The international environment

- *Weighted GNP in the major six economies fell in the fourth quarter of 1990. Cyclical divergences between the major economies seem likely to continue in the short term but are expected to narrow in the second half of the year.*

- *The US dollar has appreciated sharply since the beginning of March, after reaching all-time lows against the deutschemark; the deutschemark has weakened considerably within the ERM.*

- *Inflation declined as oil prices softened further, but inflationary pressures remain a concern, particularly in Japan and Germany.*

Economic activity was much weaker than expected in the final quarter of last year, and forecasts for growth in 1991 have generally been revised downwards.[1] Cyclical divergences between the major economies, which developed last year, seem likely to continue in the short term but are expected to narrow in the second half of the year. The turning point in activity is difficult to pinpoint in advance, but may well have already passed. The recession has continued in the United States, although there are some tentative signs that recovery is on its way. The Gulf crisis had a major adverse impact on consumer confidence but this was largely reversed by the cease-fire. The easing of monetary policy over the past year and an expected decline in inflation are likely to lift consumer spending in the second half of this year, and this should provide one of the main stimuli to the US recovery. Activity in the interest-sensitive housing sector is also expected to pick up.

In Japan, on the other hand, evidence of a slowdown is now gathering. Falls across most categories of private expenditure led to a decline in domestic demand in the final quarter of last year, although this was more than offset by a strong export performance. The Japanese economy is expected to slow further because although business investment, the main driving force behind earlier growth, has thus far remained strong, latest surveys point to an overall slowdown in investment growth and profitability over the course of the year. West German GNP growth slowed in the final quarter of last year, but this was largely owing to a weaker net external position. While unification continues to support activity in the western part of the country, rising unemployment in eastern Germany is likely to depress consumption there in the near future, although this is expected to be partly offset by increased private and public sector investment.

In general, the decline in oil prices since October has reduced consumer and producer price inflation towards pre-Gulf crisis rates. However, the German authorities are concerned about pressures that may stem from current wage settlements, and these, together with the impact increased assistance to eastern Germany may have on the fiscal position, will require monetary policy to remain tight. Despite

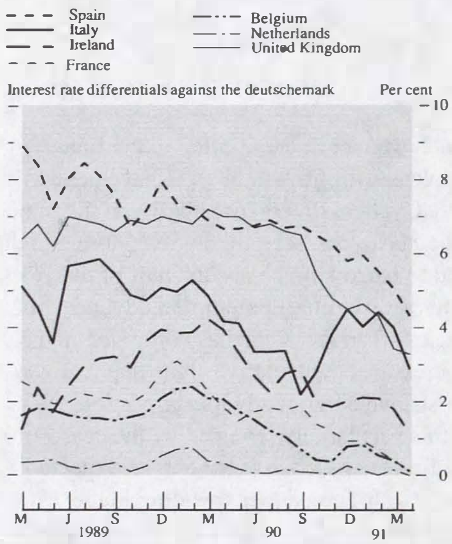
(1) See pages 187–9 for a summary of the Bank's latest forecasts of world economic prospects.

market expectations of a cut in Japanese interest rates, the Bank of Japan is maintaining its tight monetary policy stance. Although activity in Japan is slowing, the Bank of Japan remains worried about inflationary pressures. Elsewhere, monetary policy has been eased in those countries where economic activity is weak or declining.

The **dollar** *appreciates sharply, after reaching all-time lows against the* **deutschemark***; the* **deutschemark** *weakens within the* **ERM**

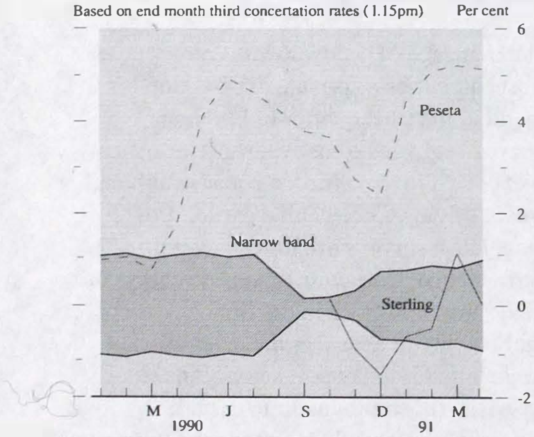
At the beginning of the year the dollar continued its downwards path, falling to all-time lows against the deutschemark and the yen. It subsequently appreciated sharply during March on a revival of optimism following the cease-fire in the Gulf and hopes that the US economy would soon recover from recession. The strength of the dollar put downward pressure on the yen, heightening concerns about inflation in Japan (although the yen has strengthened significantly against the deutschemark and sterling), while social unrest in eastern Germany and the possible implications of reconstruction in the east for the German budget deficit, along with developments in the Soviet Union, caused the deutschemark to depreciate sharply against the dollar, and within the ERM. This, along with a 1% cut in the Bank of Spain's official interest rate in the middle of March, slightly eased the pressure on the French franc. The French authorities, in a largely technical move, cut their money-market intervention rate by 25 basis points. The franc fell slightly as a result but recovered somewhat towards the end of the month. However, although domestic pressures make a further cut in rates desirable, the franc's position close to its limit against the peseta may prevent this. Meanwhile, the gradual lifting of barriers to capital flows in Spain and the fact that the foreign exchange market had largely discounted the interest rate cut kept the peseta at the top of the wide band of the ERM. The continuing tight monetary stance in Italy, at a time when the deutschemark was under pressure, brought about a sharp appreciation of the lira. However, on the basis of speculation of a cut in the discount rate and an easier liquidity stance by the Banca d'Italia, Italian short-term interest rates have edged down. While sterling has also strengthened, most other currencies within the ERM have recently depreciated.

Within the ERM, interest rate differentials narrow against the deutschemark



ERM positions

Based on end month third concertation rates (1.15pm)



The Federal Reserve cuts **interest rates** *as* **recession** *continues in the United States*

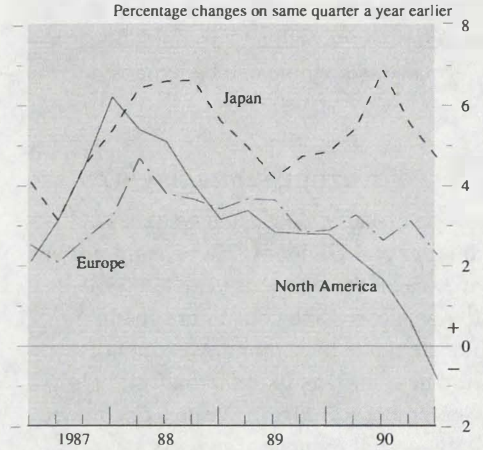
Following sharp falls in employment in the United States in the first two months of the year, the Federal Funds rate was lowered further. By the end of the first quarter, it had been reduced to 6%, bringing the reduction since the end of October to 2%. The lowering of rates was in response to declining economic activity, weak monetary growth and restricted credit availability. The growth of the M2 aggregate started to recover in the first quarter, however, despite signs that activity has continued to weaken. Inflation in March was lower than expected and this easing of inflationary pressures, together with the continued weakness in activity, led the Federal Reserve Board to cut the discount rate from 6% to 5.5% and further lower the Federal Funds rate to 5.75% at the end of April. Immediately before this move, Finance Ministers and central bank Governors from the Group of Seven main industrial countries agreed on the importance of setting monetary and fiscal policies to provide the basis for 'sustained global economic recovery with price stability'.

Cyclical divergences *between the* **major economies** *are likely to continue in the short term . . .*

In the United States, advance first quarter data showed a decline in real GNP of 0.7%, following a fall of 0.4% in the final quarter of last year. Business and residential investment fell sharply in the first quarter, while the consumption decline was less pronounced than in the previous three months. Declines in industrial production and industrial and capital goods orders in the first quarter suggest activity may remain weak in the near term. Although building permits and sales of existing homes rose in February and March, there are few signs that activity in the housing sector has picked up. The personal sector has been constrained by deteriorating real wealth and income, and an increased tax burden (owing to the increase in many State and local government indirect taxes at the beginning of the year). Since the beginning of the year non-farm employment has fallen by almost 850,000. However, the end to hostilities in the Gulf boosted consumer confidence, and personal income and consumption rose in February and March. The earlier easing of monetary policy, as well as an anticipated fall in inflation, are expected to lift consumer spending in the second half of the year. This is likely to provide the main stimulus to growth. Nevertheless, prospects are still for a relatively slow recovery in overall activity.

GNP contracts in North America as growth in Europe and Japan slows . . .

Percentage changes on same quarter a year earlier



Conditions have generally deteriorated further in Canada although there are signs of a pick-up in housing activity, albeit from a low level. Retail sales fell sharply in January, mainly as a result of the replacement of the Federal Sales Tax with the Goods and Services Tax. With unemployment having risen to 10.5% in March, declining income levels are likely to depress consumer spending further in the second quarter. In addition, profit margins have fallen to such low levels that business investment may also be slow to recover. Any return to growth in Canada will depend, to a large extent, upon a recovery in the US economy.

. . . with **growth in Japan and Germany** *beginning to slow*

There are clear signs of a slowdown in the Japanese economy. Growth of real GNP slowed from 1.1% in the third quarter of last year to 0.5% in the fourth, bringing growth over the year as a whole to 5.6%, up from 4.7% in 1989. However, an improvement in the external sector more than accounted for fourth quarter growth; declines in consumption expenditure and housing investment and a rundown in stocks produced a fall in domestic demand for the first time since early 1986. While business investment remained strong (having now accounted for more than half of the economy's growth since the end of 1986), surveys by the Bank of Japan and the Economic Planning Agency point to a slowdown in investment growth and profitability in 1991. In addition, possible lagged effects from the decline in wealth resulting from the fall in equity prices last year suggest that the pace of activity in Japan may slow further over the coming year. Growth in 1991 may well be less than official forecasts of 3.5%.

In western Germany, real GNP growth slowed to 0.6% in the fourth quarter of last year compared with a rise of 2% in the third, but growth in 1990 as a whole was still 4.5%, up from 3.9% in the previous year. With strong investment and consumption in the final quarter of last year, it would appear that demand from eastern Germany has sustained activity in the west in the face of otherwise weaker net external growth. Increased unemployment and short-time working in the east suggest that consumption there is likely to weaken, while fear of unemployment is expected to induce those currently employed to shift income from consumption to saving. However, this is expected to be offset somewhat by increased private and public sector investment. The impact on growth in Germany as a whole of the July indirect tax increases, imposed partly to assist in funding reconstruction in the east, is uncertain. Forecasts for west German growth are around 2.5% in 1991, although growth in Germany as a whole can be expected to be much weaker than this.

. . . and **activity** *in the rest of* **Europe** *remaining weak*

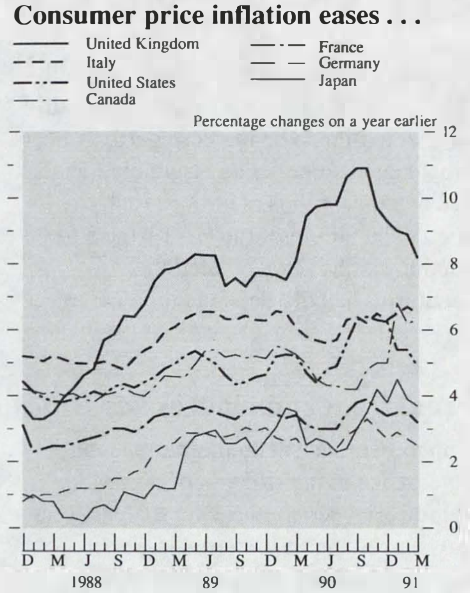
The picture elsewhere in Europe is one of continued weakness. In France, a decline in fourth quarter real GDP of 0.2% brought growth in 1990 down to 2.8%, from 3.6% in the previous year. Unemployment continues to rise, depressing consumer spending, and latest surveys do not indicate that a pick-up in investment is likely in the near future. Growth in 1991 is likely to be well below the 2.7% envisaged in last September's Budget. While a decline in activity is not expected in Italy, partial indicators suggest a slowdown of growth across all categories of expenditure in the final quarter of last year. Industrial production remained depressed over the first two months of this year. The official forecast for real GDP growth in 1991, at 2.1%, seems likely to be overoptimistic. In the Netherlands growth has been stronger. Weaker domestic demand in the third quarter was offset by a strong net export performance which has benefited from German unification, and fourth quarter data are expected to show a similar picture. In Spain, the gradual slowing of growth, from the high rates achieved last year, is likely to continue. While inflationary pressures may rule out a significant easing of monetary policy, the authorities are nevertheless concerned about the rise in unemployment.

Although there is little evidence of the Gulf crisis having direct output effects (except in the oil industry), confidence effects have contributed to the downward revisions to growth forecasts for the major overseas economies in 1991. The crisis has affected the progress of budgetary consolidation. Supplementary budgets to finance Gulf-related expenditures have been approved in Japan and proposed in the United States, while in Germany a package of tax increases has been adopted, largely to offset the rising costs of unification but also to finance contributions to the Gulf war effort. In France, public expenditure is to be reduced partly to offset costs of funding the Gulf crisis.

Falling **oil prices** *continued to reduce* **inflation** *. . .*

The most visible impact of hostilities in the Gulf was on the price of oil, but the upward movement proved short-lived. With the announcement of a cease-fire in the Gulf at the beginning of March, the oil market's attention was focused on the OPEC meeting on 11 March in Geneva. There was a general expectation that OPEC would take this opportunity to agree on a substantial cut in production to match seasonally declining demand. In the event, OPEC ministers agreed a production ceiling of 22.3 million barrels a day (a reduction of 700,000 barrels a day from the highest production levels achieved between August 1990 and February 1991) which will apply for the second quarter of 1991. Quotas, suspended in August, were reintroduced—most producers accepting around a 5% cut on February production. The meeting reaffirmed the objective of a $21 per barrel OPEC reference price. However, given the agreed high production ceiling, as well as the expected level of demand, further downward pressure on prices is likely. Brent oil prices had fallen below $17 per barrel in February, before surging just prior to the OPEC meeting. They fell back to around $18 per barrel following the announcement of the agreement, and have fluctuated in a range of around $18–20 since then.

Consumer price inflation eases . . .



With growth pressures absent or receding, and the unwinding of the earlier boost from higher oil prices, recorded inflation in most major economies is expected to fall. However, there remains a need to continue to exert downward pressure on inflation. The pick-up in US core consumer price inflation in January and February was partly the result of special factors: despite poor sales, the usual discounting of auto prices at the beginning of the year did not occur and the timing of new fashion clothing introductions upset the usual seasonal pattern. The March core inflation rate was more modest (5.1% relative to 5.7% over the year to February), but unemployment is still quite low and capacity utilisation is relatively high for this point in the business cycle. Offsetting this, wage pressures are moderate, and the recent appreciation of the dollar may provide downward pressure on prices.

In Canada, the effect of lower oil prices at the turn of the year was obscured by the introduction of the Goods and Services Tax, with the annual inflation rate jumping from 5% in December to 6.8% in January. Inflation has since eased to 6.3% in March. Specific inflation targeting by the Federal Government and the Bank of Canada may provide some extra discipline over the medium term.

. . . *although* **inflationary pressures** *remain a concern in* **Japan** *and* **Germany**

In Japan, consumer price inflation was 3.7% in March, remaining high by Japanese standards. However, underlying pressures are not so worrying: the outcome of the Shunto wage round was for increases of around 5.5%, lower than the 5.9% awarded last year, and this is particularly encouraging given that the labour market is still very tight. A combination of moderating wage demands, reduced price pressures (as oil prices have softened) and slower monetary growth has led to calls for an easing of monetary policy. However, the Bank of Japan still maintains that the level of the money supply is too high relative to economic activity.

Consumer price inflation in western Germany averaged around 2.7% in the first four months of the year. However, indirect tax increases are expected to add 0.7% to the inflation rate in July; forecasts for annual consumer price inflation for 1991 are around 3.5%. Wage pressures also remain a concern. The public sector has been awarded a 6% increase, which is effectively a rise of 7.5% when fringe benefits are taken into consideration, and this has contributed to intransigence on the part of workers in the steel industry, who are still calling for increases of 10%. In eastern Germany, consumer prices rose strongly in the first quarter, with the annual inflation rate reaching 7.7% in March. This was largely owing to the removal of a number of price controls, but also reflects strong wage growth. These pressures are of particular concern, since they come at a time when the deutschemark has weakened, and the all-German current account balance has slipped into deficit. The Bundesbank is therefore likely to maintain a firm monetary policy.

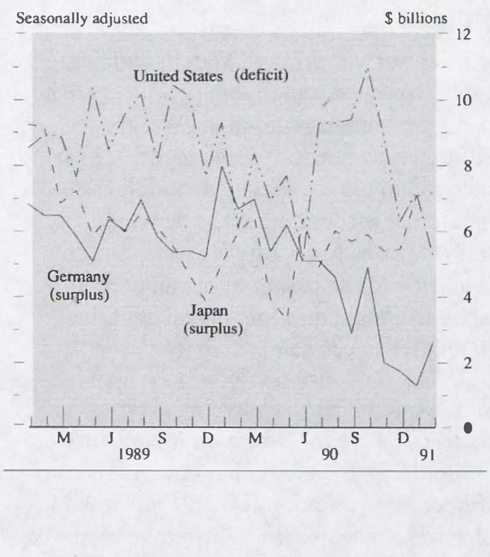
Elsewhere in Europe, experience with inflation has been varied. In France, consumer price inflation is falling—down from a recent peak of 4.0% over the year to October to 3.2% in March. Provided wage increases are kept in check, French inflation could fall below 3% by the end of the year, thereby reversing the inflation differential with Germany. In Italy, inflation remains stuck at around 6.5%, while Spanish inflation fell to 5.9% over the year to February and remained at that rate in March, after averaging around 6.5% for some time. In both cases, services sector inflation remains particularly strong. Inflation in the Netherlands, at 2.4%, is the lowest among the ERM members.

Non-oil commodity prices reached a trough in mid-February, and increased (in SDR terms) by 2.3% during the first quarter, but still remained 14% lower than a year earlier. The increase partly reflects supply factors, although buoyancy in some sectors (notably metals and timber) can be attributed to expectations of stronger activity in some key importing countries. The failure of the GATT talks to reach a conclusion earlier in the year has exacerbated the uncertainty of developing countries heavily dependent on income from commodity exports.

The narrowing of **external trade imbalances** *has stalled*

Exchange rate movements up to February, with their impact on competitiveness, and the divergence in the strength of domestic demand in the three largest industrial economies over the past year have gone some way towards narrowing the external trade imbalances between the major economies. In the United States, gains in competitiveness from the past depreciation of the dollar, together with a fall in demand for imports as the economy slowed, have reduced the trade deficit. Although progress was interrupted in the third quarter of 1990 because of the impact of higher oil prices, a dramatic fall in oil import volumes in the final quarter led to a considerable improvement in the merchandise trade deficit. This decline in the deficit was reversed in January owing to higher imports, mainly of industrial materials and motor vehicles and parts, but the deficit then fell in February, to the lowest recorded level since September 1983. Continued improvement in the external position will depend upon the extent to which the dollar appreciates (although at the April level it still remains 35% below its 1985 effective exchange rate), and the pace at which domestic demand and world activity recover later in the year.

G3 trade balances



While the trade deficit in the United States declined towards the end of last year, the current account deficit rose owing to transfers overseas relating to the Gulf crisis. An increase in receipts relating to the Gulf conflict should reverse this in the first quarter of this year. Canada's trade account is largely unaffected by fluctuations in the oil price, but the fourth quarter contraction of the US economy was an important factor in reducing Canada's trade surplus. Any increase in the surplus is partly conditional upon a US recovery.

The decline in Japan's trade surplus was reversed in the third quarter of 1990, although the surplus stabilised later in the year.

The higher price of oil boosted import costs but this was offset by stronger exports, particularly to South-East Asia, in the fourth quarter. So far this year, export volumes have continued to grow strongly. In Germany, the surge in imports brought about by unification and a decline in export market growth (due to weakening world activity and the strong deutschemark) narrowed the trade surplus of Germany as a whole in January and February. At the same time, the all-German current account slipped into deficit. Although German growth remains reasonably strong, a slowdown of demand in the east is likely to weaken import growth. Import prices fell sharply at the beginning of the year but are expected to edge up, reflecting the recent weakness in the deutschemark. France's monthly trade deficit is currently running at around the average level for the past two years.

There are tentative signs of a recovery in non-oil commodity prices, but fairly poor export market growth and a continuing deterioration in their terms of trade have limited the resources available to non-oil developing countries to service their debt. Hence, to a large extent, successful debt servicing will continue to depend on the success of domestic policies and strong adjustment efforts. There have been positive developments in a number of countries which have made such efforts. Following Chile's successful $320 million bond issue late last year, of which the first tranche was provided by the participants in March 1991, Mexico successfully floated a $200 million 5-year bond issue in February 1991—its first such issue since the debt crisis broke in 1982. Both countries have witnessed a recovery in the secondary market prices of their debt in recent months.

Nearly ten years after Poland's first debt restructuring, the Paris Club agreed, in March, the outline of a package involving the forgiveness of at least 50% of Poland's principal debt outstanding to official creditors on 1 April. Although similar terms are likely to be applied to Egypt, these two countries' cases are exceptional and not intended to set a precedent for other debtors. A more concessional package for the poorest countries, along the lines of that proposed by the Chancellor in Trinidad last September, is still under consideration, since existing 'Toronto terms' provide less debt reduction than has been granted to Poland.

The decline of **activity in Eastern Europe** *has been greater than expected, but* **progress on reform** *continues*

The progress of political and economic reform, which began throughout Eastern Europe some eighteen months ago, has continued, albeit at different speeds within individual countries. Poland and Czechoslovakia have both chosen to implement a rapid reform programme in the move towards a market economy, while Hungary has opted for a more gradualist approach. During the first quarter, both Romania and Bulgaria negotiated IMF-backed programmes.

The decline of activity in Eastern Europe has been greater than expected, partly because of the sharp fall in trade between the countries of the region and the Soviet Union, reflecting the latter's liquidity problems. It is therefore essential that stabilisation programmes in these countries are accompanied by structural reforms in order to generate the appropriate supply-side responses. Reforms in areas such as legal infrastructure, privatisation, financial markets and social security systems are beginning, and initial results in Poland, Czechoslovakia and Hungary have been encouraging.

The West has responded to the needs of all countries by providing both financial and technical assistance through multilateral organisations as well as on a bilateral basis. The bulk of this has come from the official sector, and this capacity should be enhanced by the European Bank for Reconstruction and Development (EBRD), which was formally inaugurated on 28 March. The EBRD will provide loans and other financial assistance to the countries of Central and Eastern Europe '...committed to, and applying the principles of, multiparty democracy, pluralism and market economics'. A greater contribution from the private sector in subsequent years will ultimately depend on the success of the reform programmes themselves which, at this stage, are inevitably surrounded by considerable uncertainties.

World economic prospects—latest Bank forecasts[1]

The latest Bank forecasts are for the period 1991–93 and focus on the major six overseas economies. An important feature of the forecasts is the depth and length of the recession and the extent to which this will bear down on inflation. Some estimates of the prospects for unified Germany are also presented.

In 1991 the major overseas economies are expected to continue slowing, with growth averaging ¾% compared with 2½% last year. Indeed, there is projected to be a recession, in the technical sense of two quarters of negative growth, for the major six overseas economies at the turn of the year. Activity is expected to remain fairly flat in the second quarter of 1991 before returning to modest growth in the second half of the year. Throughout 1992 the recovery is quite slow, but by 1993 growth returns broadly to potential. The recession is unusual compared with previous downturns because of the sharp distinction in performance between the English-speaking economies, particularly in North America— which led the downturn—and Japan and mainland Europe—which continue to grow, albeit at a much reduced rate.

Much of the initial downturn in activity stemmed from personal sector consumption and investment, but this has been followed by a slowdown in corporate sector expenditure growth. Real government expenditure growth is projected to be slower over the forecast period than in the recent past, while neither stockbuilding nor, because of the general slowdown outside the major economies, net trade are expected to contribute much to growth in the major six economies in the near future.

Table A
Demand and output in the major overseas economies[a]

Percentage points

	Estimate	Forecast		
	1990	1991	1992	1993
Domestic demand	**2.5**	**0.7**	**2.5**	**2.8**
of which:				
Private consumption	2.2	0.6	2.2	2.6
Private fixed investment	3.8	0.1	4.2	4.8
Public expenditure	2.8	2.0	1.5	1.5
Stockbuilding (b)	-0.4	—	0.2	—
Net external demand (b)	0.1	0.1	-0.1	-0.2
GNP/GDP	**2.5**	**0.8**	**2.3**	**2.5**

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

The fall in the oil price from its peak during the Gulf conflict implies that the short-term outlook for inflation has improved since the turn of the year. This, coupled with the slowing of activity and easing of capacity constraints in many of the major overseas economies, means that inflation is projected to fall over the forecast period, but is expected to be broadly the same on average in 1991 as in 1990. The slowdown in industrial activity is expected to have a continued marked effect, in the short term, on industrial commodity prices in dollar terms, but the beneficial effect on the general price level is partly offset, outside the United States, by the recent strengthening of the dollar exchange rate.

Table B
Prices in the major overseas economies

Percentage changes

	Estimate	Forecast		
	1990	1991	1992	1993
Import prices (a)	1.9	-1.1	2.9	3.6
Unit labour costs (b)	3.5	4.7	2.3	1.3
Wholesale prices	2.9	3.9	3.7	2.9
Consumer prices (c)	3.8	3.8	2.9	2.9

(a) Weighted average of countries' local currency average indices for imports.
(b) Whole economy.
(c) Consumers' expenditure deflator.

Output in the United States is expected to fall by ½% in 1991 as a whole, although this is concentrated in the first half of the year with modest growth expected in the second half. There is expected to be a recovery towards potential growth in 1992 with output rising 1¾%. The recession was led by personal sector retrenchment, which appears to have been partly caused by a loss of confidence at the onset of the Gulf crisis. Confidence has now begun to recover, but it is difficult to gauge how quickly, and to what extent, this will be reflected in a pick-up in consumers' expenditure. Residential investment is expected to fall again this year following the 5% fall recorded last year. The forecast recovery in personal sector expenditure partly reflects the lagged effect of the easing of monetary policy which began last year. The corporate sector, which has recently been running financial surpluses, has been less affected by the downturn in confidence. Nevertheless, accelerator effects from the general downturn in activity mean that business investment is expected to fall this year before recovering to 3½ % growth per annum over the following two years. This profile is sufficient to maintain business investment at around 12½% of GNP, which remains low compared with Japan and many European countries. Since changes in employment tend to lag changes in activity, employment is expected to continue falling for the rest of 1991. Productivity growth is projected to be around 1% this year. It is expected that slow growth in the labour force, together with the recovery in activity, will cause unemployment to stabilise at around 7% by 1992.

(1) These forecasts have been produced by the Bank's world economic forecasting team, with help from country analysts, using the Global Econometric Model supplied by the National Institute of Economic and Social Research.

Inflation in the United States, as measured by the consumers' expenditure deflator, is expected to remain stubbornly high this year at around 4½% despite lower activity, but is projected to improve to 3% next year. Thereafter, improvement is slow because output is projected to grow broadly in line with potential. The outlook for the current balance for 1991 is favourably affected by large balance of payments transfers associated with the Gulf crisis, and there is also an improvement in the underlying trade position due to domestic demand developments and lagged competitiveness effects stemming from past dollar weakness. However, the current balance is expected to deteriorate through 1992 and 1993 as the US economy recovers and the relative competitive position worsens.

There is expected to be some reduction in the rate of growth of real public sector consumption and investment, but this may be offset by slower growth in tax receipts and increased transfer payments. Overall, the Federal sector deficit is expected to remain above 2% of GNP over the next two fiscal years.

The Canadian economy is expected to follow the fortunes of the United States closely in the short term. Output is expected to fall this year, and inflation to remain broadly flat after rising at the beginning of the year following the introduction of the Goods and Services Tax (GST) in January. However, owing to weak activity and the response of the labour market, wages are not expected to respond fully to the initial upturn in inflation, and by 1992 there is a significant fall in inflation. In 1992 the pick-up in growth is quite marked compared with many of the other industrialised economies. This partly reflects underlying productivity growth, the continued increase in the labour force and supply improvements stemming from the introduction of the GST, as well as the recovery of export markets.

Japan is expected to retain its position as the fastest growing of the major overseas economies in 1991. Nevertheless, the growth of domestic demand is expected to more than halve to 2½%. The most significant slowdown is expected to be in investment expenditure, with business investment growing by less than 5% compared with average growth of almost 15% per annum over the preceding three years, reflecting the maintenance of tight monetary policy to bear down on inflation. Nevertheless, past growth in investment should underpin further growth in productivity throughout the forecast period.

The reduction in output growth is expected to cause unit labour costs to rise quite sharply this year. By 1992, however, favourable trends are re-established and relative trend unit labour costs remain broadly flat over the following year. Japanese export market growth is forecast to fall sharply in 1991, to 1½%, reflecting the overall slowdown in world trade. The relatively fast growth in domestic demand does not cause a deterioration in net trade because of the low response of imports to changes in domestic demand compared with other major economies. Within the current balance, the continued trend decline in the services balance is forecast to be offset by a trend rise in the interest, profits and dividends balance, which largely reflects past current account surpluses. The current balance is affected this year by Gulf transfers to the United States. Overall, the current balance is expected to average around 2% of GNP over the period 1991 to 1993. The cyclical upswing in productivity, together with a slight decline in nominal pay settlements, is expected to reduce inflation from 3½% this year to 2% in 1992.

The outlook for Germany continues to be dominated by unification. Growth in western Germany is projected to remain well above 2% this year. This partly stems from the effects of unification on residential investment and consumption following the net inward migration from the east. Employment (and hence personal income and consumption) is expected to continue its rapid growth in the short-run but revert to a slower rate of growth by the end of the year. Partly offsetting these positive effects on domestic demand will be the effects of the various tax and expenditure measures already announced. Output is expected to be strongly boosted by west German firms supplying goods and services to the east, although it is difficult to gauge how much of this simply reflects a switching away from traditional export markets. The German authorities' willingness to maintain high interest rates is expected to continue to have only small direct effects on activity. Overall, the rapid pace of activity over the past two years is expected to lead to inflation which will remain high, compared with past German experience, throughout the forecast period. A key factor will be developments in the labour market through 1991. Average earnings are expected to grow by around 7% this year moderating to below 5% by 1992. Despite inflation remaining relatively high throughout the forecast period, the underlying trend is down by 1992 as the pressures from unification start to diminish.

Despite large fiscal transfers from the government which help to maintain domestic demand, output in the east is expected to fall by just under 20% in 1991 before beginning to recover in the second half of 1992. Even allowing for a relatively rapid rate of growth thereafter, it will be 1994 before output returns to its 1990 level. Overall, weighting together east and west, Germany may grow by only ½% this year before picking up in 1992 and 1993 to around 3% per annum.

Demand from the east will increase imports from outside Germany. Together with a switch away from non-German markets by west German firms and a loss of competitiveness relative to a non-unification base, this means that there will be a sustained reduction of the current account surplus—a factor which is already evident in published figures. Unified Germany is expected to run a current account surplus of around $25 billion by 1993, well below the $50 billion per annum surplus recorded over the late 1980s for the west alone. The total German public sector deficit is projected to rise to DM 150 billion in 1991 after allowing for the tax and expenditure measures already announced by the authorities. Thereafter, the long period of adjustment in the east will mean that the deficit is likely to decline gradually, only reaching around DM 100 billion in 1993.

Both France and Italy are expected to slow considerably in 1991. In France there is expected to be a broadly based slowdown in all elements of domestic demand which together with a slight improvement in net visible trade is projected to reduce GNP growth to around 1½% in 1991 compared with 2¾% last year. Recent favourable figures on inflation are embodied in the forecast for 1991 of under 3% growth in the consumers' expenditure deflator. The reduction of growth in Italy is expected to be more heavily concentrated on investment than consumption expenditure compared with some of the other overseas economies. Growth in real government current expenditure is projected to be fairly modest as the Italian authorities seek to restrict the size of the primary fiscal deficit. The Netherlands and to a lesser extent Belgium benefited in 1990 from German unification and this is expected to sustain export growth and industrial activity in 1991.

Overall, for the European Community as a whole activity is expected to decelerate in 1991, but not actually decline as in North America. Growth of perhaps 2% is likely this year[(1)] followed by 2¼% per annum over the next two years. With activity thus holding up quite well, there may be less progress on inflation than in North America and Japan. For the OECD as a whole industrial production is expected to fall marginally this year. This is reflected in overall world trade growth, which slows markedly from 7% in 1989 to 2% in 1991. The relatively short-lived recession and slow recovery mean that trade growth recovers to 5% in 1992 and 1993, thus returning to its recent historical pattern of growing around twice as fast as overall activity. Unemployment in the OECD is expected to continue rising until early 1992, increasing by some 4¼ million compared with the low point reached in early 1990.

Outside the OECD the forecasts focus on the likely current balance position of key country blocs. For OPEC the fall in the world oil price since the beginning of the year, coupled with slower activity in the industrialised economies, will have an adverse effect on revenue. In the medium term the industrialised countries are likely to become more energy-conscious following events in the Gulf, while expenditure on reconstruction and on military equipment will be considerable. Overall, the OPEC bloc is expected to run current account deficits throughout the forecast.

Developments in eastern Europe imply a large potential demand for western goods, particularly investment goods to secure long-term growth. These countries, however, remain largely constrained in their ability to finance such purchases. The Asian NIEs (Korea, Taiwan, Hong Kong and Singapore) are being affected by the slowdown in their export markets, particularly the United States. Therefore, although domestic demand growth is becoming more significant, the rapid growth rates seen over the past decade are unlikely to continue. Overall, the NIEs are expected to experience a deterioration in their current account position.

(1) The figures presented for the European Community exclude the United Kingdom, and are UK trade weighted.

Manufacturers' domestic and export profit margins in the major overseas economies

Manufacturing output price inflation fell to 3½% in the six main overseas economies in 1990, reversing the upward trend of the previous three years. The slower rate of increase reflects a slight moderation of both raw material and unit labour cost increases. Profit margins grew strongly over the 1980s in the United States, France and Canada as well as the United Kingdom, adding to producer price inflation rates in these countries. But during 1990 domestic margins grew most strongly in the United States and Italy while only Japan recorded an increase in export margins.

Table A
Contributions of manufacturers' costs to growth in output prices

Percentage points

	1984	1985	1986	1987	1988	1989	1990
United States							
Unit labour costs	-1.5	0.3	0.6	-0.9	0.5	1.0	—
Raw material prices	0.6	-2.1	-2.4	1.9	0.7	2.1	1.6
Domestic margins	3.0	2.7	0.5	1.0	1.3	2.0	3.3
Export margins	1.8	4.1	4.8	1.5	4.3	-0.9	-0.8
Domestic prices	2.1	0.9	-1.3	2.0	2.5	5.1	4.9
Export prices	0.9	2.3	3.0	2.5	5.5	2.2	0.8
Japan							
Unit labour costs	-3.4	-1.0	2.9	-4.4	-2.2	1.2	1.7
Import prices	-0.3	-0.5	-4.4	-1.0	-0.6	1.4	1.2
Domestic margins	3.4	0.4	-7.6	1.6	1.8	—	-0.8
Export margins	2.8	0.8	-13.6	-0.5	0.2	4.3	2.3
Domestic prices	-0.3	-1.1	-9.1	-3.8	-1.0	2.6	2.1
Export prices	-0.9	-0.7	-15.1	-5.9	-2.6	6.9	5.2
Germany							
Unit labour costs	0.6	1.0	2.7	3.9	0.2	0.2	1.4
Import prices	2.7	1.2	-7.4	-2.8	0.4	3.4	-1.2
Domestic margins	-0.5	-0.1	2.3	-1.5	1.0	-0.2	1.3
Export margins	-2.6	2.6	2.7	-3.2	-0.2	1.0	-0.3
Domestic prices	2.8	2.1	-2.4	-0.4	1.6	3.4	1.5
Export prices	0.7	4.8	-2.0	-2.1	0.4	4.6	-0.1
France							
Unit labour costs	4.8	-7.1	1.6	1.5	-0.5	—	2.9
Import prices	3.5	0.7	-5.0	-0.4	0.9	2.3	-0.6
Domestic margins	0.9	10.8	0.6	0.5	4.9	3.0	-3.4
Export margins	4.2	12.0	1.3	-0.6	3.2	2.2	-3.6
Domestic prices	9.2	4.4	-2.8	0.5	5.3	5.3	-1.1
Export prices	12.5	5.6	-2.1	0.5	3.6	4.5	-1.3
Italy							
Unit labour costs	3.2	5.0	2.3	2.5	1.8	5.6	2.8
Import prices	2.9	1.9	-4.6	-0.4	1.1	2.0	-0.7
Domestic margins	4.3	0.4	1.4	0.6	1.8	-1.2	5.3
Export margins	4.9	2.6	-2.4	-2.0	1.8	-1.3	-1.0
Domestic prices	10.4	7.3	-0.9	2.7	4.7	6.4	7.4
Export prices	11.0	9.5	-4.7	0.1	4.7	6.3	1.1
Canada							
Unit labour costs	-2.5	1.6	4.0	3.7	3.2	5.7	5.7
Raw material prices	0.8	0.3	-4.8	2.0	-0.9	0.9	1.2
Domestic margins	6.2	0.9	4.7	-2.9	1.9	3.3	-6.7
Export margins	6.3	-0.2	0.3	-4.9	0.8	4.5	-5.4
Domestic prices	4.5	2.8	0.9	2.8	4.2	2.1	0.2
Export prices	4.6	1.7	-3.5	0.8	3.1	3.3	1.5

This note examines recent developments in profit margins and their contribution to manufacturers' output price inflation in the main overseas economies. The methodology follows that used in the article on profit margins in the May 1989 *Bulletin*.(1) Changes in margins are taken as the residual between changes in firms' output prices and changes in costs. Costs comprise actual unit labour costs and raw material or import prices as a proxy for all other costs.(2)

Changes in manufacturers' profit margins are partly explained by developments in international competitiveness and capacity utilisation rates. The extent to which changes in costs are passed on by manufacturers in their output prices will often depend upon such pressures. However, manufacturers' pricing behaviour varies significantly between countries and also between domestic and export markets.

As might be expected, export margins are influenced more by considerations of international competitiveness, particularly that driven by exchange rate fluctuations, than domestic margins. This is partly a result of the relative dominance of domestic producers in their home markets. But it also reflects a 'price-to-market' policy by which exporters absorb changes in cost competitiveness in their export margins, maintaining local currency prices in their export markets to maintain market share. The latter explanation appears to be important in the case of Japanese and German exporters but much less so with US producers, who have sought to retain export margins, even during the period of the dollar's substantial real appreciation in 1982–85. The subsequent fall in the dollar during 1986–88 led both Japanese and German exporters to cut margins while the improved cost competitiveness of US manufacturers was partially absorbed in higher export margins. There is some evidence that manufacturers absorb cost fluctuations in their domestic pricing policy as well. The large decline in raw material input costs that occurred in 1986 was not fully passed on in Italy or Canada, nor in the United Kingdom, resulting in margin-building substantially greater than that explained by either capacity utilisation or competitiveness factors.

Over the 1980s as a whole, several economies experienced a sustained rise in profit margins. In the case of the United States, France and the United Kingdom this occurred in both domestic and export markets. In Japan, domestic margins have risen since 1980 while export margins have not

(1) 'Profit margins in the major overseas economies'.
(2) Labour costs and raw material/import prices are weighted according to their estimated long-run elasticities in the National Institute's Global Econometric Model. The weights are as follows: United States—labour 0.72, raw materials 0.28; Japan—0.88, 0.12; Germany—0.54, 0.46; France—0.67, 0.33; Italy—0.74, 0.26; Canada—0.73, 0.27.

Chart 1
Export profit margins

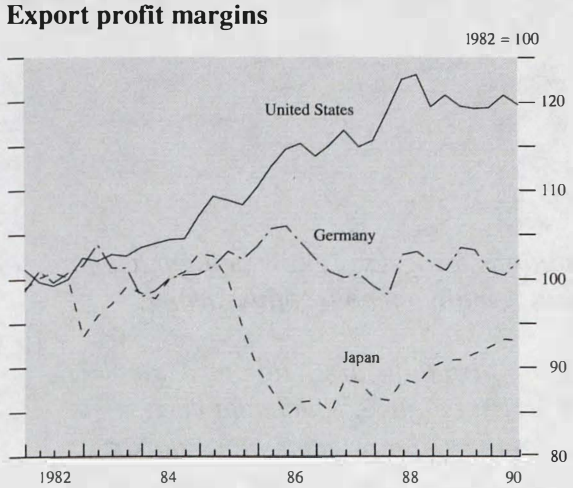
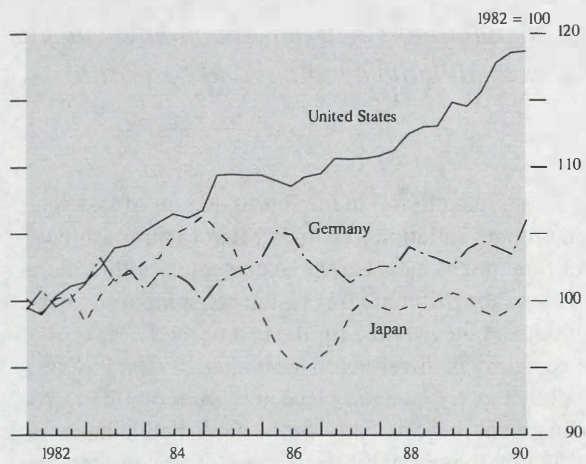


Chart 2
Domestic profit margins



recovered their 1980 level after falling sharply during the yen's 1986–88 appreciation. This suggests an element of price discrimination as Japanese producers capitalise on a buoyant domestic market with low import penetration while maintaining price competitiveness in overseas markets. Rising capacity utilisation has played a significant role in pricing behaviour in these and the other major economies, acting to raise prices during the long upswing from 1983 to 1989. This should have benefited all producers as it was broadly based, yet Germany has experienced little growth in either domestic or export margins over this period. Slower growth in 1990 in the United States did not prevent further margin-building. But in Canada margins suffered a substantial decline in 1990 as falling output put upward pressure on unit labour costs while output prices were squeezed. The demand pressures created by German unification during 1990 allowed an increase in domestic margins while the associated rise in the deutschemark contributed to lower export margins.

It is clear that long-run changes in profit margins act as an important signal to manufacturing investors. Two countries that have seen the most sustained rise in margins, the United States and the United Kingdom, both experienced substantial inward direct investment in manufacturing during the 1980s. A substantial proportion of this inward investment has come from Japan, where manufacturing exporters experienced a sharp fall-off in margins during 1986 which has not been fully recovered. However, recent developments suggest that, while US domestic margins remain strong, the stronger dollar in 1989 and the first half of 1990 reversed some of the gain in US relative to Japanese export margins that had occurred earlier in the 1980s.