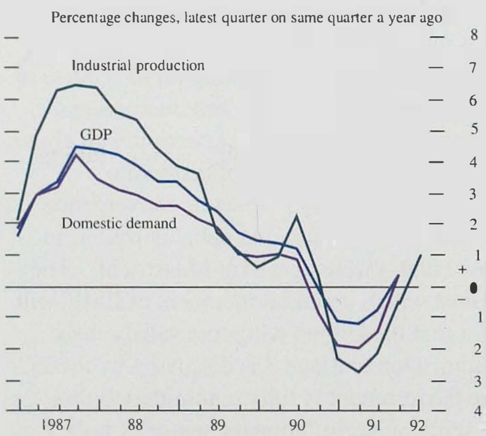
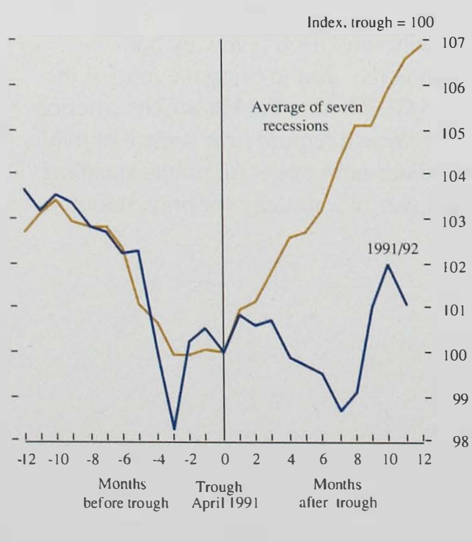
The international environment

- *The US economy is showing signs of revival, although the recent increase in activity may moderate in coming months. In Japan, business confidence is at its lowest for four years. While activity in Germany is still on a weak trend, there are signs that activity in France and Italy may be beginning to expand.*
- *Underlying inflation is stable in most countries, although in Germany the wage round and the strength of monetary growth continue to give cause for concern.*
- *The Federal Reserve eased monetary policy in April in response to a slowing in the rate of money supply growth. The Bank of Japan lowered its official discount rate by 75 basis points, owing to the weakness of the economy. The Portuguese escudo joined the wide band of the ERM.*

Activity *in the* **United States** *has begun to revive*



Retail sales *have been* **weaker** *than in past recoveries . . .*



The United States *has begun to* recover, but Germany and Japan are weaker

In the major industrialised economies aggregate output has increased more slowly than had previously been expected: in each quarter of 1991, OECD area growth was around 1% at an annual rate. The current slowdown is, however, less severe than in the early 1980s and mid-1970s because the cyclical positions of the major economies are now less closely synchronised. In 1991 there were falls in activity in the United States, Canada and the United Kingdom, while growth, though slowing, was relatively robust in Japan and Germany. Unlike the two previous recessions, there has not been a common external shock, nor are the major economies following a common policy stance.

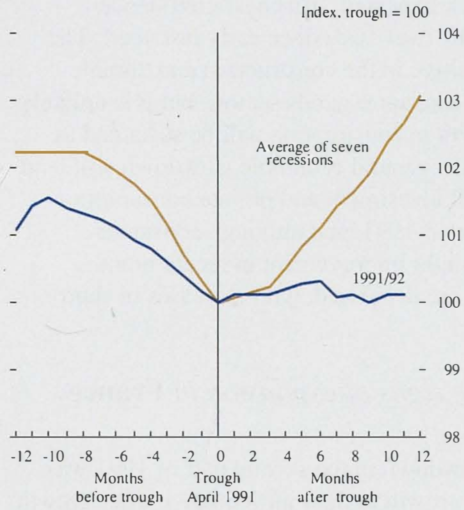
The relative cyclical positions of the three major economies are currently changing—the United States has begun to recover, but activity in Germany slowed last year and Japan is weakening rapidly. It is uncertain whether the conditions are now right for a sustained recovery, or for how long cyclical differences between countries will persist.

The revival in the US economy *is likely to moderate in the short term*

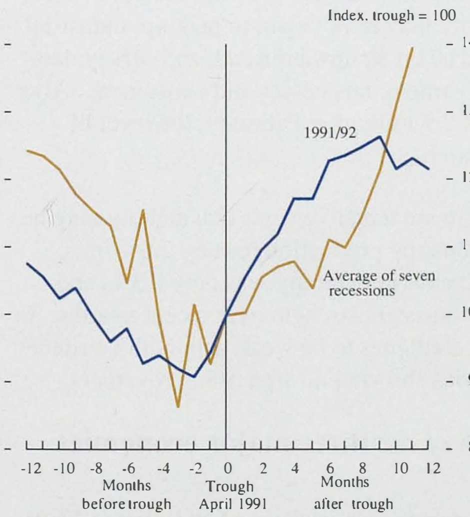
In the United States the economy is showing signs of revival, although the recovery has been held back by high indebtedness and weak growth in income and employment (the latter rose by only 4,000 in the first quarter). GDP grew by 2% at an annual rate in the first quarter, its highest rate of increase since 1989. Consumer spending and activity in the housing sector increased strongly, stimulated by cuts in interest rates and a number of temporary factors, including the mild winter and the early payment of income tax refunds. This increase in activity, however, is likely to moderate in coming months: the temporary factors have now abated and mortgage rates have increased in line with movements in long yields.

Industrial production is recovering more slowly than the housing sector. Output is still below the levels of last summer, and there

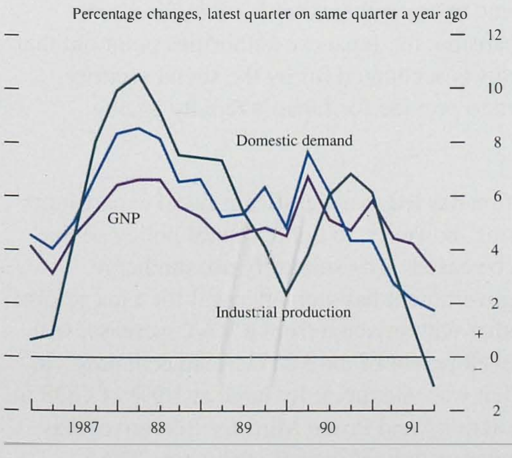
. . . as has non-agricultural **employment** *. . .*



. . . although the **housing market** *has been stronger*



The slowdown in **Japanese activity** *is most evident in industrial production*



are few incentives as yet for manufacturers to increase output sharply. There has been only a modest rebound in factory orders and unfilled orders are still declining. Lean inventories imply, however, that any increase in demand should quickly feed through to production.

The Federal Reserve's decision to ease monetary policy on 9 April, by accommodating a 25 basis point fall in Fed funds to 3.75%, surprised markets in the context of the consumption and housing market data. The recent slowdown in the growth of broad monetary aggregates was given by the Fed as the reason for the move.

The process of balance sheet adjustment, particularly in the household sector, remains a major area of uncertainty. Interest rates have fallen, and some early repayment of debt has eased levels of indebtedness. The corporate sector is reducing its level of income and capital gearing, which have been on a rising trend throughout the past decade. With interest rates falling, businesses have replaced high-cost borrowing with cheaper debt and equity. This has caused an overall improvement in corporate sector balance sheets; but, as with the household sector, it is difficult to tell how much further this adjustment has to run.

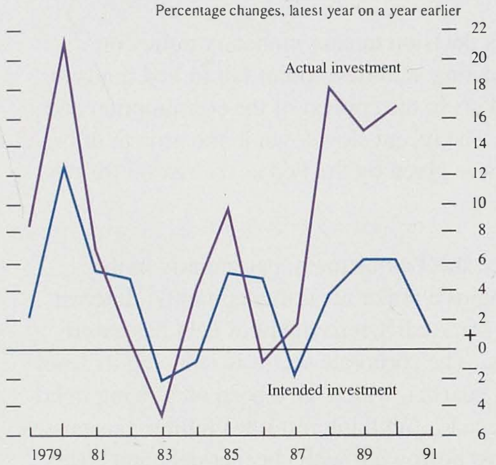
Prospects for improved activity in the Canadian economy are heavily dependent on a recovery in the United States. After declining in December, the monthly measure of GDP rose only marginally in February, and unemployment rose to its highest level for a decade in March. Manufacturing output is beginning to show signs of improvement, driven by exports, but the domestic economy remains weak, with retail sales showing no signs of strength and the value of non-residential building permits falling in January to its lowest level for six years.

While activity in **Japan and Germany** *is weak . . .*

In Japan, GNP fell slightly in the last quarter of 1991, but was still 3.2% up on a year earlier. Over the quarter investment in particular was weak in both the business and housing sectors. In the corporate sector, profits are falling and gearing is high (net liabilities of the corporate sector are now 63% of GNP compared with 31% in 1989). Industrial production fell by 5.3% in the year to March, and the Bank of Japan's 'Tankan' survey for February showed business confidence at its lowest level since 1987 (although, as the chart shows, the statistical relationship between the Tankan survey of intentions and investment appears to have broken down). Housing starts are also depressed and leading indicators of activity have been revised significantly downwards. There is also a risk of weaker consumer demand: although retail sales rose in the year to March, consumer confidence fell sharply in the fourth quarter. The present slowdown is related to less rapid growth in the other industrialised economies and to the tight monetary stance of the recent past. In an effort to reverse the slowdown the official discount rate was cut by 75 basis points on 1 April, but the stock market, already on a downward trend, weakened significantly: in early April the Nikkei index had fallen 57% from its peak at the end of 1989. This weakness may itself hold back recovery in the real economy.

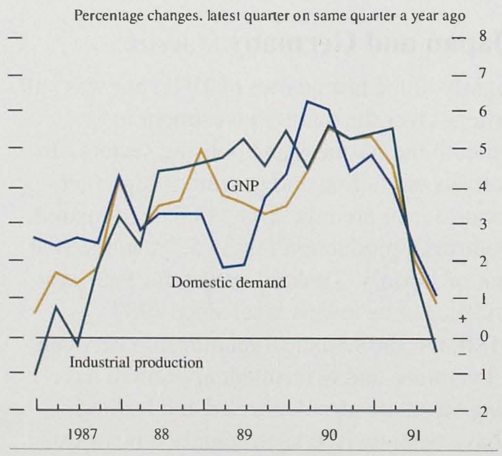
The west German economy has been slowing since the spring of 1991 with domestic demand dampened by tight monetary policy

The relationship between **Japanese intentions and actual investment** *appears to have failed*



Source: Tankan survey.

West German activity *has slowed following the end of the unification boost*



and high taxes and the exceptional boost to demand from unification now tailing off. In the last quarter of 1991 west German GDP was flat after falling in the third quarter, and activity continues on a weak trend; industrial production rose in January and February, but fell back in March. Business confidence indicators have declined by over 10% since early last year. The outlook appears more positive in the construction and durable goods sectors than in the consumer goods sector; but it is unlikely that the recent rapid growth in construction will be sustained as high mortgage rates and the general economic slowdown will tend to reduce activity. Capital investment and private consumption have been slowing since mid-1991, and although consumer confidence has shown a slight improvement in recent months labour market conditions are depressed, with increases in short-time working.

. . . there are tentative signs of expansion in **France and Italy**

In France, the gradual slowdown in the second half of 1991 was confirmed by 0.1% GDP growth in the fourth quarter, after growth of 0.8% in the third. Domestic demand continues to be dampened by the high interest rates dictated by the ERM, and sluggish demand for exports has further held back growth. However, there are some signs that activity may have begun to pick up: industrial production now seems to be on an upward trend, and survey data point to greater optimism among businesses and consumers. After reaching a record high of 2.9 million in February, the level of unemployment fell in March.

In Italy, as in France, there are tentative signs that activity may be beginning to expand. Industrial production rose by 2.0% in January, although the increase in February was only 0.3%, and orders data have shown consistent strength over recent months. In Spain, however, activity continues to be weak with both consumer and capital goods industries showing no sign of improvement.

Fiscal policy *in each of the* **three major economies** *faces constraints*

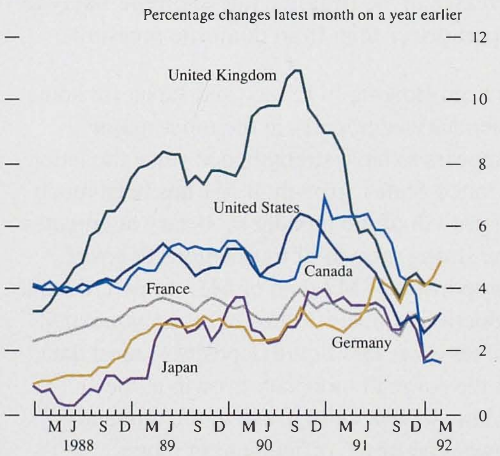
In the United States, the debate on a package of stimulatory fiscal measures is unlikely to be resumed in the near future. In Japan, a small 'emergency' fiscal package to stimulate the economy was announced on 31 March, essentially consisting of a front loading of public works and utilities expenditure into the first half of the financial year. Although the decline in the government's debt to GDP ratio has led some to argue that there is room for more substantial fiscal expansion, the Japanese authorities point out that the much of the surplus is accounted for by the social security fund, which is needed to provide for Japan's rapidly ageing population.

In Germany, unification has led to a significant fiscal expansion; pressures are increasing, however, to tighten fiscal policy so that monetary policy can be eased. The solidarity tax surcharge expires in June; the government has won approval for a tax reform package which, together with revenue from a VAT increase, will be used to finance development of the east German economy. In France the fiscal deficit was unexpectedly large at 1.9% of GDP in 1991 owing to weak activity and Prime Minister Béregovoy has announced that a similar overshoot is likely this year. The underlying position is, however, sound.

Inflation *appears generally to be under control . . .*

Despite concern over prospects for growth and employment, the reduction of inflation over the medium term remains the major objective of governments in the major economies. In Europe and Japan, inflation remains on a downward trend and in Germany inflation seems likely to have peaked. Inflation rates are likely to be lowest in Canada and Japan.

In most of the major economies **inflation** *is under control*



. . . primary commodity prices *are unlikely to put upward pressure on consumer prices*

Non-oil commodity prices have risen marginally in the three months to April, led by increases in both base metals and agricultural non-foods. Metals prices rose as a result of concerns over supply from the former Soviet Union. This rally is not expected to be prolonged if supplies are guaranteed, as the former Soviet Union's punitive export taxes have been removed and this should lead to a resumption of high export levels to a world market with low demand. The rise in agricultural non-foods prices largely reflected a recovery in the wool price.

Although the price of oil has been relatively stable, the outlook is uncertain. The former Soviet Union's production fell by 9.5% in 1991 and the rate of decline may be accelerating, although reliable figures are difficult to come by following the dissolution of the Soviet Union. There are also concerns over the possible disruption to Libyan supplies following the imposition of sanctions by the UN, which the market fears may escalate into an oil embargo. The recent OPEC quota reduction to 23 million barrels a day caused a period of volatility as the market expected a larger cut in production, but prices soon recovered. The prospect of a resumption of Iraqi exports is a further uncertainty.

US inflation *is unlikely to change much in the near future; prospects for* **Japanese** *inflation are favourable . . .*

The headline rate of US inflation was 3.2% in the year to March, down from a peak of 6.3% in autumn 1990; core inflation (excluding food and energy) was slightly higher at 3.9%. Inflation seems unlikely to increase significantly over the next several months with moderate wage pressures, cyclical productivity gains and weak producer prices. But substantial falls are also unlikely, as cost pressures are not expected to moderate further and service sector inflation remains sticky.

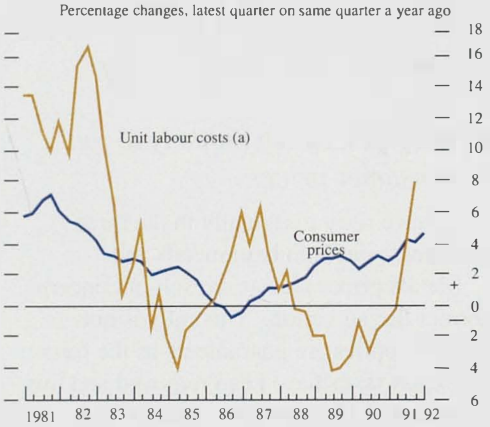
Prospects for Japanese inflation remain favourable, with corporate services prices up 2.3% in the year to the first quarter, and consumer prices up 2% in the year to March. The Shunto wage round is likely to deliver settlements at just under 5%, a little lower than last year.

. . . and the peak in **German inflation** *may have passed*

In Germany the rate of inflation increased from 2.9% in the first half of 1991 to 4.0% in the second half, and is likely to have peaked in March at 4.8%. During the first quarter of 1992 a number of increases in administered prices and indirect taxes, as well as rent increases and rising unit labour costs, have boosted the inflation rate. The bank workers' settlement, worth 5.8%, was

German unit labour costs *were rising before the* **current wage round**

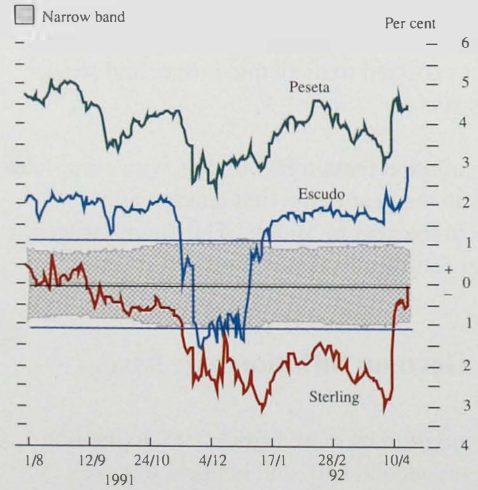
Percentage changes, latest quarter on same quarter a year ago



(a) Unit labour costs = (earnings / manufacturing productivity) / manufacturing employment.

Sterling *strengthened in the* **ERM** *after the* **general election**

August 1991 - April 1992



The zero line represents the middle of the narrow band.
The escudo entered the ERM on 6 April.

closer to the Bundesbank's 'acceptable' range than the earlier steelworkers' settlement. Attention has now moved to the public, metal and engineering sectors. OTV and DAG, representing 2.3 million workers, accepted an offer of a 5.4% pay rise, matching an arbitration proposal previously rejected by the employers. Strike action had disrupted public services throughout the country. German monetary policy is likely to remain tight, given increased fears of inflationary wage agreements and the strength of M3 growth.

In France, consumer price inflation averaged 3.1% in 1991, the lowest of the G7. Wage restraint is well established, led by a public sector settlement for 1992 based on the official inflation forecast of 2.7%. Increases in the headline rate are more likely to come from higher import prices than from domestic pressures.

Monetary growth has been slowing in France and Japan for some time, but growth of monetary aggregates in the other major overseas economies appears to have strengthened since the latter part of 1991. In the United States, growth of M1 has been much stronger recently than growth of the broader monetary aggregates M2 and M3, due to the strong growth of transactions deposits, which form a lower proportion of M2 than of M1. In part, this has been driven by the reduction in interest rates, with an associated fall in the loss of yield *vis-à-vis* less liquid deposits. Latest data, however, suggest that the surge in monetary growth at the beginning of the year has slowed, and growth in the monetary aggregates is at the lower end of the official target range.

In Japan, monetary growth as measured by M2 + CDs reached a record low of 1.6% in the year to February after a series of monthly falls, although March saw a slight increase. This low growth can be partly explained by a switch into higher yielding Postal accounts outside M2. The monetary slowdown has been accompanied by a weakness of bank lending, largely reflecting the weak state of corporate demand for funds.

German M3 growth remains well above the Bundesbank's target range of 3.5%–5.5% over the 1991 Q4 base, with M3 in March up by 9.7% over the base at an annualised rate. A sharp slowdown in M3 growth to below 4% at an annual rate from April to December would be needed to reach the upper limit of the target range. Growth in bank lending has been a particular feature of recent months.

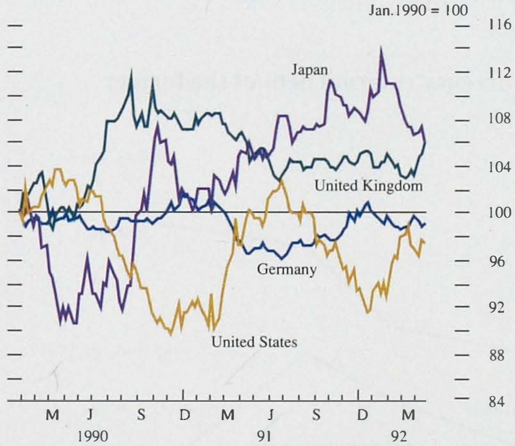
The recent appreciation of the **dollar** *has begun to flatten out; the* **franc** *has strengthened within the ERM*

With the slowdown in the German economy and continued modest growth in the US economy, the dollar appreciated against the deutschmark during January and February. Since then, however, the value of the dollar has begun to flatten off. The French franc has gradually strengthened in the narrow band of the exchange rate mechanism of the EMS, reaching an eight-month high against the deutschmark. The Portuguese escudo entered the wide band of the ERM on 6 April at a central rate of 86.94 escudos to the deutschmark, some 0.7% below the market rate ruling on 3 April. Portugal's entry had not been anticipated by the markets, which had believed that entry was contingent on a further reduction in the public sector deficit (6.5% of GDP in 1991) and in inflation (down to 8.5% in March 1992, from 12.2% the previous year).

France's *competitiveness relative to* **other European economies** *has improved in recent years*

G7 economies had broadly similar experiences of unit labour costs during the 1980s, as faster productivity growth in some economies was offset by faster wage growth. Italy and Canada have seen the highest unit labour cost growth, and the United States and Japan the lowest. France has been the exception, as its competitiveness relative to other European countries has improved markedly. This has been reflected in the external trade balance, which roughly halved in 1991 to around 0.5% of GDP, although this improved performance has also been assisted by weak domestic demand. The contrasting experience of Italy, however, suggests that a good competitiveness performance is not an inevitable consequence of ERM membership.

The **dollar's effective exchange rate** *strengthened during January and February, but has since* **levelled off**



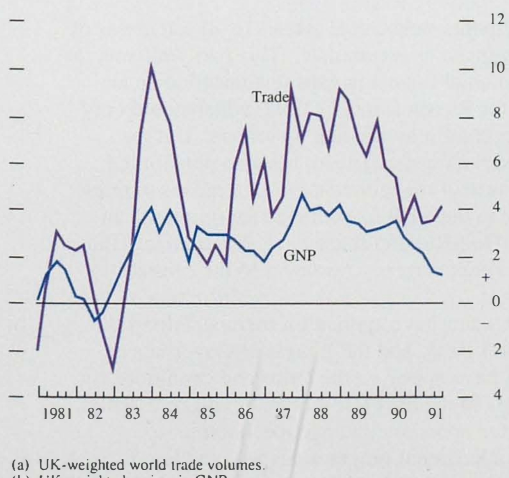
The **US trade balance** *has improved sharply*

The US current account deficit narrowed sharply in 1991, to \$8.6 billion from \$92.1 billion in 1990—the smallest deficit since 1982. There was a substantial improvement in the merchandise trade balance: this was partly due to an improvement in the terms of trade, but also reflected the slowdown in US growth relative to its trading partners. The outlook for European exports to the United States is not particularly favourable, owing to the improved competitive position of the United States *vis-à-vis* Europe, and the only modest growth in US demand.

German exports have been sluggish for some time, largely because of slow market growth (exports to the former Soviet Union in 1991 were estimated to be down by 35% from 1990 levels). Higher domestic demand within Germany has diverted trade from external markets while high labour costs, a stronger deutschmark, and higher environmental levies have reduced competitiveness. As activity weakens, however, import demand will fall off; there are already signs that the trade surplus is beginning to increase again from the very low levels seen immediately following unification.

The Japanese trade surplus increased from \$64 billion in 1990 to \$103 billion in 1991, and data for early 1992 show this trend continuing. The increasing trade surplus may again become a matter of concern, if it should revive protectionist pressures in the United States. Sluggish demand in export markets, particularly the United States, has been offset by productivity gains and switching into other markets—particularly in South East Asia. The recent reductions in the value of the yen and weakening economic conditions could further increase the trade surplus.

World trade growth *remains* **strong** *given current activity*



(a) UK-weighted world trade volumes.
(b) UK-weighted major six GNP.

IMF membership *should help to maintain the momentum of reform in* **the former Soviet Union**

In the first quarter of 1992 the Russian Government embarked on a bold and comprehensive programme of economic reform ahead of the other republics. The programme involved a tight monetary policy and the freeing of most prices, and aimed at achieving a balanced budget for the first quarter. Success to date has been mixed. Price liberalisation has increased the availability of goods, although this may reflect depressed consumer demand rather than increases in production. Most remaining price controls are to be removed in May and June, including controls on energy prices which should have a favourable effect on Russia's terms of trade.

The external debt of the former Soviet Union

Until about two years ago the Soviet Union was widely regarded as a good risk in international capital and credit markets. The country had a long and uninterrupted record of meeting its external obligations, and outstanding external debt was modest in relation to GDP. The ratio of scheduled debt service payments to exports was fairly high, but this reflected the relatively closed nature of the economy. Given the vast oil, mineral and other resources of the Soviet Union there seemed little reason to doubt that exports could be increased as required, to meet external debt servicing obligations.

On the strength of its good reputation, the Soviet Union was able to borrow abroad on a substantial scale in the second half of the 1980s. Between end-1985 and end-1989 its outstanding convertible currency debt increased from about $31 billion to $56 billion. The increase was almost wholly accounted for by net new borrowing from commercial banks (see chart).[1]

In the course of 1990 and 1991, the overthrow of communist regimes in Eastern Europe, and in particular the unification of East with West Germany, raised doubts about both the future of the communist system in the Soviet Union and the continued existence of the Soviet Union as a unified political entity. Economic performance deteriorated, as the mechanisms of central planning broke down under the implementation of perestroika, and there was no meaningful attempt to increase output by market-oriented reforms. Arrears on trade payments also began to appear.

Against this background, commercial bank lenders took steps significantly to reduce their exposure. For example, banks' short-term claims on the Soviet Union are estimated to have fallen from $18 billion at end-1989 to just $1 billion by end-1991. Other private creditors took up some of the slack, principally in the form of trade credit. But official bilateral creditors were the major source of new finance, either directly or through the provision of guarantees, and increased their claims on the Soviet Union from about $12 billion to $36 billion in the two years to end-1991.

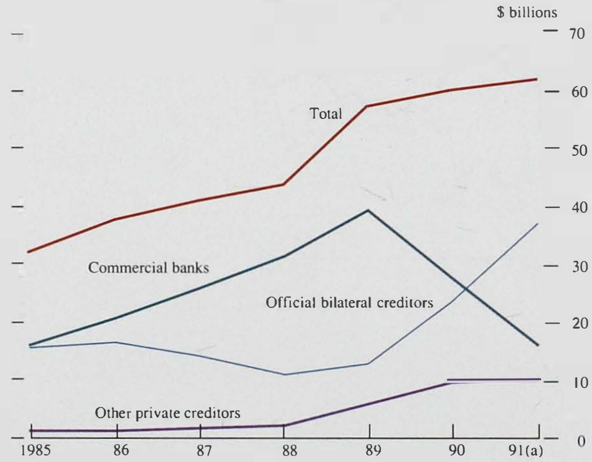
The large credits advanced or guaranteed by official bilateral creditors were sufficient to stabilise the Soviet Union's external debt stock at about $60 billion, but not to continue the rapid growth of earlier years. At the same time, the Soviet Union's capacity to meet its external debt servicing commitments was reduced by continuing declines in output, internal economic dislocation and capital flight. Despite significant compression of imports, gold and foreign exchange reserves dwindled to very low levels and attempts to reduce the trade arrears were largely unsuccessful.

In the autumn of 1991, G7 representatives met with representatives of the successor states to discuss repayment arrangements for the external debt of the Former Soviet Union (FSU). Eight of the twelve states, including Russia, acknowledged their joint and several liability for the debt by signing a Memorandum of Understanding (MOU) on 28 October (the second largest state, the Ukraine, signed the MOU in March 1992). The states also agreed to set up a centralised debt servicing mechanism through the Vnesheconombank (VEB).

For their part, the G7 countries conditionally agreed to defer until 1 January 1993 principal payments on medium and long-term official credits contracted before 1 January 1991. A similar agreement was concluded with a larger group of western bilateral official creditors in Paris on 4 January 1992. The deferral gave the FSU cash flow relief of over $3 billion up to the end of 1992, subject to review at the end of March, when it was decided to keep the deferral agreement in force and to re-examine the FSU's economic and financial position in mid-June.

On 5 December 1991 the FSU unilaterally announced a moratorium on most principal repayments to commercial creditors. Shortly thereafter a deferral agreement, broadly comparable to that with bilateral official creditors except that it ran for only 90 days, was concluded with the commercial banks. The agreement was extended at the end of March for a further 90 days. If the agreement is extended to the end of 1992 it will provide cash flow relief broadly comparable to that provided by the bilateral official creditors.

Convertible currency external debt of the former Soviet Union



Source: The Institute of International Finance, Inc.

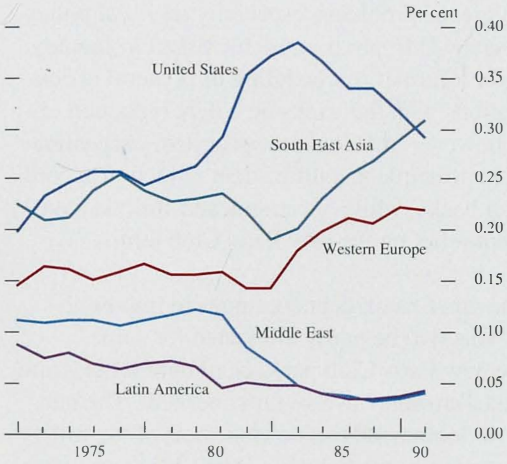
(a) Estimate.

Despite the agreements, substantial arrears to all categories of creditor have continued to accumulate. This partly reflects the existence of substantial financing gaps (estimated to be at least $20 billion for Russia alone, in 1992) which could only be filled in the short term by running up arrears. But the centralised debt servicing mechanism has also not worked well, mainly because of the reluctance of enterprises to remit foreign exchange to the VEB in exchange for roubles at an overvalued rate. Non-Russian states have also been unwilling to remit scarce foreign currency resources to the centre.

All the successor states have applied for membership of the IMF and the World Bank, and the Boards of Governors of those institutions have approved the terms and conditions for their membership. In the next few months it will be essential that the states agree upon credible macroeconomic stabilisation and adjustment programmes with the Fund. Such programmes are essential if the states are to achieve a long-term transition to market-based economies. They are also regarded by creditors as a pre-condition for any replacement of the existing temporary debt deferral agreements by a longer-lasting reorganisation of the FSU's external debt.

(1) The extent of net new borrowing is somewhat overstated by these figures, since some of the Soviet Union's external debt is denominated in currencies other than the US dollar and the latter depreciated quite markedly during this period.

Europe *and* **Asia** *have been taking an increasing share of* **Japan's exports**



Although the budget deficit amounted to approximately 14% of GDP in the first quarter this was at least an improvement on the deficit of over 20% of GDP for 1991.

The United Kingdom represented the Russian Government in the successful negotiations on the terms of Russian membership of the IMF. Membership of the IMF for Russia and the other states of the former Soviet Union should help to maintain the momentum of the reform process by providing access to Fund assistance in drawing up reform programmes, subsequent financing, and technical assistance in areas such as central banking and fiscal policy. At the beginning of April, President Bush announced a major package of financial support for Russia including a $6 billion stabilisation fund for the Rouble and balance of payments support of approximately $18 billion. This should meet Russian external financing requirements in 1992.

In **Eastern Europe**, *economic conditions and prospects continue to vary significantly from country to country*

Czechoslovakia and Hungary have persisted with some success in securing financial stability, with monthly rates of inflation in the first quarter of this year around 0.5% and 2.5% respectively. The decline in inflation has been achieved at the expense of some fall in output. In Czechoslovakia GNP fell by some 17% during 1991 and in Hungary output fell by about 8%. The falls in output were aggravated by the collapse of trade with other former members of Comecon, and, to a limited extent, the restructuring of the real economy.

Considerable progress has also been made in Poland in reducing inflation which in 1991 slowed to 70%, down from around 550% in 1990. But further improvements will critically depend on the ability of the government to contain the 1992 fiscal deficit to some 5% of GDP. Bulgaria and Romania have also initiated wide-ranging economic reform programmes, but have yet to secure fundamental progress at either the macro or the microeconomic level.

Other developing countries' *activity has been relatively buoyant . . .*

In the less developed countries as a whole activity was more robust than in the industrialised world: output is estimated to have grown by 3.3% in 1991 in the developing countries excluding Eastern Europe and the former Soviet Union, only slightly down on 1990. Within this, however, there are wide varieties of experience.

The most buoyant area was Asia, where the newly industrialising economies in particular benefited from a very strong export performance, and an increase in their share of export markets. In addition, there are indications of an increasing internal dynamism, with trade between the countries of the East Asian region rising from 4% of world trade in 1980 to over 6% in 1990.

. . . and some **Latin American** *countries have returned to the* **international capital markets**

Some Latin American countries, such as Mexico and Chile, continued to make good progress with structural reform, resulting in sustained market prices for their debt, a limited return to the capital markets (a state oil company recently became the beneficiary of the first syndicated loan by commercial banks to Mexico since 1982), and repatriation of flight capital. Other countries where reform efforts have run into difficulties, such as Brazil, Argentina and Venezuela, continue to experience problems, especially on fiscal policy. Agreement on a new IMF programme for Brazil in January paved the way for a further rescheduling of bilateral official claims; negotiations with the banks on a debt reduction agreement are, however, making slow progress. Argentina has just agreed in principle an outline debt reduction accord with commercial banks, while Nicaragua and Bolivia have been granted debt relief on the new Paris Club terms.

In Africa, on the other hand, debt continues to impose a heavy burden. This will be partly alleviated for some countries by the new Paris Club package of debt relief, from which Benin and Tanzania have so far benefited. The new package, while welcome, falls somewhat short of the full Trinidad Terms proposal made by the Prime Minister (when Chancellor of the Exchequer) in 1990. The United Kingdom will continue to encourage debt reduction for the poorest and most heavily indebted countries.

The problems arising from debt are compounded by continued declines in the terms of trade as the price of food exports continues to fall. The drought in southern Africa has created additional problems for countries such as Zimbabwe and Zambia, with extra resources needed to finance higher food imports.

World economic prospects—latest Bank forecasts (1)

Activity

Growth in the major six overseas economies in the second half of last year was broadly the same as in the first half, but was slower than had been expected. This was largely because of a contraction in west German activity in the second half of the year, which resulted from tax increases to help finance unification and continuing high real rates of interest. Growth was also sluggish in the other five major countries. The recoveries in the United States and Canada were slightly weaker than had been expected, as consumption growth failed to pick up in the second half of the year. This probably reflected uncertain employment prospects, and an associated desire by consumers to reduce their debt levels. Activity in Japan, Italy and France in the second half of 1991 was subdued. This year, the major six economies are projected to grow more strongly: output is forecast to increase by 2% in 1992 and by 3% in 1993 (Table A). The main risks to this forecast over the next two or three quarters will be the stance of German monetary policy and the extent to which wealth effects dampen consumption and investment growth in the United States and Japan.

Table A
Demand and output in the major overseas economies(a)

Percentage changes over previous year

	1991	1992	1993	1994
Domestic demand	**0.6**	**2.4**	**3.3**	**2.9**
of which:				
Private consumption	1.0	2.3	3.0	3.2
Private fixed investment	0.5	2.0	4.0	3.8
Public expenditure	1.8	1.9	2.2	1.9
Stockbuilding (b)	-0.1	0.1	0.0	0.1
Net external demand (b)	0.5	-0.4	-0.3	-0.1
GDP/GNP	**1.1**	**2.0**	**3.0**	**2.8**

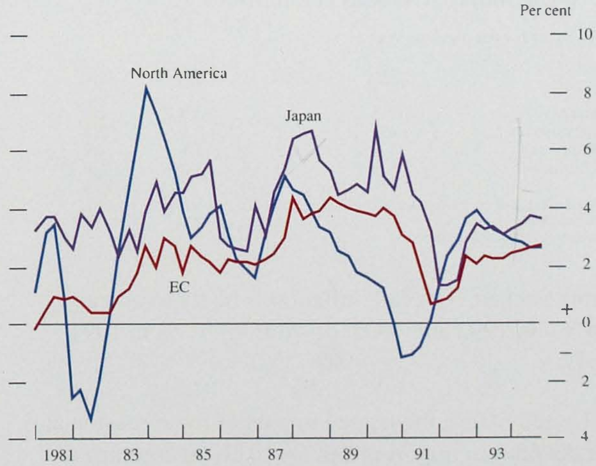
(a) Canada, France, Germany, Italy, Japan and the United States.
(b) Percentage contribution to GDP/GNP growth.

Despite contracting in the second half of last year, west German GDP grew in 1991 by over 3%. But this figure overstates the relative strength of the economy later in the year because of the effects of averaging and the strong growth in the west German economy in 1990 and the first quarter of 1991. These factors will tend to act in reverse in 1992, despite economic growth being expected to resume slowly in the first half of this year. As a result, GDP in west Germany is forecast to grow by 1% in 1992—as the impact of tax increases in the west, aimed at counteracting the expansionary influence of unification on the budget deficit, and sustained high real rates of interest to dampen inflationary pressures continue to bite—and to increase gradually to 1¾% in 1993. These growth rates represent a significant slowdown from the immediate post-unification period. Activity in east Germany is projected to recover in 1992 and 1993, following the severe contraction in 1991.

Indicators of consumer and business confidence in the United States have improved in recent months. Mirroring this, consumption and housing investment growth have strengthened and GDP growth has picked up slightly. This increase in activity should be maintained through the year as the lagged effects of interest rate cuts over the last twelve months continue to support domestic demand.

Counterbalancing these developments, the trade sector is expected to make a negative net contribution to GDP growth in 1992: import volumes are likely to increase strongly as demand picks up, given the US economy's high income-elasticity of demand for imports; at the same time, the growth rate of US export markets is forecast to fall in 1992. Overall, GDP is projected to grow by 2½% this year. Demographic considerations, and the relatively low investment to GDP ratio in the United States (and consequently its poor productivity performance) suggest that the US economy will expand more slowly in the 1990s than in the 1980s, when it grew at just over 2½% a year. Reflecting the fact that Canada has had a deeper recession than the United States, the Canadian economy is expected to perform more strongly than the United States during 1992, with GDP growth this year of around 3%, largely because of a recovery in domestic demand. Employment creation, however, is expected to remain weak, owing to continued restructuring in the manufacturing sector. As a result, whole economy productivity growth should improve significantly in 1992 and 1993.

Chart 1
Growth of GNP



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

The Japanese economy is forecast to remain sluggish in the first half of 1992, before recovering in the second half. As in 1991, investment is expected to be the weakest component of domestic demand. Business investment is forecast to be flat in 1992, as a result of the deterioration in the corporate sector's financial position, and to grow slowly thereafter—sufficient to hold the ratio of business investment to GNP at around 23%. Housing investment is also expected to be weak this year owing to the continued depressed level of land prices and the weakness of the housing market. But domestic demand is unlikely to contract in 1992, largely because of continued growth in consumption, the effects of the government's latest fiscal initiatives and the lagged impact of cuts in interest rates over the last twelve months. These considerations, combined with a small positive contribution from net trade, suggest that GNP growth in 1992 will be slightly below $1\frac{3}{4}$%. The impact of wealth effects on consumption, originating from the decline in share prices, should prevent the saving ratio from falling this year.

As a result of the slowdown in west German activity and the impact of high real rates of interest, GDP growth in France and Italy slowed significantly in 1991—to below $1\frac{1}{2}$% in both countries. France and Italy are forecast this year to share broadly the same growth rates, which are not expected to rise much above last year's rates. But by 1993 and 1994 some divergence in prospects is likely—French GDP growth is expected to be below that of Italy because of higher productivity growth in Italy and the beneficial effects of Italy's higher investment to GDP ratio. Overall, European Community[(1)] growth is expected to slow to $1\frac{1}{4}$% in 1992, down from just over 2% in 1991; in the medium term, growth is expected to be around $2\frac{1}{2}$%, somewhat slower than in the late 1980s.

Inflation

Using yearly aggregates, consumer price inflation is expected to fall this year in all of the major six overseas economies—with the exception of Germany, where indirect tax increases have outweighed demand effects—as demand pressures slacken. Overall, inflation is likely to average around 3% in 1992 and 1993, down from $3\frac{3}{4}$% in 1991 (Table B).

Table B
Prices in the major overseas economies

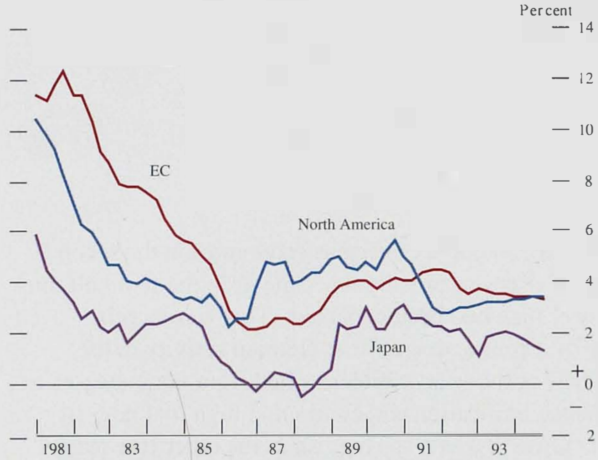
Percentage changes over previous year

	1991	1992	1993	1994
Import prices (a)	-2.0	-3.7	2.0	1.9
Unit labour costs (b)	4.0	3.7	1.7	2.5
Wholesale prices	1.6	0.5	3.1	2.9
Consumer prices (c)	3.8	3.0	3.0	2.9

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

In the United States, the lagged impact of the recession and further declines in import prices are likely to continue to bear down upon inflation in the first half of 1992. The effects of the recovery will tend to increase inflationary pressures, thereafter. But, with the economy not expected to return to potential until the end of the forecast period, and assuming there are no external price shocks, consumer price inflation is unlikely to rise above 4% per annum between 1992 and 1994. Canada's inflation is forecast to average under 2% in 1992, down from over $5\frac{1}{2}$% in 1991, reflecting the dampening impact of the recession and the elimination of an indirect tax increase from year-over-year calculations of inflation. The average rate of inflation in Canada and the United States is therefore likely to remain, as it is now, below the European Community average during the forecast period. Inflation in Japan is also expected to decline in 1992 as demand pressures ease. Forecast declines in import prices and domestic wholesale prices are likely to bring down average consumer price inflation to about 2% in 1992. Wage settlements appear to be turning out somewhat lower this year, with downward pressure on earnings likely to be reinforced by lower bonuses.

Chart 2
Growth of consumer prices



Wage inflation pressures in Germany appear to have abated somewhat. Settlements reached to date in the current pay round have, on average, been below the levels of a year ago: as a result, earnings growth is projected to decline. The current extent of strike activity, however, adds some degree of uncertainty to this projection. Furthermore, because of the cyclical slowdown in productivity, any improvement in wage inflation is unlikely to be translated into slower unit labour cost growth until 1993. These considerations, and the continuing impact of previous indirect tax increases, suggest that consumer price inflation in 1992 is unlikely to fall below its 1991 level. The scheduled 1% increase in VAT in 1993 is further likely to constrain any reductions in inflation next year. Over the medium term, once tax changes are no longer a factor, consumer price inflation is expected to fall towards $2\frac{1}{2}$%.

French inflation is forecast to slow slightly in 1992 as import prices fall and unit labour cost growth eases off. However, even though unit labour cost growth is unlikely to pick up,

(1) All European Community figures quoted in this article exclude the United Kingdom and are UK trade weighted.

inflation is expected to be above 3% in the medium term, because of a rebuilding of profit margins following the declines in 1991. A similar rebuilding of profit margins is likely in the Netherlands and Belgium because of the reduction in the competitive pressures exerted by German exporters in domestic markets, now that inflation rates in these three countries are below the German rate. As a result, inflation in the Netherlands and Belgium is expected to fall only gradually this year. Italian consumer price inflation is forecast to average below 5½% in 1992, down from just under 6½% in 1991. Much of the fall is attributable to a moderation of unit labour cost growth, in turn reflecting a strong cyclical rise in productivity. In Spain an increase in indirect tax rates is likely to leave inflation at around 6% this year, with an easing in price pressures beginning in 1993 and continuing through the forecast period thereafter.

Commodity prices

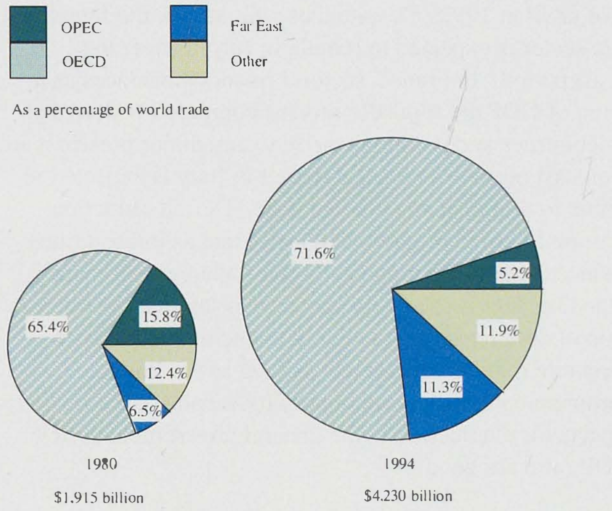
Commodity prices are thought to have reached their trough and a gradual recovery is expected in the first half of 1992. But, because of the sluggishness of the economic recovery in the OECD countries and the timing and extent of the trough, it is likely that commodity prices will fall further during 1992 as a whole. Thereafter, the recovery in non-food prices is likely to outpace increases in world food prices.

Demand for oil is likely to rise in 1992 and 1993 as activity in the industrial world recovers from the low levels of 1991. The pick-up in demand is forecast to be gradual, because of the expected slow pace of the recovery and, consequently, oil price movements are unlikely to have a significant impact upon world inflation this year. In 1993, when all of the major industrial countries have become more synchronised in their economic cycles, demand is expected to rise by 3%. This increase in demand is assumed to be met largely by increased production by OPEC, whose combined current account deficit is expected to diminish through the forecast period. While it is anticipated that OPEC will be able to increase its output capacity to meet the forecast increase in demand, there is a risk that lags in the creation of that capacity could put upward pressure on prices. On the other hand, the forecast assumes that Iraqi production will remain tightly constrained by sanctions; a lifting of sanctions would be likely to depress prices by releasing an additional 2 million barrels per day onto the market. Because of the restructuring of the Russian oil industry, non-OPEC supply is unlikely to play a significant role in meeting the increase in demand.

Trade

After narrowing sharply in 1991—due to transfer payments related to the Gulf war and cyclical factors—the US current account deficit is expected to widen over the forecast period. The main counterpart to this is likely to be an increase in the Japanese surplus. The unified German current account is forecast to remain in deficit in 1992 as west German producers continue to focus mostly on east Germany. By

Chart 3
Export market shares (as a percentage of world trade)



1993, however, the recovery in east Germany is expected to have begun to reduce the trade deficit with west Germany, which should allow west German producers to switch production away from east Germany towards their more traditional export markets. But, although this produces an increase in German exports and restores a current account surplus, west German producers are not expected to regain their lost market share fully because of the steep increase in relative unit labour costs following unification. The current account deficit of France is expected to diminish further in 1992 as exports to North America and Germany pick up, while Italy's current account deficit is expected to remain broadly flat. Over the medium term, the French current account deficit is expected to deteriorate to around ½% of GDP and the Italian deficit is forecast to improve to between 1% and 1½% of GDP.

Public sector finances

With the expected recovery in the east German economy and a consequent reduction in the flow of government finance to east Germany, the unified German public sector deficit [1] is expected to reach its peak in 1992, at around 6½% of unified GDP. The deficit is forecast to narrow thereafter. In contrast, the nominal level of the general government deficit in the United States is expected to increase in 1992 and 1993 and remain flat in 1994. This increase in the deficit over the next two years is entirely attributable to the federal government; state government budgets are expected to return to balance this year. Overall, the general government deficit is expected to reach 5½% of GDP in 1992 (including RTC expenditure), rising to 6% of GDP in 1993. The deficit declines as a fraction of GDP thereafter.

In Japan, the general government is in surplus. This position has enabled the Japanese government to introduce a modest expansionary fiscal package aimed at boosting domestic demand by front loading expenditure into the first half of the year. Government investment in the second half of the year is assumed to be increased to offset this front loading. These

(1) Estimates for the German fiscal deficit are on a public sector basis and include 'shadow' budgets for the Treuhand, postal and rail services.

measures combined with a cyclical increase are estimated to be sufficient to reduce the general government surplus by $^{3}/_{4}$% of GNP in 1992. Despite these initiatives, the Japanese public sector is expected to remain in surplus over the forecast period. In France, sectoral financial balances as a fraction 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 is expected to continue to diminish at a gradual pace. Deficit reduction efforts are likely to progress at a faster rate as interest rates fall, since the average maturity of the Italian government's outstanding debt is relatively short, ensuring that the interest burden of debt repayment is likely to decline in line with interest rate reductions. Hence, as long as the Italian government continues to run a primary surplus, the prospects for a reduction in the general government deficit to GDP ratio are good.

Developing world

The current account of eastern Europe and the former Soviet Union is expected to remain in deficit throughout the forecast period. This is largely because of a sharp contraction in the volume of exports in 1992 as most of these countries restructure their major industries. Thereafter, export volumes are expected to recover quite strongly. However, the performances of the different countries in the region are likely to show considerable divergence, with Czechoslovakia, Hungary and Poland likely to do better than the other countries in the group.

Growth in the newly industrialised economies of South Korea, Taiwan, Hong Kong and Singapore was relatively unaffected by the slowdown in the major industrialised nations. This reflects two factors. First, intra-regional trade has expanded and, second, countries in the Far East (including Japan) have benefited from German unification which enabled them to gain market share. The forecast increase in OECD demand will help to maintain strong growth in the block and enable these Far Eastern countries to increase further their share of world export markets.

Overall, the growth rate of OECD industrial production is expected to recover to $1^{1}/_{4}$% in 1992, following a small contraction in 1991. This improvement in OECD prospects gives rise to stronger growth in world trade volumes. This trend is likely to continue in 1993.