The international environment

- *Policy easing by the Federal Reserve has laid the foundations for recovery in the United States. Activity indicators generally point to recovery proceeding at a weak rate. In Japan and Germany, evidence is mounting of a gradual slowdown in activity. Labour markets in both countries remain tight and this has contributed to growth in real wages and consumption, thereby offsetting to some extent signs of weakening in the business sectors.*

- *The Bundesbank has repeatedly expressed its concern over persistent inflationary pressures in Germany. The annual rate of French inflation has been around 1% lower than in Germany since July, and French and German short-term interest rates are currently close to parity.*

- *The differential between short-term interest rates in Germany and the United States has risen to an historically high level. This has contributed to a partial reversal of the gains made by the dollar earlier in the year. The higher yields on yen assets* vis-à-vis *the dollar and the widening Japanese current account surplus have contributed to the strength of the yen.*

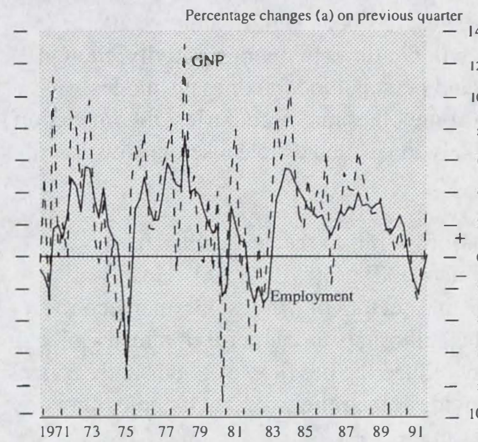
Recovery in the United States *is proceeding, but at a weak rate. The gradual* **slowdown in Japan and Germany** *is being led by the business sectors*

The US economy is emerging from recession, helped by the cuts in interest rates which have occurred since 1989. The lagged effect of these cuts should continue to stimulate a slow recovery in output into next year, but there remain several weak sectors of the economy. In particular, there is as yet no conclusive evidence that lower interest rates alone will be sufficient to lead to a sustained recovery in consumer spending. This has implications for the durability of the recovery in manufacturing and other sectors of the economy.

The manufacturing sector has led the recovery. From its trough in March to September, industrial production grew by nearly 3%. The continued pick-up in production in the third quarter (albeit at a slower rate) has been accompanied by a slowing in the previously rapid pace of destocking which contributed to a slight fall in GNP in the second quarter. A pick-up in investment also contributed to GNP growth of 2.4% (seasonally adjusted annualised rate) in the third quarter. Survey evidence from the business sector, provided by the National Association of Purchasing Managers, suggests a broadly based business sector expansion. For this optimistic sentiment to be reflected in GNP data, a sustained recovery in consumption may be necessary, but in the remainder of the year consumption growth could remain sluggish.

The speed of recovery in consumption (which grew by 3.8% at an annualised rate in the third quarter) has been limited by slow growth in employment and real wages, rising state and local government taxes and problems of high debt. Although successive cuts in the Federal Funds rate have partially alleviated the effects of high levels of personal sector gross indebtedness on consumers' expenditure, the impact has been limited by banks widening their margins so that interest rates facing consumers have declined more slowly. Recently, the authorities have suggested that fiscal policy might be used to give impetus to the recovery. However, any fiscal package would be likely to have a limited short-term economic impact, since, in accordance with last year's budget agreement, measures must be revenue neutral.

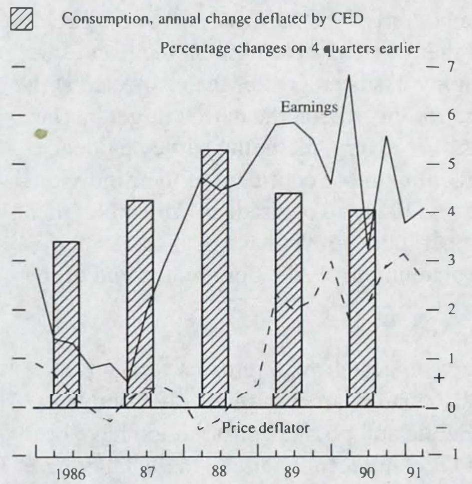
US GNP and employment



(a) At a seasonally adjusted annual rate.

The rate of employment growth as the economy emerges from recession has been of particular disappointment to many commentators and has been a factor in the Federal Reserve's decisions to cut interest rates. In the United States the employment cycle is quite closely synchronised with that of GNP (see the chart opposite)—in contrast to European economies, where employment tends to lag developments in activity. This may be attributable to the more flexible structure of the US labour market. Relative to the fall in output, however, the decline in employment was greater than the average of recent recessions. Part of the explanation for this is that a large proportion of the job losses have been in services, where measured productivity is low. The job losses reflect pressures on government spending, and restructuring in finance and retailing. These factors have also contributed to the recovery in employment so far being slower than in the average upturn from previous (more severe) recessions.

Japanese earnings, prices and consumption



Growth in Japanese GNP in the first half of 1991 totalled 3.2% over the second half of 1990, despite some slowdown in the second quarter. Even allowing for expected slower growth in the second half, this points to a strong performance for the year as a whole, in a period when most of the other major economies have been growing at rates close to their cyclical lows. This is owing partly to growing net exports and robust consumption. Consumption has grown steadily for several years (see the chart opposite), driven by significant growth in real wages and expanding employment. The tightness in the labour market has been easing slightly since the second quarter of 1991, but growth in consumption may continue to cushion the economy in the current slowdown.

Last year the corporate sector registered a record net financial deficit of 9% of GNP to finance its substantial investment programme; the deterioration of the corporate sector's financial position has contributed to the business sector leading the slowdown in activity. Industrial production growth has slowed in September to only 0.7% over its level a year earlier, compared with over 7% at the start of the year; further weakness is evident from machinery orders. The Bank of Japan's latest Tankan survey reports that business conditions for major corporations have continued to deteriorate. One sector which has already weakened significantly is construction. September housing starts were over 25% below their level of a year ago and property companies have figured prominently in the increasing number of corporate bankruptcies, which in July were 80% above their level a year earlier.

The decline in west German GNP in the second quarter followed a very strong first quarter performance, in part reflecting seasonal factors. The slowdown in west German activity is proving quite gradual, with real GNP in the second quarter still 4.3% higher than a year earlier. Recent data, however, show signs of a more evident slowdown in the business sector. Industrial production declined 0.3% in the twelve months to September, while manufacturing orders in July were barely higher than a year earlier. The OECD's leading indicator for Germany peaked in August 1990 and has fallen gradually since.

Steady real wage growth stemming from a tight west German labour market has bolstered the consumer sector, though there are signs that it too is adjusting its expenditure onto a more sustainable path. Following very rapid growth after unification, the recent trend in retail sales in the west has been significantly weaker. Tighter monetary policy will continue to restrain activity, though because gross corporate and personal indebtedness is modest, at least in comparison with some other major countries, the impact on spending patterns is unlikely to be such as to cause the slowdown to accelerate markedly.

The surge in west German 'exports' to the east contributed significantly to west German GNP growth in 1990. However, survey evidence suggests that sectors of the east German economy are starting to recover; the authorities are hopeful of a resurgence in output in 1992. This may reduce the net flow of goods and services from west to east and provide some relief to capacity constraints and inflationary pressures in the west.

Following two quarters of flat activity, French GDP grew by 0.8% in the second quarter, owing largely to strong export performance and a large decline in imports. However, domestic demand is still weak and the support that German growth has given to French exports is now lessening. Furthermore, the room for flexibility in the authorities' policy response is limited. There was a modest reduction in French official interest rates in October and French and German short-term rates have recently been close to parity, but with the franc close to the bottom of the narrow band of the ERM, there is little scope for further monetary easing. On the fiscal side, the slowdown in the economy has been greater than expected at the time of the last budget and for this reason the deficit target has been overshot. There are signs of recovery, including survey evidence showing that firms are becoming more confident of their individual prospects, but any recovery is likely to be gradual. Unemployment, already at 9.6% in September, may not yet have peaked, as many firms report that they are planning to shed labour by the end of the year.

Latest activity data for Italy suggest growth remains weak. Real GDP grew by 0.3% in the second quarter and was 1.4% above its level a year previously. Public and private consumption have been the strong components of GDP in recent quarters, in the latter case supported by growth in real wages. The rate of recovery may be limited by high interest rates and, over the longer term, by increasing pressures on government to exercise fiscal restraint in order to bring the public sector debt/GDP ratio closer to the EC average. As predicted by the OECD's composite leading indicator for Italy, the trend in industrial production has remained weak, the three-month moving average has remained consistently below its level a year ago since late-1990, and the signs of a pick-up are as yet tentative.

A rebound in real disposable income and domestic demand led to strong Canadian GDP growth of 4.9% (seasonally adjusted annual rate) in the second quarter, more than offsetting the decline in the first. Underpinning the recovery in domestic demand has been a rapid fall in interest rates, short-term rates having declined by over 5 percentage points from their mid-1990 peak. In the remainder of the year, recovery is likely to proceed at a steadier pace, owing in part to slower growth in employment and the slow rate of US recovery.

Global monetary growth *has slowed*

The slowdown in global monetary growth has caused some concern that it may presage renewed weakness in activity. Evidence suggests, however, that there is no simple relationship between monetary growth and changes in nominal GDP and that broad money has limited power as a coincident or leading indicator when used in isolation from other activity indicators. This is partly because increased competition in several countries following financial deregulation has blurred the relationship between broad money and spending, and partly because of volatility in the velocity of circulation. Furthermore, in Japan, where the slowing of broad money growth has been particularly pronounced, the slowdown follows a period in the late 1980s when an asset price boom accompanied very fast monetary growth. An additional factor in explaining the slow growth of M2+CDs in Japan has been shifts of deposits from banks to postal savings accounts, and the Bank of Japan has recently suggested that the money supply is adequate for the level of activity.

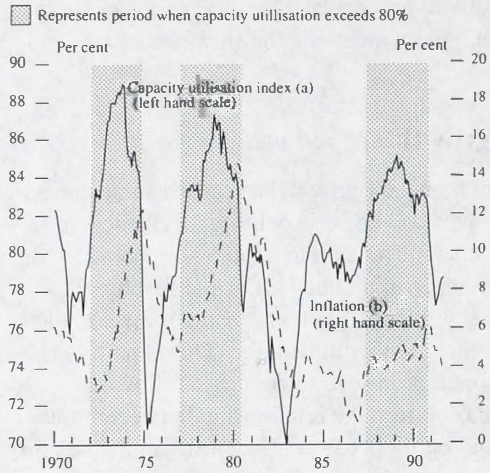
In the case of the United States, the growth of M2 has been at or below the bottom end of its target range, but this is owing partly to portfolio shifts out of small time deposits; M1, which does not include small time deposits, grew by over 6% in the year to September. German unification has caused volatility in aggregate monetary growth rates, but in September, German M3 grew at an annualised rate of 4.6% over its fourth quarter base, in the top half of its target range.

Inflation *falls in the* **United States and Japan** . . .

Non-oil commodity prices remain subdued, having fallen in the three months to October. Declines in metals prices have been led by aluminium, whose price has fallen to its lowest level for over three years. Metals prices may remain weak as production is generally strong and stocks are at very high levels. Agricultural non-food prices have also continued to fall but the rate of decline has slowed more recently. Oil prices have moved upwards in recent months in part reflecting uncertainty over Iraqi supplies. At the OPEC meeting on 24 September the production ceiling was raised to 23.7 million barrels a day from 22.3 million, though no individual output quotas were assigned. This agreement effectively allows member countries to pump at near maximum capacity for the rest of the year. However, as demand rises in line with an expected recovery in output in the industrialised economies, and with Iraq unlikely to be producing at full capacity at least until next year, the oil price is unlikely to decline much from present levels.

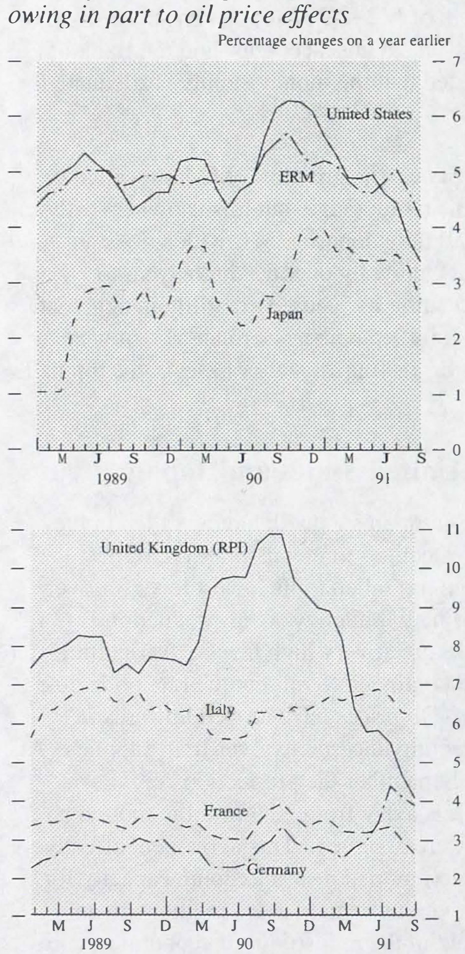
As the US economy pulls out of recession the immediate outlook for headline inflation there appears bright. The 3.4% rise in consumer prices in the year to September represents the lowest annual rate of inflation since early 1987. However, core inflation

Capacity utilisation and CPI inflation in the United States



(a) Manufacturing. IFO survey.
(b) All items (latest month on 12 months earlier).

Rates of **consumer price inflation** *have eased, owing in part to oil price effects*



(excluding food and energy prices) is 4.5%, and there is concern that the level of capacity utilisation is high for this stage in the cycle (though in part this may reflect the shallowness of the recession). Research at the Federal Reserve Banks of Chicago and Cleveland suggests that the non-inflationary level of capacity utilisation is below 80%. In the chart opposite, the shaded areas represent periods when capacity utilisation has exceeded 80%.

Japanese consumer price inflation has eased in recent months, falling to 2.7% in the year to September. The strength of the yen has been an important factor, with import prices in the third quarter over 4% lower than a year earlier. Despite persistent labour shortages tightness in the labour market has marginally eased in recent months so that, although the economy is slowing, growth in unit labour costs is likely to continue to be moderate. Along with very slow growth in producer prices, this suggests that a resurgence in inflationary pressures is unlikely.

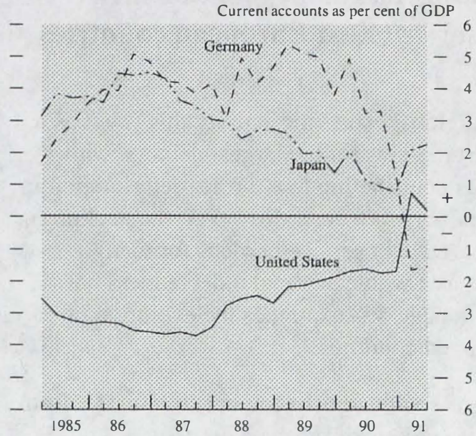
. . . while **inflation in France** *was over 1% lower than* **in Germany** *in each of the three months to September*

For several months west German inflation has remained at rates which are the highest since the early 1980s. The Bundesbank has repeatedly expressed its concern over persistent inflationary pressures, which are largely domestically generated and show little sign of abating in the short term. The labour market remains tight, the economy has expanded faster than potential, and the provisional headline inflation rate of 3.5% in October has been increased by indirect tax increases to help finance unification. Wage settlements over the past few months have remained around 7% and the growth of unit labour costs may continue to accelerate in the short term as the slowdown in activity is likely to affect productivity before it impinges on wage growth. The effect on consumer price inflation has been offset to some extent by weak import prices, caused by still subdued commodity prices and the partial recovery since July of the ERM currencies against the dollar.

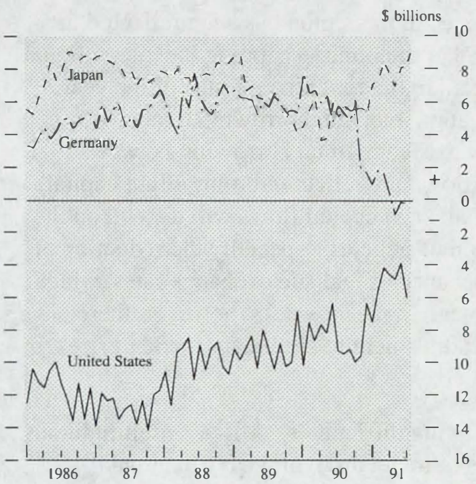
The annual rate of French consumer price inflation has remained in the region of 3% for nearly three years, the most stable performance of any G7 country, and currently the best. The current rate of 2.6% in September is the lowest since 1988. The French have had little room for manoeuvre in monetary policy in the recent slowdown, and high real interest rates have helped contain inflationary pressures. Moderate wage settlements, particularly in the public sector, have contributed to growth in unit labour costs which compares favourably with that in other major countries.

Inflation rates in other ERM countries have shown a greater degree of convergence in recent months. Consumer prices have been rising more slowly in Italy and Spain, though the annual growth rate has been helped by the dropping out of last year's oil price increase. Inflation in the Netherlands, which had been the lowest among ERM members for several years up to mid-1990, has risen since then. The latest increase, to 4.5% in the year to July, is attributable to price rises in public services as the government seeks to reduce its budget deficit. In Canada, consumer prices were raised by indirect tax increases in January, but since then they have grown at an annualised rate of around 2.5%. The outlook is helped

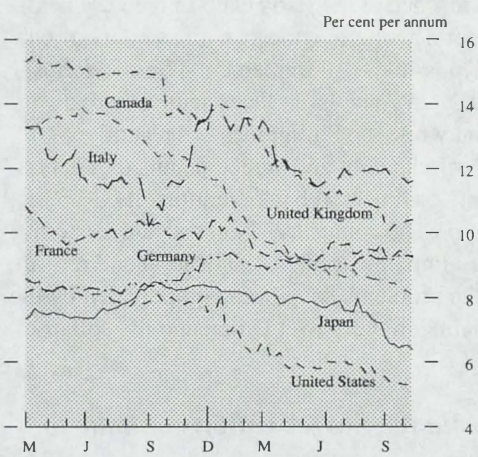
The Japanese trade and current account surpluses have widened



Balance of visible trade



The differential between **German and US short-term interest rates**(a) *is at an historically high level . . .*



(a) End-week 3-month money market rates.

by falls in producer prices over the year to August and by lower wage settlements in the second quarter.

The Japanese current account surplus *has widened. The* German trade account *may soon return to surplus as activity slows in the west of the country*

Current account data for the first quarter were distorted by the effect of Gulf transfer payments on the invisible accounts of the major economies. However, data for current accounts in the second quarter and for trade accounts throughout 1991 broadly reflect movements in relative domestic demand in the major economies. Lower oil prices have also helped oil importers such as Japan. The short-term effect of appreciation of the yen over 1991 may also have contributed to resurgent Japanese external surpluses—in contrast to Germany where both the trade and the current account moved into deficit in 1991. This was a widely expected consequence of the boost to domestic demand generated by unification. As east German production is showing signs of picking up, while the west German economy is slowing, the German trade account may soon return to surplus. In terms of bilateral trade with France, Germany returned to a surplus in June after unprecedented monthly deficits in April and May. Over the longer term, the recovery in the United States and the slowdown in Germany suggest that the major three economies could return to the pattern of trade and current account positions of the 1980s, although as a percentage of GDP the imbalances may be smaller.

The differential between short-term interest rates *in* Germany and the United States *has risen to an historically high level*

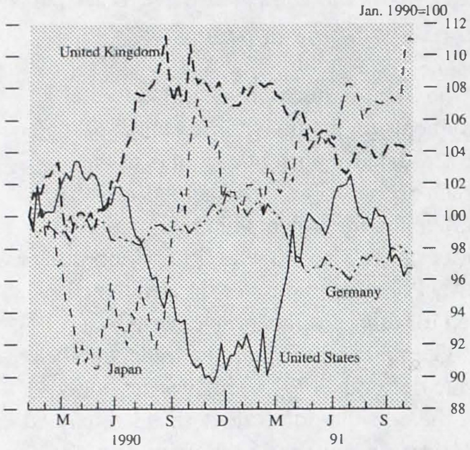
The Federal Reserve's easing of monetary policy has signalled to markets its sensitivity to any possibility of an interruption to the recovery. This, and the burden being placed on German monetary policy to control inflation, pushed the short-term interest differential between German and US rates to around 4% in October, the highest level for over 30 years and compared with an average margin of US rates over German of about 3 percentage points since 1970. Similarly, a positive short-term interest differential of Japanese over US interest rates has now persisted for over a year—the first one since 1980.

The yen has appreciated *while the* dollar has weakened

This changing pattern of interest rates has contributed to the partial reversal of the dollar's gains made earlier in the year, even though the dollar remains competitive in terms of purchasing power parity and in comparison with the past performance of its real effective exchange rate. The yen has remained strong, partly reflecting its higher yield *vis-à-vis* the dollar and also because of the resurgent current account surplus.

Within the ERM, short-term interest differentials have continued to narrow over recent months. Official French rates were cut in October, and French and German short-term interest rates are close to parity. The franc has remained near to the bottom of the narrow band.

. . . and this has contributed to the **dollar's weakness**



Confidence in the **economic revival of Latin America** *continues to grow, while the outlook for the* **Soviet Union, India,** *and several* **East European countries** *remains precarious*

An overall slowdown in global economic activity this year has led to a weakening of export markets for the largest debtors, with falling commodity prices contributing to a further deterioration in the terms of trade of primary producers. However, the declines in US interest rates have eased debt service burdens for many countries, and for LDCs as a whole external indebtedness has stabilised. The article on page 498 examines the evolution of the debt crisis in less developed countries.

In some countries, progress with adjustment and structural reform is beginning to bear fruit in terms of renewed access to international capital markets. This has been most apparent in Latin America, where secondary market prices for debt rallied over the summer. Rising confidence in the region has been reflected in a large increase in the number of countries tapping the international capital and credit markets. In the first nine months of the year, the aggregate value of Latin American borrowing totalled $12.2 billion, an amount exceeding total borrowing between 1982 and 1989. Part of the inflow may reflect returning flight capital, and the sustainability of all such capital flows will depend on the continued implementation of policies, especially the reduction of fiscal deficits and maintenance of realistic exchange rates, which sustain investor confidence. In recent weeks, however, there has been a sharp downward adjustment to secondary market prices, in particular for Brazilian debt.

Other regions face continuing difficulties. Africa's multitudinous problems—falling terms of trade, drought, heavy external indebtedness, inappropriate domestic policies—remain as serious as ever, although there is some prospect of debt relief following the commitment given at the G7 summit. At the Commonwealth Summit in Harare in Ocober, the British Prime Minister stated that 'if agreement cannot be reached at the Paris Club in the very near future, the United Kingdom, acting in concert with as many of our Paris Club colleagues as possible, will implement Trinidad terms' (see the note on page 505). In Asia, India faces acute external financing difficulties, and while the Philippines has recently rescheduled its bilateral official debt and agreed details of a debt reduction package with its commercial bank creditors, its IMF programme is under strain. The countries of Central and Eastern Europe have continued to implement their stabilisation and reform programmes, although the problems have been compounded by the continuing economic decline in the Soviet Union and the collapse of CMEA trade.

Economic conditions in the **Soviet Union** *continue to deteriorate*

While discussions in the Soviet Union concerning an inter-republican economic treaty have taken place in the wake of the abortive coup in August, effective economic management has largely been absent. As a consequence output has fallen further, contributing to a loss of revenues for the central budget. This loss has been accentuated by the decision of some republics to withhold revenue from the centre, as well as by those republics which appear to be running sizable fiscal deficits. The resulting fiscal imbalance has been an important factor behind the sharp acceleration in money growth, which in turn has fed inflation. Stabilisation of the domestic economy is urgently required.

The external situation in the Soviet Union also remains serious, despite severe import compression during the first eight months of the year. A further worsening in export performance in 1991 has partly reflected problems within the oil industry, but also general dislocation of supply and distribution networks. Associate status of the IMF and the World Bank has now been finalised and should help the adjustment process, as would improved access for Soviet exports to western markets. The G7 governments are intensifying their technical assistance programmes.

World economic prospects—latest Bank forecasts[1]

On the basis of national accounts data (now fairly complete) for the first half of the year, activity in the major six overseas economies appears to have held up much better than projected six months ago.[2] This is partly because neither consumer nor business confidence was set back as seriously as had been feared as a result of the Gulf conflict. In addition, the western German economy has continued to be stronger than expected following unification. Having now passed the low point in terms of growth, the major six economies are projected to recover gradually during the remainder of 1991. Output is likely to increase by $1^1/_2$% in 1991 and by 3% in 1992 (Table A). The expected strength of the recovery across the major six over the next two or three quarters will depend on the different monetary policy stances within the G3 economies. Japan and particularly the United States have eased interest rates over recent months, while rates have remained high in Germany (and Europe as a whole).

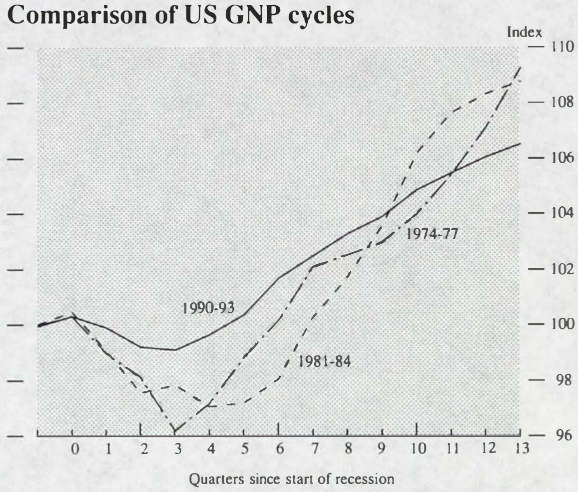
Table A
Demand and output in the major overseas economies[a]
Percentage changes over previous year

	1990	1991	1992	1993
Domestic demand	**2.4**	**1.0**	**2.9**	**3.2**
of which:				
Private consumption	2.2	1.5	2.6	2.9
Private fixed investment	4.0	-1.1	4.3	6.2
Public expenditure	2.8	1.5	1.1	1.5
Stockbuilding (b)	-0.4	-0.1	0.3	0.1
Net external demand (b)	0.1	0.4	0.1	-0.1
GNP/GDP	**2.6**	**1.4**	**3.0**	**3.1**

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

In the United States the authorities' main concern remains the strength of recovery from the recession. Much of the effect of interest rate cuts over the past year is yet to feed through to activity. GNP is projected to grow by just over 3% in 1992; this is slower than the recovery from other recent recessions, but partly reflects the fact that the recession was shallower on this occasion (Chart 1). Greater labour shedding relative to output has kept productivity higher than in past recessions; but the rate of productivity growth during the recovery is expected to be similar to past recoveries. However, employment growth is expected to be slower than in the past, which together with slower labour supply growth means little change in unemployment. Overall, potential growth is projected to be around $2^1/_4$% per annum in the early 1990s, below the average of $2^1/_2$%–$2^3/_4$% for the 1980s. The Canadian economy is expected to perform more strongly than the United States over 1992 and 1993, owing to both faster domestic demand growth and a more positive contribution from net trade, largely driven by

Chart 1
Comparison of US GNP cycles



exports to the United States. Import penetration in the United States is expected to rise gradually throughout the forecast period, although it remains well below that in the European economies.

In Japan, housing investment has been the main area of the economy to show weakness, while other components of domestic demand continue to grow. After three years of exceptionally fast growth in business investment, which has raised such spending to 24% of GNP, significantly slower growth is now forecast, partly because of a deterioration in the corporate sector's financial position. However, past growth in business investment should enable the Japanese economy to maintain productivity growth of around 3% a year over the forecast period. Overall, the trend rate of growth in Japan is estimated to be above 4% compared with perhaps $2^1/_2$% elsewhere in the industrialised world. Cyclical variations of output around the trend are expected to continue to be much less marked than in many countries.

In west Germany, activity is expected to weaken in the second half of the year, with growth slowing to just below 2% in 1992 compared with $4^3/_4$% in 1990 and $3^1/_2$% in 1991; this reflects the ending of the initial boost from unification, and the impact of tax measures in the west—aimed at counteracting the expansionary influence of unification on the budget deficit—beginning to feed through. As activity cools in the western part of the country output is projected to stabilise and then grow in the east. Overall, German GNP growth is expected to recover to perhaps 4% by 1993.

Activity remained less depressed in France and Italy than in many of the English-speaking economies in 1991, in part

(1) These forecasts have been produced by the Bank's world economy forecasting team, with help from country analysts, using the Global Econometric Model supplied by the National Institute of Economic and Social Research.
(2) See 'World economic prospects—latest Bank forecast' in the May 1991 *Bulletin*, page 187.

owing to stronger effects from German unification. In both countries relatively high interest rates have impinged on interest sensitive elements of demand, with investment falling by around $^3/_4$% in 1991 in both countries, before a projected recovery to growth of 3%–5% per annum thereafter. Employment growth in Italy is expected to be modest in the forecast period, at around $^1/_2$% per annum; but overall GNP growth of around $2^1/_2$% per annum should be possible owing to productivity growth stemming from the rise in the ratio of investment to GNP in the late 1980s. French GNP is also expected to grow at a similar rate. Overall, European Community growth is expected to recover to $2^1/_2$% in 1992 and $2^3/_4$% in 1993, up from just under 2% this year.[1]

The outlook for inflation in the major six overseas economies is mixed. Overall, inflation is expected to average 4% in 1991 declining to $3^1/_2$% in 1993 (Table B), with significant differences between countries. In the United States, the recession is expected to continue bearing down on inflation until the beginning of 1992, but as the economy recovers the fall is likely to be partly reversed. Although output is projected to rise by over 3% in 1992 it is not expected to reach the estimated level of potential output until the end of the forecast period and therefore upward pressure on prices is limited. Output growth in Japan will probably slow sufficiently to allow some easing of demand-induced price pressures, and this, together with weak import prices, is expected to reduce consumer price inflation to around 2% per annum. Commodity prices, particularly for industrial commodities, have been affected by the recession, but are projected to increase at a slightly faster rate than overall world manufactured export prices throughout the forecast, largely because of a strengthening of food prices.

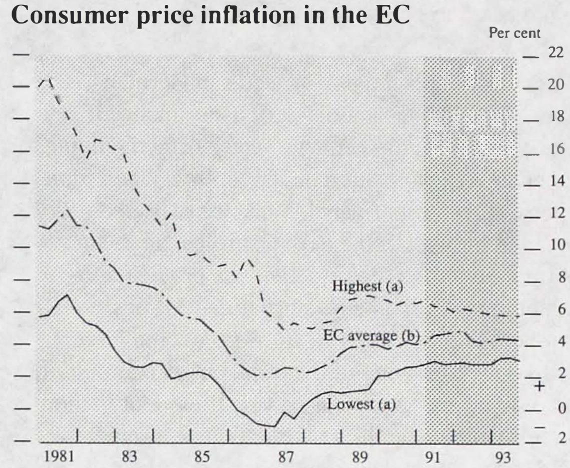
Table B
Prices in the major overseas economies
Percentage changes over previous year

	1990	1991	1992	1993
Import prices (a)	1.7	-1.3	4.1	4.3
Unit labour costs (b)	3.7	3.8	3.1	2.6
Wholesale prices	3.2	2.4	3.8	3.9
Consumer prices (c)	4.0	4.0	3.4	3.4

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

The key to German inflation will be the level of wage settlements over the coming winter pay round; settlements are expected to fall compared with earlier in 1991, but overall unit labour cost growth may well rise as output growth eases back following the initial boost from unification. Thus inflation could rise above 4% in the first half of 1992, falling back in the third quarter as the effect of the July 1991 rise in indirect taxes drops out of the annual comparison. Nevertheless, inflation is forecast to remain fairly high and is projected to be above 3% in 1993, owing to a rise in the VAT rate. Inflation in France is expected to remain below that of Germany for much of the forecast, but

Chart 2
Consumer price inflation in the EC



(a) Highest / lowest of Germany, France, Italy, Belgium, Netherlands and Spain.
(b) EC excluding the United Kingdom (UK trade weighted).

a crossover occurs towards the end of 1993 as German inflation falls and French inflation rises. The Italian economy has slowed in 1991, and this allows some progress on inflation; but the rate is expected to remain well above the other major economies throughout the forecast. The associated fast growth of unit labour costs means that competitiveness falls, which leads to a deterioration in the current balance as the forecast proceeds, although it remains small as a percentage of GNP. Elsewhere in Europe, inflation in the Netherlands is expected to rise in the short term, because of imported inflation from Germany and also because of indirect tax changes. On average, inflation in the EC is expected to settle at around 4% throughout the forecast, with little further convergence of individual country rates (Chart 2).

The balance of payments positions of the G3 were strongly influenced in the first half of 1991 by Gulf transfer payments, and in the case of Germany by unification. The US current account position is expected to deteriorate somewhat over the forecast period, but the deficit is not expected to reach the levels recorded in the mid-1980s. The increase in the deficit has less to do with absolute movements in demand in the US relative to its competitors than with the relative propensity of the economy to import when it is expanding. The main counterpart to the growing US deficit is an increase in the Japanese surplus, despite domestic demand growth significantly above the average for the other major overseas economies. The Japanese current balance benefits from strong import growth in many of the smaller OECD economies as well as the United States and the Far East. The unified German current account continues in deficit until 1993, when recovery in the east has progressed sufficiently to reduce the deficit with the west, thus allowing companies in the west to switch production away from eastern markets towards their more traditional export markets outside Germany. Elsewhere in Europe the current account deficits of both France and Italy are projected to fall in the near term, reflecting their cyclical position with respect to Germany. Over the longer term

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

both are expected to continue running deficits, although these are projected to be small as a percentage of GDP.

Over the next few years the public sector in Germany is projected to run fairly substantial deficits to finance transfers to the east. In the west the personal sector is facing higher taxes to keep the fiscal position under control. Therefore, with the personal sector's financial balance expected to deteriorate, and only a small external surplus, the main counterpart to the public sector deficit is a projected improvement in the corporate sector's financial position, which is not only consistent with firms producing large volumes of goods following unification, but also an initial expansion of margins. A similar pattern is evident in the United States, where a public sector deficit of around 3% of GNP (on a national accounts basis) is projected throughout the forecast, with the counterpart surplus largely provided by the corporate sector. The fiscal deficit remains large despite subdued real government expenditure growth, because of rising interest payments and slow revenue growth following the recession.

In Japan, the public sector is in a 'virtuous circle', despite reasonably fast growth in government expenditure compared with the rest of the major six economies, since private sector expenditure is growing even faster and hence increasing tax revenues. Therefore, the public sector is projected to remain in surplus throughout the forecast. In France, sectoral financial balances as a percentage of GDP are typically modest compared with many other countries and do not give rise to any major pressures in the forecast period. The fiscal deficit in Italy remains above 10% of GDP throughout the forecast, although this represents an improvement in the primary balance (excluding net interest payments). The debt/GDP ratio increases to around 110% by the end of the forecast.

With growth in the industrialised world expected to pick up in the forecast period, and a brighter outlook for activity in some of the developing countries (in Latin America in particular), demand for oil is likely to rise significantly. With little response from non-OPEC suppliers projected in the forecast (though one area of great uncertainty is the net oil position of the Soviet Union), increased demand is likely to lead to an increased call on OPEC and hence to a rise in their export revenue. The projected OPEC trade surplus is more than offset by a deficit on invisibles, leading to current account deficits throughout the forecast. The deficit on invisibles reflects restructuring and military expenditure following the Gulf conflict.

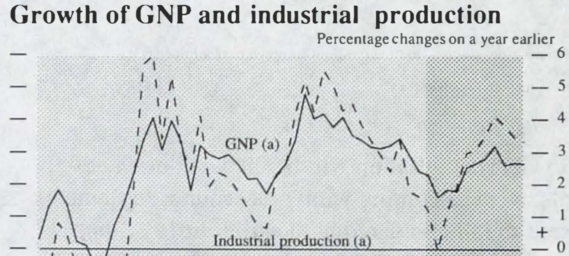
Developments over the past six months make projections for eastern Europe and the Soviet Union extremely difficult. The combined current account is projected to continue in deficit throughout the forecast although at less than 0.1% of G7 GNP. The projections reflect the view that the current account is likely to be constrained by the amount of savings which the rest of the world is prepared to channel into Eastern Europe and the Soviet Union. Within Eastern Europe performance is expected to diverge markedly, with Czechoslovakia and Hungary, for example, expected to make more headway in their reforms than, say, Romania and Bulgaria.

The forecast embodies a fairly optimistic set of projections for the Latin American economies, with both sides of the trade account set to grow faster than the world average. However, trade of these countries as a group is likely to move from surplus to deficit. Of particular importance is the performance of the Mexican economy (which together with Brazil accounts for over half of total Latin American trade), where the prospective Free Trade Agreement with the United States is likely to boost trade in both directions.

The overall picture for the newly industrialised economies (South Korea, Taiwan, Hong Kong and Singapore) remains healthy in terms of activity. The aggregate current account position of the four economies is expected to be closer to balance over the next few years than the fairly substantial surpluses recorded over the late 1980s. This, however, disguises a combined trade deficit offset by a surplus on invisibles. Inflation is expected to remain fairly high in some of these countries.

Overall, world trade is expected to grow by just over 3½% this year before rising to 5% in 1992 and 5½% in 1993. However, trade aggregates are difficult to interpret because of special factors—such as German unification and reform in eastern Europe. OECD industrial production is expected to remain broadly flat this year with growth picking up to around 4% a year thereafter. Unemployment in the OECD is projected to rise by some 3 million this year, largely concentrated in the English-speaking economies. Employment in the following years is expected to grow at broadly the same rate as the workforce, implying little net change in unemployment.

Chart 3
Growth of GNP and industrial production



(a) UK trade-weighted average of Canada, France, Germany, Italy, Japan and the United States.