The international environment

- *Many of the major overseas economies are slowing and some are in recession, but the likely extent of the overall slowdown in world activity is difficult to gauge because of uncertainty concerning events in the Gulf.*

- *The divergence of economic performance among the major economies continues to increase, with the growth of output in Japan and Germany still healthy while in the United States and Canada output has fallen over recent months.*

- *The fall in oil prices in the fourth quarter was reflected in inflation figures at the end of the year, which were lower than many commentators had expected.*

Real GNP/GDP growth in the six major overseas economies

Percentage changes on previous quarter; *seasonally adjusted*

		United States	Japan	Germany	France	Italy	Canada	Major 6
1989	Q1	0.9	1.0	2.5	1.3	0.6	1.2	0.4
	Q2	0.4	0.0	1.0	0.7	0.9	0.3	0.5
	Q3	0.4	2.4	1.0	0.6	0.8	0.8	0.9
	Q4	0.1	1.3	1.0	0.7	0.7	0.7	0.6
1990	Q1	0.4	1.6	3.0	0.6	0.6	0.5	1.0
	Q2	0.1	1.4	-0.5	0.2	-0.2	-0.3	0.2
	Q3	0.3	1.0	2.0	1.3	0.7	-0.3	0.7

Many of the major overseas economies are slowing, and some are already in recession. The depth and length of recession is still difficult to predict at this stage, owing in particular to the uncertain effects of the Gulf conflict. The direct effects of the Gulf crisis on activity and inflation are, so far, thought to have been relatively small, but will have added to existing pressures. The indirect effects on, say, business and consumer confidence are difficult to isolate from other factors. The differences in economic performance across countries have led to divergent policy strains. Monetary policy has been eased in the United States to help minimise the extent of the recession and tightened to counterinflationary pressures in Germany. The authorities in Japan have not eased policy because inflation is still perceived as the primary concern.

The price of Brent oil fell in the fourth quarter and ended the year at just over $25 per barrel compared with the peak of around $40 reached in early October. World demand for oil continued to be satisfied, chiefly because of increases in production outside Iraq and Kuwait but also owing to lower demand itself, which has responded to the higher price and a slackening in the pace of economic activity. Much of the fluctuation of the oil price in the second half of 1990 can be explained by precautionary stockbuilding by industrialised countries at the start of the crisis, plus a premium related to the perceived risks of armed conflict and the damage to supplies that might result. After the outbreak of hostilities, following the United Nations' 15 January deadline for the withdrawal of Iraqi forces from Kuwait, the oil price initially rose then fell to below $20 as many people in the oil market came to believe that the risks to Saudi Arabian supplies were not as great as first feared.

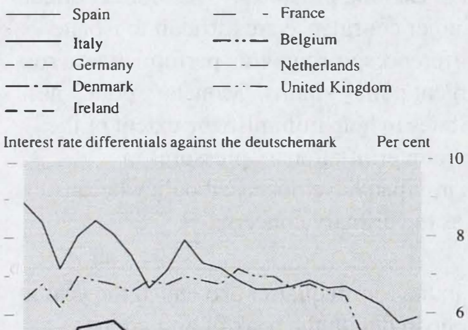
The US authorities reduce **interest rates** *as activity slows*

Since the beginning of November, the US Federal Reserve has lowered its target for the federal funds rate in five stages, taking the rate to 6.25%. The discount rate was lowered by half a percentage point to 6½% in December and by the same amount in February. US commercial banks responded to these moves by lowering their prime lending rates; these determine the rates that directly face households and many businesses. Prime rates at most banks were cut to 9½% at the beginning of January and subsequently some banks reduced their prime rates by an additional half a percentage point in early February: the previous change was around a year ago when rates were lowered from 10½%. The interest rate cuts came at a time of considerable uncertainty about the risks of restricted credit availability and the depth and length of the recession in the real economy. Both moves to reduce the discount rate were officially described as a response to the weakness of the economy, constraints on credit and slow growth of the money supply. The interest rate moves were helped by inflation figures which were not as high as many commentators had expected, at least in part owing to the easing of oil prices towards the end of the year.

The dollar has been influenced since August by developments in the Gulf, as it is still to a degree perceived as a safe-haven currency. The dollar also gained ground against the deutschemark in response to events in the USSR and, in particular, the resignation of Soviet Foreign Minister Shevardnadze and, more recently, military intervention in the Baltic states. Despite these influences the dollar recorded new lows against many currencies in the fourth quarter and fell 9% in effective terms through 1990 as a whole. The yen's effective rate weakened towards the end of the fourth quarter and ended the year around 1% below the level of a year earlier. Following the outbreak of hostilities in the Gulf the dollar weakened again as markets reassessed the likely length of the conflict.

At the end of January the Bundesbank raised the discount rate from 6% to 6½% and the Lombard rate from 8½% to 9%. The Netherlands, which has pegged its currency tightly to the deutschemark, raised rates in response. The move by the Federal Reserve to lower the discount rate shortly after the Bundesbank's increase led to a further weakening of the dollar against the deutschemark.

The spread between currencies in the narrow band of the ERM widened . . .



(a) Last working day each month.
(b) The Italian lira was realigned in January 1990.

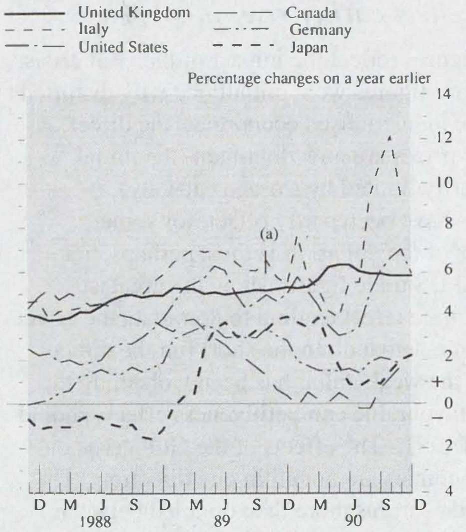
Interest rate differentials *within Europe continue to narrow*

In Europe, interest rate differentials have narrowed over the past few months. Three-month money-market rates in Germany have crept up since unification. With French three-month rates holding broadly steady at around 10% the interest rate differential has been reduced to below 1%. Interest rate differentials against Germany have also continued to decline for Spain and Ireland, but the general decline in the Italian-German differential in the second and third quarters was reversed in the fourth when Italian market rates reached almost 14%. Among the G7, Italy was the only country where long-term bond yields increased in the fourth quarter. Elsewhere, the rise in long-term bond yields following the outbreak of the Gulf crisis was largely reversed in the fourth quarter as perceived inflationary risks receded. In early January, long-term bond yields increased slightly in most of the G7 before continuing to fall slowly.

The peseta has remained the highest currency in the ERM. The relative position of currencies within the narrow band did not change significantly until the end of the year, with the deutschemark at the top and the French franc at the bottom. Towards the end of the year the spread between narrow-band currencies widened, as the deutschemark strengthened. During January the deutschemark weakened against both the dollar and European currencies within the ERM in response to events in the USSR (to be replaced by the Belgian franc as the strongest currency within the narrow band). During November and December sterling was the lowest currency in the ERM, but since the end of 1990 sterling tended to move more in line with the dollar as events in the Gulf have unfolded, rising towards its central rate against the deutschemark by mid-January, but falling when the Bundesbank raised rates at the end of the month.

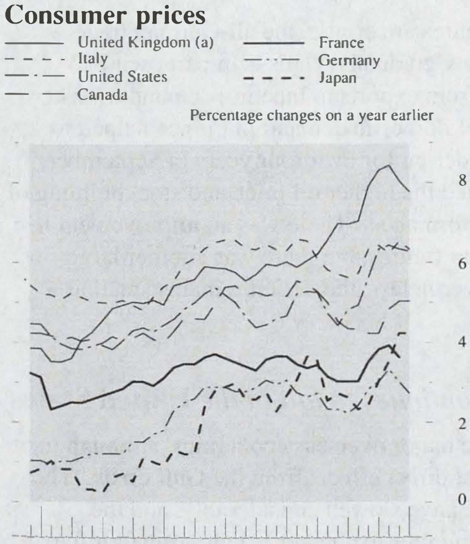
The German authorities have announced a target for M3 monetary growth for 1991 of 4%–6%. This is unchanged from last year's target range but incorporates the former GDR for the first time. The target is made up of an allowance of 2% for 'unavoidable' inflation, 2½% for potential growth and a further ½% for changes in the velocity of circulation. However, since unification it has been extremely difficult to interpret the monetary data, a problem that will continue this year. Among the various factors hindering interpretation is the unknown extent to which east German individuals have already, or will during the course of 1991, convert their bank deposits into other types of financial instrument, some of which will not be included in the M3 monetary aggregate. The velocity of circulation in the east, as well as the degree of seasonal variation of money demand, is also relatively difficult to estimate. Nevertheless, the German authorities caution against exaggerating these difficulties. East German money stock is only around 10% of the total, so even fairly large errors in its estimation would have only a limited impact on the overall aggregate.

Producer prices



(a) New series.

Consumer prices



(a) Excluding mortgage interest and community charge payments.

The easing of **oil prices** *at the end of last year has helped to hold down* **inflation**

In Japan, wholesale and consumer price inflation rose in the second half of last year. In the United States, core producer and consumer price inflation was flat overall in the second half. There were some signs at the turn of the year that the increase in inflation in some European economies was coming under control—with several countries reporting figures that were below market expectations. This may, however, have reflected the fall in oil prices towards the end of the year rather than an improvement in the underlying position. German consumer price inflation fell to 2.8% in the year to December compared with 3.3% in October and 3.0% in November. This fall may largely illustrate a rapid response to changes in the oil price. Worries remain concerning the inflationary impact of unification, and the coming round of pay settlements will be particularly important. Some have been encouraging, with some workers in the steel industry accepting a deal worth around 6%, against their initial claim of 10%. On the other hand, in Italy there has been a rapid increase in producer price inflation from little more than 5% in June to almost 12% by October followed by a fall back to 9½% in November, reflecting the high weight of energy. These movements have not been reflected in consumer price inflation, which remains little changed from the same time last year.

Elsewhere in Europe inflation has also been rising. The Netherlands retains one of the lowest inflation rates in the European Community, but even there consumer price inflation has risen steadily since late in 1987. Inflation has risen to some extent in France, Belgium, Denmark and Ireland since the initial rise in oil prices, but it remains at or below 4%. In both Portugal and Spain some of the progress made in reducing inflation earlier in the year has been reversed, but the deterioration is not out of line with the European Community average.

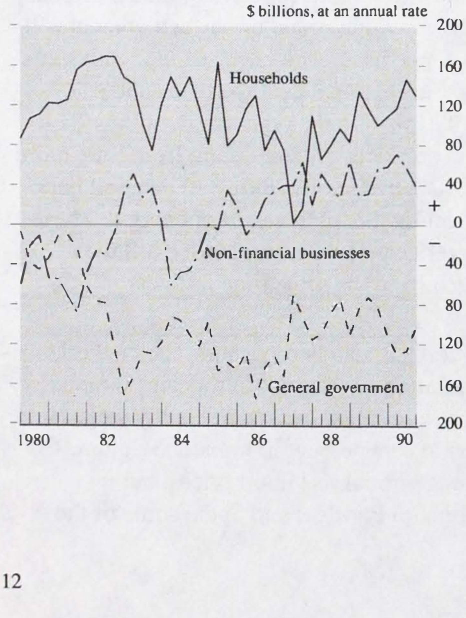
In the fourth quarter of 1990, non-oil commodity prices were 11% lower, in SDR terms, than in the third quarter and reached their lowest level since April 1987. There were falls in all three sub-indices: metals (14.5%), foods (7.2%) and agricultural non-foods (11.0%). Metals prices fell steeply over the quarter, reversing the increases since the start of the Gulf crisis, and are at their lowest for three years. This is owing to both unexpected increases in supply (leading to high stock levels) and weak demand caused by the expectation of a more generalised slowdown in activity. Many food prices have been depressed owing to the continued absence of the Soviet Union from the market because of financing constraints. The prices of sugar, maize and wheat have all been undermined by a supply surplus. Weak demand is also evident in agricultural non-foods, especially wool and timber.

While **trade figures** *reflect earlier rises in oil prices. . .*

The fourth quarter trade figures reflect the impact of the Gulf crisis. Although some of the earlier figures were initially heavily distorted by oil stockbuilding by the industrialised economies, the direct effects of higher dollar oil prices are now dominant (the initial stockbuilding was necessarily limited by storage capacity). Nevertheless, these effects have been partly offset, for some countries, by the weakness of the dollar. It is thus, perhaps, not surprising that the nominal US trade figures show the greatest deterioration, with the oil price effect tending to dominate the effect of the slowdown in domestic demand. In the short run the direct terms of trade effect from the weak dollar has been worsening the US trade balance, but the favourable competitiveness effects should have more of an impact in 1991. The effects of the Gulf crisis on the major six overseas economies are not all in one direction. The Canadian merchandise trade surplus more than doubled between August and September, largely as a result of a surge in oil and natural gas exports to the United States.

Although the monthly figures are erratic, the all-German trade surplus continues to narrow gradually. This is in part owing to switching of production from exports to meeting demand in eastern Germany. The strength of domestic demand in France helped to produce the largest trade deficit for over four years in September, but the deficit also reflected the higher oil price and stockbuilding of oil, and a poor export performance. There was an improvement in the October and November figures, but there was another large deficit in December. Nevertheless, the deficit remains small as a percentage of GNP.

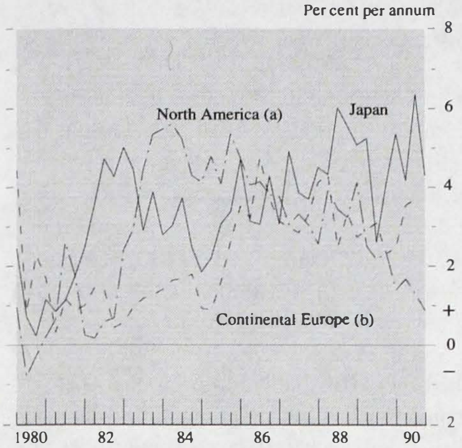
US sectoral financial balances



. . . **output growth** *continues to fall in the* **United States**

Activity has slowed in the major overseas economies, although there is little evidence, as yet, of direct effects from the Gulf crisis. The United States and Canada have slowed considerably, and the continental European economies to a lesser extent: growth in Japan is falling, albeit from high rates. The US economy grew by 0.3% in the third quarter following growth of 0.1% in the second. The first published estimates suggest that output fell by around 0.5% in the fourth quarter. It seems unlikely that the recent easing of monetary policy will have significant direct effects on the real economy until

Consumption growth



(a) Weighted average of the United States and Canada.
(b) Weighted average of Germany, France and Italy.

later in 1991. However, the easing may reduce worries about some sectors of the financial system and help to improve business and consumer confidence. One factor which suggests that any fall in output will not be too marked is that the non-financial business sector has been running a small financial surplus, so any effects from a cut-back in the availability of credit might not impinge so greatly on corporate sector expenditure. Furthermore, there appears to have already been a period of household sector retrenchment, with the financial surplus tending to rise over the past three years, and a parallel rise in the household sector's saving ratio compared with the low reached in the second quarter of 1987; this adjustment by individuals and firms is reflected in the gradual decline of the current account deficit over recent years. However, the main counterpart to the current account deficit remains the public sector financial deficit, which is still large.

The latest employment data for the United States illustrate the weakening of the economy in the fourth quarter, with large monthly falls throughout the quarter followed by a further fall in January. It is possible that these figures represent a faster than usual response to falling demand, as consumer and business confidence fell. It is too early to judge the size of the underlying decline in employment. Unemployment is climbing steadily, reflecting falling employment. Moreover, survey evidence continues to indicate that the economy is weakening. The purchasing managers' index fell in January for the seventh successive month to reach its lowest level since the trough of the 1981/82 recession. Industrial production suffered its biggest monthly decline since January 1982 when it fell 1.8% in November, and it fell again in December.

In Canada output fell by ¼% in the third quarter following a similar fall in the second. Activity has remained depressed since then, under the influence of the recession in the US economy. The situation in Canada will also be affected by the new Goods and Services Tax which was introduced at the beginning of January.

. . . and **Japan,** *but not yet in* **Germany**

Growth in Japan fell to 1% in the third quarter from 1½% in both the first and second quarters, but remains robust compared with that in most other major industrialised countries. Nevertheless, there is concern about the weakness in the property market and its potential effects on both the financial sector and real activity. This, together with the effects from continued high interest rates, more difficult fund-raising conditions in capital markets and possible confidence and wealth effects (associated with the fall in the Japanese stock market in 1990), may have acted to slow growth. On the other hand, the strength of investment over recent years and technological developments may help maintain strong productivity growth, which in turn should hold unit labour costs down and maintain competitiveness. Thus net trade, despite adverse relative demand developments, is unlikely to make a negative contribution to output growth.

Strong demand raised western German GNP by around 2% in the third quarter, boosted by the initial impetus from unification. The first estimate for western German GNP in the fourth quarter suggests that growth was broadly the same, bringing growth for the year as a whole to around 4½%. This is above the 1989 figure and the highest rate recorded since 1976. GNP figures for the eastern part of Germany are not expected to be available until March or

April. The pattern of growth in Germany has been more erratic than in some of the other major economies over recent quarters, particularly because of unification effects.

France experienced faster growth in the third quarter than in the second and the outturn was above market expectations. Output was 1¼% up on the second quarter and 3% above the level of a year earlier. Furthermore, growth was evenly balanced across the industrial and non-industrial sectors of the economy. Italian GDP increased by around ¾% in the third quarter and was 1¾% higher than a year earlier. This rate of growth is well below the average of 2¾% per annum recorded between 1985 and 1989.

Outside the G7 many of the other OECD economies are still, on average, growing at a reasonable pace, but there are signs that activity is slowing in several countries. Belgium and the Netherlands, where industrial production has been growing strongly, have probably benefited from increased demand from unified Germany. This is supported by the latest trade data and is consistent with the evidence that the industrial sectors of these economies have been growing faster than other sectors. Growth in retail sales in the Netherlands, in particular, has been well below growth of industrial production. In Spain, where interest rates have been kept high, industrial production has fallen from its peak, although retail activity remains strong, resulting in the trade deficit running at around $30 billion per annum (or around 6% of nominal GDP). Outside the European Community, both Sweden and Australia are in recession, with industrial production down 4% in the year to October in Sweden and GNP down ¾% in the year to the third quarter in Australia.

The prospects for many of the **developing countries** *continue to deteriorate*

The Uruguay Round of trade talks broke down on 7 December when trade ministers of the member countries of the General Agreement on Tariffs and Trade (GATT) agreed to suspend their negotiations. Although progress was made on a number of topics, negotiations reached an impasse because of failure to reach agreement on agriculture. It was hoped that negotiations would resume early in 1991.

Movements in oil prices have a differential impact on debtor countries. Although a few highly indebted oil exporting countries (such as Mexico, Nigeria and Venezuela) benefited from higher oil prices at the beginning of the Gulf crisis, the already weak external positions of the other debtors (for example, India) have been exacerbated by the loss of other sources of foreign exchange, such as workers' remittances from the Gulf. To assist such countries the IMF and the IBRD are to expand their existing lending facilities temporarily. Current uncertainties over future oil prices will mean that financing needs will have to be reappraised once the crisis is over. The easing of US monetary policy over recent months and the associated decline in market interest rates should, however, help some of the debtor countries.

Many non-oil-exporting developing countries are likely to experience further terms of trade losses and weakening of overseas markets, although those countries in the Far East (particularly the newly industrialised economies) which rely most heavily on Japan should fare better, since growth in Japan remains healthier than in much of the G7. There are also worries about the possible repercussions should the GATT talks fail to deliver a substantial agreement. For example, a failure to liberalise markets for agricultural and other exports of the heavily indebted developing countries would damage the prospects for such countries to service their debts to industrial country creditors. At the same time consumers, in particular, in the industrialised countries would continue to be denied the welfare benefits of free trade.

In September, the Paris Club announced its intention to provide easier rescheduling terms to certain lower middle income countries as well as facilitating, at the option of creditors, the conversion of foreign claims into local currency instruments or equity, albeit on a limited scale. Four countries have already benefited from those terms. Further consideration is being given to the particularly acute debt problems of Poland and Egypt. The United Kingdom's 'Trinidad' package proposing substantial official debt relief to those of the poorest countries pursuing adjustment and structural reform is also under discussion by the creditors.