squeeze on bank lending and the downturn in the equity market, together with the expectation of lower corporate profits and tight monetary policy, tend to point to a slowdown from the current rate of growth in investment. The recent cyclical upswing has been characterised by a sharp rise in the share of GNP accounted for by investment, reaching 25% in the first half of 1990. The rise of business investment’s share of GNP during the 1980s may in part be accounted for by quicker obsolescence of machinery as equipment which is subject to rapid depreciation, such as computers, took an increasing slice of total investment. A reduced supply of new entrants to the labour market has also encouraged many firms to focus investment on productivity improvements rather than expanding capacity. As the chart shows, investment in Japan continues to outstrip that in the other major economies, and has outstripped Japanese consumption growth significantly in the 1980s.

Growth in Germany paused in the second quarter after the first quarter’s exceptional performance, but the economy is still on course to match last year’s strong performance in 1990. Second quarter GNP fell by 0.5% to stand 3.4% higher than a year earlier. The pause in growth was partly accounted for by mild weather early in the year, which boosted activity in the construction sector in the first quarter. Domestic demand has become an increasingly
dominant stimulus to growth, in contrast to last year when growth was underpinned by a strong export performance. The problems facing newly incorporated east Germany have deepened over the course of this year. Unemployment and short-time working have both increased substantially, and together amounted to around 2¼ million in September (approximately 25% of the workforce). Industrial production fell by some 42% in July compared with a year earlier, underlining the difficulties facing firms experiencing direct competition from the West for the first time. Although the eastern German economy may begin to pick up during 1991, the extent of the restructuring required suggests that it may take a number of years before eastern incomes reach a level approaching even those of the poorer regions of western Germany.

The cost of German unification has exceeded most expectations, with a steep rise in borrowing necessary to fund a significant shortfall in East German state revenues this year. Political unification on 3 October has given the German federal government greater control over state spending in the east, and this should provide a discipline to control costs that was previously lacking. Nevertheless, following the introduction of a third supplementary budget in October, the all-German deficit for 1990, including the Unity Fund, borrowing by the Treuhandanstalt (privatisation body) and the social security fund, is expected to exceed DM100 billion (about 4% of GNP). The budget deficit next year may exceed this year’s total. To contain the deficit, a proposed cut in corporate tax has been postponed, and the possibility of raising taxes has been highlighted.

In France, growth slowed moderately in the first half of 1990, with year on year growth of 2.2% recorded in the second quarter. However, there is some optimism that the rise in oil prices already seen is unlikely to push the economy into recession. While Italian growth continued strongly in the first quarter, at 3.1% year on year, it slowed markedly in the second quarter to 1.9%. GDP growth is still likely to average around 2½%-3% over the year, only slightly below last year’s performance, both consumption and business investment maintaining some momentum. In Spain, after a long period in which tight credit conditions failed to slow domestic demand significantly, signs of weakness have become more apparent during the first half of 1990. A combination of currency appreciation and accelerating wage settlements has eroded Spanish competitiveness, putting pressure on corporate profit margins.

The oil price increase will also weaken the current account position of the non-oil developing nations.

The rise in oil prices has contributed to a further deterioration in the terms of trade of non-oil developing countries. The rise in oil prices is set against slower growth rates in Asian economies, partly reflecting capacity constraints and rising labour costs. The World Bank has moved towards normalising lending to China, where domestic demand has slackened and import volumes have contracted in 1990. This has weakened Hong Kong’s export performance. In Taiwan, sharp falls in equity prices have contributed to slow growth in consumer demand, while export growth has stagnated. The current account for Asia’s newly industrialised economies has therefore deteriorated markedly this year.
With the exception of the minority of debtor nations that are also oil exporters (such as Mexico and Nigeria), the position of the debtor nations has been further damaged by the Gulf crisis. In addition to the burden of higher oil prices, a number of the poorest Asian economies, including some significant debtors, are facing a sizable loss of remittances from their nationals who were working in the Gulf and the problem of absorbing these workers as they return home. The front-line states of Jordan and Turkey also face the loss of a substantial proportion of their external trade as a result of the United Nations embargo, although the international aid package should go some way to compensate them for this loss.

Higher oil prices have improved the terms of trade for several Latin American economies, including Mexico, Venezuela, and Ecuador. However, Brazil (a substantial oil importer) and Argentina still face severe economic difficulties, with inflation remaining high. The reform programmes in Brazil and Argentina have had some success, although arrears to both official and bank creditors continue to mount. Venezuela has received bids from banks holding 95% of the debt covered by its debt reduction package. Following President Bush’s ‘Enterprise for the Americas’ initiative, moves to liberalise inter-American trade have gathered momentum, with Brazil, Chile and Argentina lifting intra-regional trade barriers. The ‘Trinidad Terms’ initiative launched in September by the Chancellor envisages further debt relief for the poorest countries pursuing adjustment and structural reform. It calls for a write-down of official bilateral claims by two thirds. Repayments would be rescheduled over a period of twenty-five years and be broadly linked to export capacity.

In the third quarter, world commodity prices (other than oil) averaged 4% lower than in the second quarter. Weakness in both food and agricultural non-food prices more than offset the increase in metal prices, which have been strong over the quarter. Metal prices have been supported by a tight supply situation due to the effects of labour disputes and, in the case of aluminium, actual and feared loss of supplies due to the Gulf crisis. Food prices have fallen steeply. Sugar, wheat and cocoa markets have been dominated by over-supply following bumper harvests. Prices have been further depressed by the loss of export markets in the Gulf and because of financing constraints restricting Soviet imports.

...and compounded the adjustment problems of eastern Europe

In eastern Europe, higher oil prices will further exacerbate the already painful process of adjustment as these countries undertake the transition to market economies. The increase in oil prices will pose particular difficulties for this region’s large heavy-industrial sector, which formerly relied on heavily subsidised energy supplies from the Soviet Union. Inefficient use of energy supplies bred by subsidised prices has resulted in output per unit of energy being between one third and two thirds of its level in the west. The decision of the CMEA to move to hard currency trade among eastern bloc nations at world prices during 1991 will accentuate the adjustment problems for Eastern Europe. However, in the Soviet Union, increased foreign currency earnings resulting from the oil price rise should help to alleviate short-term payments problems, although production difficulties have affected the volume of oil exports.
Most EC member states have agreed on a date for the start of the second stage of European monetary union

The informal ECOFIN meeting in Rome in early September was notable for a greater degree of realism about the difficulties surrounding rapid movement to Stages 2 and 3 of EMU. The need for caution was also recognised in the Bundesbank’s statement of 19 September, which called for a lengthy transitional phase to ensure the degree of economic convergence that would be necessary if EMU were to prove durable and to consolidate monetary stability. Subsequently, however, at the meeting of the European Council in Rome in late October, eleven members of the Community (the United Kingdom dissenting) agreed that the Inter-Governmental Conference on EMU, which first meets on 14 December, should take 1 January 1994 as the starting date for Stage 2. The United Kingdom, while advocating its own proposal for a new monetary institution and a common Community currency, argued that decisions on the substance of a move beyond Stage 1 should precede decisions on timing. The eleven did not propose a date for the start of Stage 3: instead a review of the functioning of the second phase, looking in particular at progress made in real economic convergence, would take place within three years of the start of Stage 2.
The latest Bank forecasts are for the period 1990–92 and focus primarily on the major six overseas economies. An important feature of the forecasts is the increase in oil prices, which is already having a significant effect on inflation. The rise in oil prices is likely to produce important differential effects across countries, as economic agents react to the oil price increase in different ways. It also remains extremely difficult to quantify the likely effects of German economic and monetary union.

In 1991 the major overseas economies are expected to experience a much sharper slowdown than in 1990, as high interest rates continue to restrain domestic demand and inflation erodes real incomes. GNP in the major six is projected to grow by 2¾% in 1990, slowing to 2% in 1991. Of particular significance is the slowdown in business investment following 2–3 years of relatively strong growth (although the investment to GNP ratio remains at a relatively high level) and also a slowdown in consumption as growth in real personal disposable income (RPDI) declines. In 1992 growth rates are projected to return towards potential as inflation falls and a cyclical recovery begins. The period of sub-potential growth during 1991 should be sufficient to reverse the present upward trend in inflation. However, tight monetary and fiscal policies are still required to maintain the downward trend in inflation through 1992. The outlook for inflation in the major six overseas economies is helped by expectations of relatively sluggish growth in the prices of non-oil commodities.

Table A
Demand and output in the major overseas economies

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<td>GNP/GDP</td>
<td>3.3</td>
<td>2.8</td>
<td>1.9</td>
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</table>

(a) Canada, France, western Germany, Italy, Japan and the United States.
(b) Percentage contribution to GNP/GDP growth.

Following the unification of Germany(2) a protracted transition period for eastern Germany is envisaged. Substantial economic problems are expected to persist throughout the forecast period. Capacity constraints, particularly within the construction industry, and shortages of labour with the relevant skills are factors that are likely to limit the pace at which the east can attain an income level approaching that of western Germany. In eastern Germany large reductions in domestic output are expected in the transition period, due to the weak competitive position of industry in the east as its markets are opened up. Moreover, the transition to a market economy involves a major shift in the pattern of demand: existing industries are unable to react rapidly enough to the new situation and as a result unemployment in the east is expected to rise quickly as domestic output falls. Lower demand, associated with rising unemployment and falling incomes, should help to reduce any inflationary pressures within the economy. Those who remain in work are likely to seek wages comparable to those in the west. However, changes in the composition of demand make it extremely difficult to measure the effect of lower demand on the aggregate price level, because the mix of goods and services bought will change.

As unemployment benefit levels will reflect those in the west, the authorities will have to make large fiscal transfers to the east to replace the loss of locally generated incomes. The individuals who receive these transfers can be expected to have a high propensity to spend. At present it is likely that most of the goods that they purchase will come from western Germany rather than from other countries. In western Germany there will be a substantial increase in the budget deficit to finance the transfers. A deficit of up to DM150 billion, or over 5% of GNP, is projected for 1991. Although this may prove a peak, large deficits of this magnitude can be expected to continue for some time, given the protracted nature of the transition period, unless offsetting fiscal measures are introduced. To some extent, however, the fiscal transfers will be recycled back to companies in western Germany through the increase in sales to eastern Germany. In order to meet demand for goods from eastern Germany, capacity utilisation levels in the west will have to rise from already high levels. These factors, together with the oil price increase, are expected to raise the rate of inflation in western Germany to 3½% in 1991. The outlook for inflation is improved by the recent strength of the deutchmark and the authorities’ willingness to maintain high interest rates.

In the labour market, immigrants from the east are not expected to exert significant downward pressure on wage settlements in the west primarily because they do not have the required skills and also because they are, initially at least, outside the bargaining procedure. Thus, pressure on earnings is expected to be strong because of general tightness in the labour market, but this is not expected to result in a wage-price spiral because of the maintenance of

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1. These forecasts have been produced by the Bank's world economic forecasting team and country analysis using the Global Economic Model applied by the National Institute of Economic and Social Research.
2. For the purposes of this forecast the two parts of Germany are treated as two distinct countries.
tight monetary policy. Steady employment growth is expected to continue and productivity growth is expected to slow. A slowing of productivity growth is consistent with reaching the high levels of capacity utilisation mentioned earlier.

The growth outlook for the rest of Europe, although supported at least in the short term by growth in western Germany, is not as favourable. In France, domestic demand growth is expected to slow to around 2\% per annum over the next two years, around 1 percentage point less than in Germany. There is a small positive net trade contribution to growth in domestic demand is below growth in export markets. The Italian surplus on services, after reaching a peak in 1989, is expected to decline because of a deterioration in competitiveness (which will affect, for example, tourism). The deficit on interest, profits and dividends, also continues to grow, as would be expected given the continued accumulation of current account deficits.

The outlook for Italy is, as in the case of France, for a gradual slowing in GNP growth. However, the components of GNP do not move in line with France. Consumption growth, in particular, remains more robust than elsewhere in Europe, largely because of stronger real earnings growth. The contribution to GNP growth from net trade is expected to switch from a small positive contribution to a small negative one in 1990–91 in response to both a loss of competitiveness and slower growth in export markets. The Italian surplus on services, after reaching a peak in 1989, is expected to decline because of a deterioration in competitiveness (which will affect, for example, tourism). The deficit on interest, profits and dividends, also continues to grow, as would be expected given the continued accumulation of current account deficits.

The outlook for inflation in Italy is not particularly favourable: this is partly because of the rise in consumer price inflation which has already occurred and which continues to feed through the economy during 1990. This factor is reinforced by higher oil prices. The Italian economy still remains more prone to wage-price spirals than many of its competitors. There is a marked improvement in the inflation rate in 1991 and 1992, but it remains above that in France and Germany. In response to this, nominal interest rates in France, Italy and Germany converge only slowly, reflecting the lack of progress in achieving any further convergence of inflation rates.

In response to the tightness of monetary policy over the past two years, growth in the United States has continued to slow markedly. GNP growth of around 1\% per annum is expected for 1990 and 1991, before recovery to around 2\% in 1992. The main factor behind this slowdown is consumer spending, which is expected to grow by only 1\% next year compared with 3\% in 1988, 2\% in 1989 and 1\% in 1990. The direct effects of high interest rates on consumption are thought to have been modest: the main factor in explaining slower consumption growth has been the reduction in RPDI growth, associated with slower employment growth and higher prices. The rise in inflation also impinges on consumption growth directly as households save more to compensate for the effects of inflation on their wealth. The depressed state of the residential property market directly reduces housing-related consumption; a fall in residential investment is expected this year with only shallow growth thereafter. There may be important housing and financial wealth effects on consumption, and consumer confidence may play a role over and above that already embodied in the factors mentioned. Business investment is expected to grow by under 2\% per annum over the next two years compared with growth of 5\% per annum between 1987 and 1989. This reflects the continued high level of interest rates and the low level of profits which has reduced the funds available for reinvestment. This implies little prospect for an improvement in underlying productivity growth. Adjustment in the US labour market can be characterised as a relatively quick acceptance of real pay cuts, but rather more inertia in employment. Thus, despite the rapid slowing of the economy, employment adjusts relatively slowly and productivity growth falls close to zero in 1991, before recovering in 1992. The weak employment outlook helps to explain why the rise in prices in the United States does not develop into a wage-price spiral.

The rise in the oil price, together with a weakening of the dollar causes a deterioration in the United States’ terms of trade, but this is more than offset by volume developments which reduce the current account deficit from just over 2\% of GNP in 1990 to around 1\% by 1992. In particular, there is a marked reduction in the volume of oil imports. Overall, however, the US trade balance benefits from a period when growth in domestic demand is below growth in export markets. This factor is more important than the competitiveness effects. Nevertheless, the improvement in export competitiveness associated with the dollar’s weakness against the yen and the deutschmark over recent months does help to boost net trade, but this is still offset, to some extent, by lagged effects from the relative strength of the dollar last year. The nature of the US economy means that the rise in oil prices does not induce a major increase in domestic wholesale prices. This is helped by the failure of wages to respond fully to the initial price rise and the consequent deflationary impact of lower real earnings.

The performance of the Canadian economy mirrors closely that of the United States. The slowdown in US import volume growth is an important determinant of the prospects for Canadian exports. The replacement of the existing federal sales tax by the 7\% Goods and Services Tax (GST) in 1991 is expected to impinge on the supply side of the economy. Prices of imported goods will then be on an equal

### Table B

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</thead>
<tbody>
<tr>
<td>Whole-economy</td>
<td>2.7</td>
<td>4.6</td>
<td>4.6</td>
<td>3.0</td>
</tr>
<tr>
<td>unit labour costs</td>
<td>3.9</td>
<td>4.9</td>
<td>9.5</td>
<td>-7.0</td>
</tr>
<tr>
<td>Import prices (a)</td>
<td>3.8</td>
<td>4.3</td>
<td>4.5</td>
<td>3.0</td>
</tr>
<tr>
<td>Consumer prices (b)</td>
<td></td>
<td></td>
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</tbody>
</table>

(a) Weighted average of individual countries’ local currency average value indices for imports.
(b) Consumers’ expenditure deflator.
footing with domestically produced goods and this is expected to boost net external trade. A reduction in the cost of business investment following the implementation of the GST is also projected to boost investment. However, the economy is expected to lose competitiveness and this counterbalances the favourable relative demand developments, with the result that the Canadian current deficit is expected to rise as a percentage of GNP.

The Japanese economy continues to contribute strongly to overall world growth. Domestic demand is expected to grow by 6\(\frac{3}{4}\)% this year before slowing to around 3% per annum thereafter. Within this total, consumption growth is projected to slow from 4% this year to just over 2% next year. Business investment growth is expected to slow sharply in 1991 relative to growth in the previous three years, but is nevertheless still expected to grow by 3%-4% per annum. This slowing is due to the general cooling of activity and the maintenance of high interest rates. The fall in Japanese equity prices is not expected to affect investment decisions significantly, at least in the short term, because much of the investment has been self-funded and dependent primarily on past levels of profits.

The relative strength of the Japanese economy is reflected in the recent strength of the yen against the dollar. Despite this factor and the rise in oil prices, competitiveness in export markets is helped by continued strong productivity growth which keeps unit labour costs down. Domestic prices are largely determined by favourable trends in local unit labour costs, such that other non-wage costs (for example, higher oil prices) do not feed through very strongly. Moreover, movements in export prices reflect these domestic price trends. Japanese export markets, like the United States, are affected by the general slowdown in world activity, but are still expected to grow by around 4\(\frac{1}{2}\)% per annum, on average, over the next few years. Overall, Japan’s current account surplus is reduced sharply in 1990 and 1991 owing to higher oil prices, but recovers quite rapidly in 1992 as favourable trends in competitiveness reassert themselves.

The growth of world trade, as measured by import volumes, is projected to slow from 8\(\frac{1}{2}\)% in 1989 to around 5\(\frac{3}{4}\)% per annum in 1990 and 1991 before recovering to 7% in 1992. These figures reflect an almost universal slowdown in import volumes. There is, however, considerable uncertainty about the employment of the higher oil revenues received by the OPEC countries in response to higher oil prices. The Asian NIE’s (Korea, Taiwan, Hong Kong and Singapore) are expected to experience a slowdown from the growth rates seen in 1989. Export market growth, in particular, is depressed owing to the weakness of the United States, which accounts for around 30% of the NIEs' exports. Overall, the current accounts of the NIEs are expected to deteriorate. In Latin America, Brazil is the only major loser from the oil price increase so far as the terms of trade and current account are concerned.