The international environment

- *Growth of the world economy has yet to gain momentum. In North America, moderate expansion appears to be under way, but has not yet become firmly established. Japanese economic growth continued to slow during the first half of the year. In Europe, activity has generally been subdued, with the impact of restrictive monetary policies beginning to take hold in Germany and continuing to exert a negative impact on demand in most other countries.*

- *On the inflation front, US and Japanese consumer price increases are expected to remain moderate and in Canada, inflation reached a twenty-year low. European inflation performance is more mixed. Rising unit labour costs have added to inflationary pressure in Germany, while rates of consumer price increase in Spain and Italy, though falling, remain high. Only in France, among the larger continental countries, has price performance been broadly satisfactory. Monetary aggregates are hard to interpret, having slowed significantly in Japan and the United States, but stabilised at a high level in Germany.*

- *The apparent hesitancy of activity prompted the US Federal Reserve to cut interest rates by half a percentage point at the beginning of July, lowering the discount rate to 3.0%. The federal funds rate fell by a similar amount to 3.25%, and leading commercial banks responded by reducing prime lending rates from 6.5% to 6.0%. The weakness of activity and demand led the Bank of Japan to cut its Official Discount Rate by half a percentage point to 3.25% at the end of July.*

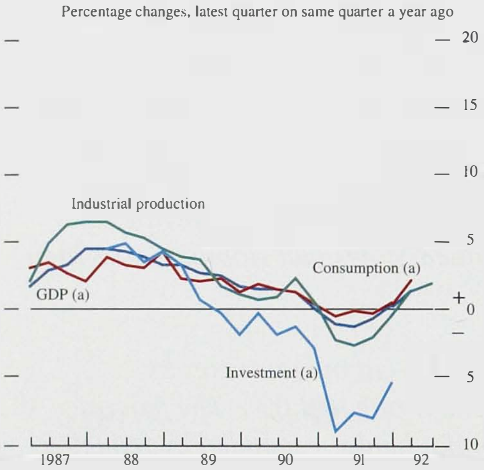
- *The Bundesbank responded to continued strong monetary growth by raising its discount rate from 8.0% to 8.75% on 16 July, although market interest rates in Germany were largely unaffected. Some, though not all, European countries responded to the Bundesbank by tightening their own monetary conditions. The Banca d'Italia had to act forcefully on several occasions in June and July in response to pressures in financial and currency markets, precipitated initially by the uncertainty caused by the 'No' vote in the Danish referendum on the Maastricht Treaty.*

World economic growth *has remained sluggish*

Growth of the world economy has yet to gain momentum. The relatively robust increases in GDP recorded in Japan and Germany in the first quarter are thought to have overstated the underlying strength of activity; and Q2 growth in the United States was slower than in the previous quarter. The Munich Summit of G7 countries noted signs of a global recovery, and stressed the need to pursue policies to support it without rekindling inflation. The latest IMF and OECD world economic forecasts point to moderate activity growth for this year, and broadly confirm the prospects outlined in the Bank's world forecast and reported in the May 1992 *Bulletin*.

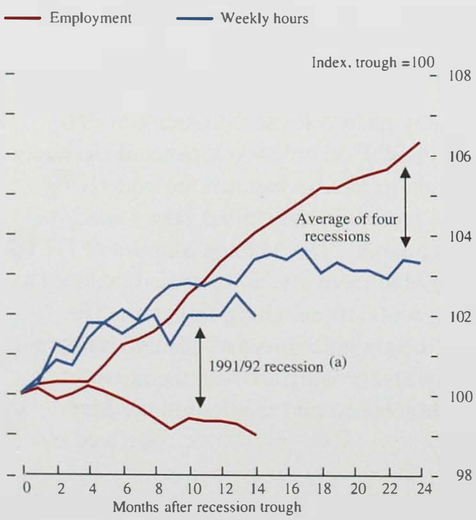
Each of the three largest economies continues to face structural problems, which complicate the task of strengthening economic growth. High levels of personal and corporate indebtedness in the United States and Japan may mean that a given easing in monetary policy has less of a stimulatory effect than in earlier periods. Thus, in the United States, despite a fall in short-term interest rates of 2.25% over the year to April 1992, weaker than expected

US activity *grew modestly in the first quarter*



(a) Before release of Q2 advance national accounts data and revisions.

Employers in the **United States** *seem reluctant to increase staff significantly*



(a) Trough is April 1991.

economic data, the continued movement towards price stability and sluggish monetary growth prompted the Federal Reserve in early July to cut short-term interest rates once again. In Japan, the Bank of Japan responded to the weakness of demand by lowering the Official Discount Rate to 3.25% on 27 July, and further fiscal measures to stimulate economic activity seem likely. In Germany the structural problem is of a different character. The monetary authorities are having to deal with the effects of unification, which have widened the fiscal deficit, stimulated demand, helped fuel wage pressures and added to the pace of monetary growth. These factors have resulted in a progressive tightening of the monetary stance, the latest step in which was a rise of three quarters of a percentage point in the discount rate on 16 July.

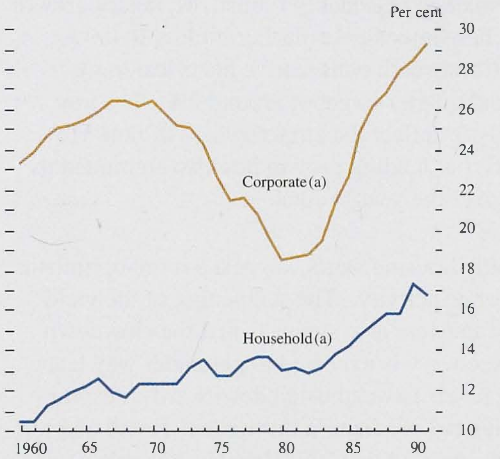
Modest expansion in the **United States** *has continued . . .*

In the United States, economic growth picked up somewhat in the first half of 1992. Even so, it remains quite moderate by historical standards for the period following a recession. Preliminary estimates suggest that GDP grew at an annual rate of 1.4% in the second quarter, after a rise of 2.9% in the first quarter. Growth in the first quarter of 1992 was led by a significant increase in final sales, particularly consumer spending. In the second quarter, fixed investment and stockbuilding were the main sources of growth, as businesses quickly responded to the pick-up in demand by investing in new equipment and stepping up production. Manufacturing output has been on an upward trend since January and is now back above the levels of last summer. The car industry—which has typically accounted for much of the volatility in industrial production—has staged a sharp rebound. By contrast, activity in the housing sector slowed in the second quarter, after growth in the first quarter had been exaggerated by mild weather conditions. Still, with mortgage rates at their most attractive since the mid-1970s, the sector is likely to continue to support overall growth.

Labour market conditions improved between February and May, contributing to increased consumer spending. June data recorded a drop of 63,000 in non-farm payroll employment, the first decline since January. This may in part have reflected seasonal distortions, as employment increased by 198,000 in July. Despite a rise in non-farm payrolls of 228,000 over the last three months as a whole, the unemployment rate has risen from 7.2% in March to 7.7% in July, reflecting increased participation rates. For some time, concern over the pace of growth appears to have discouraged employers from significantly increasing staff. In the manufacturing sector, while the rise in the average work week since April last year is broadly in line with that recorded in the initial phase of previous recoveries, employment has continued to decline. With overall employment prospects uncertain, and consumer confidence still weak, the growth rate of consumer spending may remain modest over coming months.

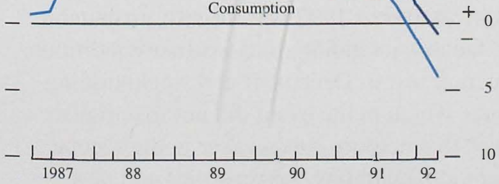
Money and credit data remain weak. In June, M2 had grown at an annual rate of only 1.5% over its fourth quarter base, compared with a target range of 2.5%–6.5%. The aggregates have been distorted by a number of factors, however, not the least of which has been the progressive restructuring of portfolios away from depository institutions. Credit growth also remains slow,

Gearing *is high in the* **US household** *and* **corporate** *sectors*



(a) Ratio of debt (at book value) to assets (at current value).

Consumer spending *in* **Japan** *has remained relatively robust*



particularly in the household sector where outstanding instalment credit fell sharply in both April and May. Although income gearing in the household sector is still high, debt servicing costs have fallen. Hence, consumption is likely to grow, albeit at a moderate pace as debt repayment continues. Corporate gearing has risen consistently since the beginning of the 1980s, and has probably contributed to the recent recession by inhibiting capital expenditure. However, business sector net interest payments as a proportion of cash flow have fallen, and this may facilitate a slow pick-up in investment.

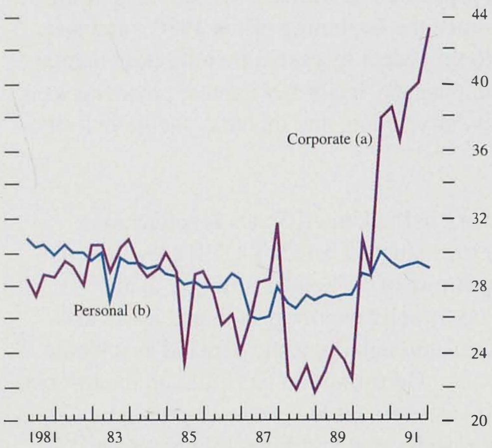
The hesitancy of recovery in the United States is reflected in Canadian economic performance. Canada's GDP growth in the first quarter, at an annual rate of 1.7%, was stronger than expected; it was boosted by solid export growth and a rise in government expenditure, although domestic demand as a whole increased only marginally. Consumption has fallen in the last two quarters, and real retail sales remain lower than a year ago. Although employment rose in May and June, following six consecutive monthly declines, the unemployment rate has now risen to 11.6%, largely resulting from increased entry of part-time female workers into the labour force. There are, however, some tentative signs of recovery. Consumer confidence picked up sharply in the second quarter despite the rise in unemployment. Housing starts have trended upwards during the first half of the year, manufacturing output picked up towards the end of the first quarter and new factory orders grew on a year-on-year basis for the first time since late 1989. However, the external sector, led by exports to the United States, is likely to be the main source of growth, with the Canadian dollar having depreciated by around 5% against its US counterpart since November last year.

. . . but **Japanese** *economic growth continued to slow during the first half of the year*

In Japan, GNP rose at an annual rate of 4.3% in the first quarter, having fallen slightly in the final quarter of last year. This apparent strength, however, was partly because of leap year effects on recorded consumption, which, according to the Economic Planning Agency, accounted for half of the 0.8% growth in consumption. The rise was also boosted by government stockbuilding, which had been depressed in the final quarter of last year and rebounded in the first quarter for reasons associated with rice stock purchases. Industrial output fell by around 2.7% in the first quarter, and stock levels remain higher than a year ago.

The slowdown has been driven by a fall in business investment which seems to have been due in part to financial factors. During 1990 and 1991, the ratio of corporate debts to assets rose sharply. This reflected an increase in borrowing and, more importantly, the fall in the value of the Nikkei share price index, which reduced the value of corporate shareholdings. The Nikkei index declined by 40% between January 1990 and December 1991; it has fallen a further 27% over the seven months to July. Although gearing is highly cyclical in Japan, the change in stock market valuation may be having real effects on expenditure through its impact on companies' financial positions. However, while balance sheet adjustment is taking place, survey evidence still shows companies to be relatively cash-rich for this stage of the cycle, having borrowed freely when it was cheap to do so. Liabilities in the

Gearing *has risen rapidly in the* **Japanese corporate** *sector*



Source: Bank of Japan—Financial flows, Economic Planning agency—Capital stock.

(a) Ratio of corporate net debt to physical capital.
(b) Ratio of personal sector liabilities to assets.

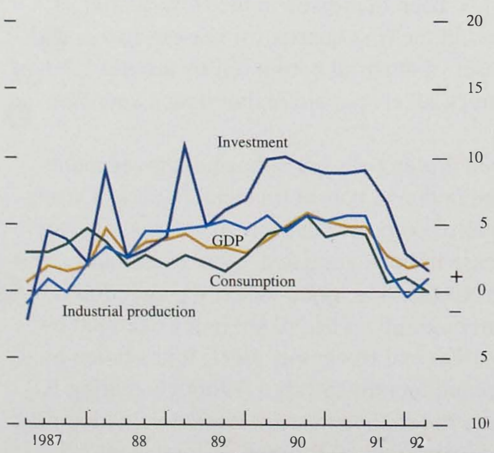
Japanese household sector have also risen relative to financial assets, but not to unprecedented levels. There are risks to the household sector in the aftermath of the asset price boom—the number of personal bankruptcies has risen markedly—but spending has so far remained reasonably robust. Monetary growth (M2+CDs), however, has slowed even further, falling to 0.9% over the year to June (its seventh consecutive historical low), compared with a second quarter target of around 2%. The low growth continues partly to reflect the attractiveness of non-M2 postal savings deposits, but lending growth has also continued to slow, falling to 2.7% over the year to June.

Other indicators, notably housing starts, suggest a more optimistic picture of future economic activity. The steepening of the yield curve since the start of the year also suggests that the slowdown may be short-lived. Recovery is expected to get under way later in the year once stock levels have adjusted downwards; despite further declines in industrial production during the second quarter, the June Tankan survey showed that stock levels were still generally considered 'excessive'. The high level of corporate indebtedness and deteriorating profit forecasts have depressed business confidence, although the Tankan survey recorded an expectation of improved confidence in the third quarter.

An economic package is expected to be put forward in late August, to be followed in October by a 'supplementary budget', providing a possible stimulus of around ¥6–7 trillion. The measures will probably be divided between additional central government capital expenditure, financed by bond issuance, and additional measures via the Fiscal Investment and Loans Programme. A package of the size mentioned would be around 1.3% of GNP. The timing of its effect on output is uncertain; lags in implementation could mean there is no noticeable impact on GNP until 1993.

Most areas of **expenditure,** *except residential investment, have weakened in* **Germany**

Percentage changes, latest quarter on same quarter a year ago



Output growth in **Europe** *is likely to be moderate*

Output in the European Community (excluding the United Kingdom) grew by around 1.5% in the first quarter of 1992. However, as this figure was helped by a temporary surge in recorded activity in western Germany and elsewhere, it overstates the strength of the underlying growth in GDP. Data relating to the second quarter suggest that high interest rates are having their expected effect, offsetting the effects of higher government spending in Germany and exercising a dampening effect on demand elsewhere in Europe.

While the overall picture in the European Community is one of moderate real growth there are important differences in the situation of individual economies. The sharp growth in western German GDP in the first quarter of 1992 was largely attributable to a number of special factors, including mild weather conditions, a catching-up of production lost in December and stockbuilding ahead of expected strikes which in the event did not materialise. Preliminary data suggest that activity was weaker in the second quarter, as precautionary stockbuilding was reversed and new orders remained weak. In addition, weakening competitiveness and high interest rates continued to depress activity. As a result, manufacturing production is expected to be flat this year at best. Investment in machinery and equipment was low in the first quarter and is expected to remain lacklustre, although a pick-up in investment in eastern Germany will create demand for investment goods from the west. One of the few sectors remaining quite robust is the construction industry, where the effects of unification together with favourable tax measures continue to provide a stimulus to growth.

Labour market conditions have deteriorated: seasonally-adjusted unemployment has increased by 120,000 over the first half of the year in western Germany against the background of a rising labour force. As demand slows, employers will find it increasingly difficult to cover higher wage costs stemming from recent settlements by raising prices, and may be forced to cut jobs further.

In the second half of the year, activity should be supported by slightly more buoyant private consumption and an improved export performance. Private consumption is likely to be boosted somewhat by the abolition of the 7.5% income tax surcharge on 1 July this year (worth some DM 10 billion) and by increases in child benefit and family allowances (worth a further DM 7 billion). Consumers may also bring some expenditure forward, ahead of the VAT increase in January 1993. Despite the expected pick-up in domestic demand, growth in western Germany is likely to be around 1% for 1992.

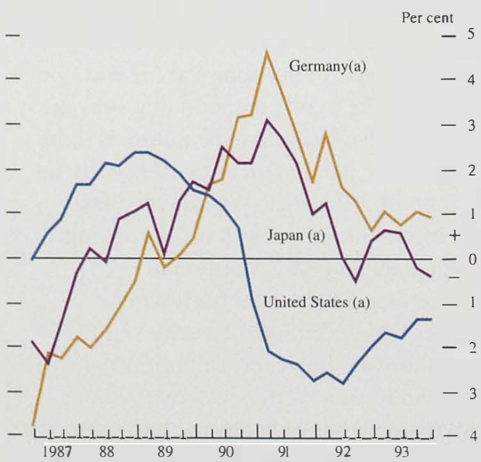
Largely responding to continued rapid growth in money and credit aggregates, the Bundesbank increased the discount rate on 16 July, from 8.0% to 8.75% while leaving the Lombard rate unchanged. There was little effect on money-market rates, which remained close to the Lombard rate of 9.75%, but the increase in the discount rate put pressure on banks to raise their lending rates to personal and commercial customers. One factor behind the need to maintain a tight monetary policy stance is the Government's large budget deficit. On 1 July, the German Finance Minister Mr Waigel won Cabinet approval for widespread government spending cuts in 1993 to offset continuing subsidies to eastern Germany. The growth of federal expenditure is to be limited in nominal terms to 2.5% per annum until 1996, with an overall public spending limit of 3% growth per annum. This would help to reduce the central government's net borrowing requirement next year by a planned DM 2.5 billion to DM 38 billion. By 1996, central government borrowing is planned to fall to well under DM 25 billion. To achieve lower borrowing by all public authorities, however, commitments will also be needed from state and local governments, over whose spending the Federal Government has only limited influence. The combined deficit of the three levels of government (federal, state and local) and the German Unity Fund is expected to reach 4% of GNP this year. On a broader definition of the public sector, which could take in the social security fund, public corporations and the Treuhandanstalt, the deficit may well total around 6% of GNP this year.

French GDP grew by 1.0% in the first quarter, helped by a relatively strong external performance in the wake of competitiveness gains. Investment, however, remains weak, with stock levels still high, and business and consumer confidence recovering only cautiously. For the year as a whole, the French economy is expected to grow by around 2%. Full recovery will depend on a revival of domestic demand, which continues to be inhibited by high real interest rates. Meanwhile, unemployment continues to rise; the unemployment rate was 10.3% in June. Government measures aimed at the long-term unemployed are expected to influence levels over the medium term.

In the first quarter, Italian GDP was up 0.6% on the previous quarter; however, it is uncertain whether even this modest increase can be sustained. Current indicators show a mixed picture, although some forward-looking indicators, such as industrial orders and wholesale sales, are relatively positive. The key economic policy priority in Italy is to deal with the budget deficit. An emergency fiscal package was the first item to be considered by the new Italian government. The cabinet proposed a series of measures to reduce this year's deficit by Lit 30 trillion: even if fully implemented, however, this will not be sufficient to bring the deficit close to the original 1992 target of Lit 128 trillion (8.5% of GNP).

There has been little evidence of a pick-up in Spanish activity in the early part of 1992, although it is expected that EXPO and the Olympics will stimulate growth in the second and third quarters of the year. Registered unemployment fell from 15.4% in March to 14.5% in June. An important concern is the rise in the fiscal deficit, which is well in excess of the government's target. The mid-year package of fiscal measures is designed to rein the central government deficit back to 2.6% of GDP this year, although this objective will not be easy to achieve.

Output *in the* **United States** *remains well below potential*



Source: Bank of England estimates.

(a) Actual output relative to potential.

Although **inflation** *is not generally seen as the key problem, it is still a concern in some countries*

In the United States and Japan, wage pressures and the moderate pace of monetary growth suggest prospects for inflation remain good. In Germany, although consumer price inflation has eased in recent months, the monetary authorities remain concerned about high monetary growth and cost and price pressures. For each country, supporting evidence is provided by the relationship between actual and potential output. In the United States, where slow growth has left output well below its potential level, it should be some time before capacity constraints place upward pressure on prices. In Japan, output fell towards potential at the end of last year, and is forecast to remain at around its current relative position. By contrast, estimates suggest that the level of German GDP is still a little above potential. Such calculations need to be treated with caution, however, particularly in the case of Germany following unification.

After rising in the second quarter, **oil** *prices have eased; other* **commodity** *prices have fallen in real terms*

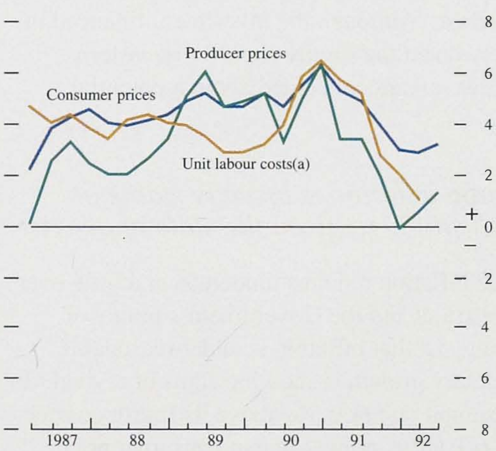
The price of oil rose during the second quarter, initially as a result of concerns over future disruption to Libyan supplies following the imposition of limited United Nations (UN) sanctions, and latterly when OPEC unexpectedly continued its second quarter production ceiling into the third quarter (with the exception that Kuwait could continue producing at capacity—a level which is constantly rising as damaged wells come back on stream). However, oil prices fell back in early July when the International Energy Agency revised down its forecast for oil demand in the second half of the year.

The prospective sale of US$1.6 billion of Iraqi crude, with proceeds to be channelled towards humanitarian aid, war reparations and the funding of UN operations in Iraq, continues to overhang the market.

Non-oil commodity prices have risen slightly in dollar terms over the three months to mid-July. Despite coffee and cocoa prices both falling to long-term lows within the period, price stabilisation talks partially reversed the decline and the overall food index recovered some of its previous losses. Agricultural non-food prices were also down, but metals prices rose. The relative weakness of the dollar, however, meant that all commodity prices fell in real terms.

Inflationary *pressure in the* **United States** *remains moderate*

Percentage changes, latest quarter on same quarter a year ago



(a) Unit labour costs (whole economy) = $\frac{\text{average earnings}}{\text{productivity}}$

Prospects for **inflation** *in the* **United States** *remain reasonably satisfactory . . .*

The headline rate of inflation was 3.1% in June, and the core rate (excluding food and energy) was 3.8%. The service sector has provided the main source of inflationary pressures, but latest data suggest that these pressures are abating. Similarly, with nominal wage increases gradually easing, and some cyclical productivity gains still to come through, growth of unit labour costs is likely to slow further.

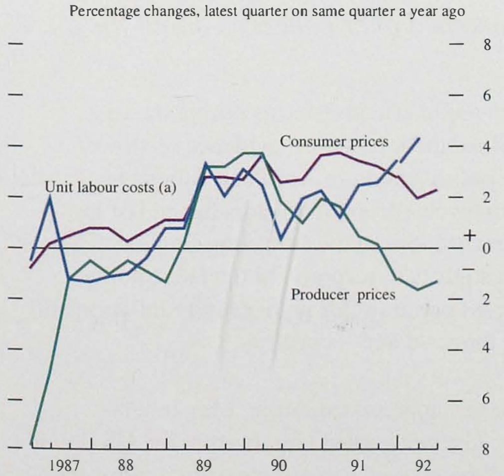
The rate of inflation in Canada eased to 1.1% in June, the lowest of the G7 countries and Canada's lowest rate in over twenty years. Core inflation (excluding food and energy) fell to 1.9%, ahead of the Bank of Canada's inflation reduction target of 3.0% by the end of 1992. With wage settlements falling and activity below potential, price pressures are likely to remain low for the rest of the year.

. . . and **inflationary** *pressures remain subdued in* **Japan**

In Japan, annual consumer price inflation fell back to 2.0% in May, from 2.4% in April, and is expected to remain in this range for some time to come. Wholesale prices are continuing to fall and the June Tankan survey reported that more respondents expected prices to fall than rise. With labour market conditions still tight, and recent wage settlements moderate, higher unit labour costs have come primarily from the effect of lower output on productivity growth.

Unit labour cost *growth in* **Japan** *reflects the slowdown in activity*

Percentage changes, latest quarter on same quarter a year ago



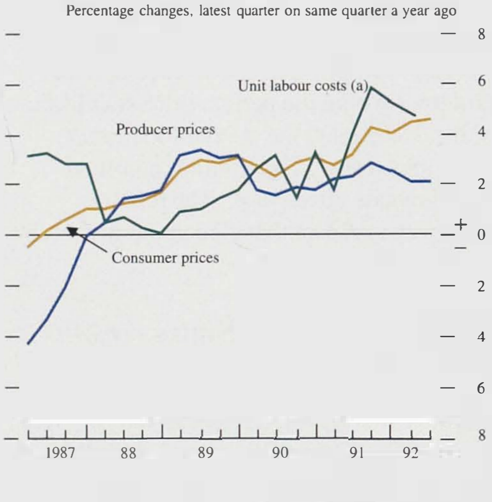
(a) Unit labour costs (whole economy) = $\frac{\text{average earnings}}{\text{productivity}}$

Despite the slowdown in **German** *economic activity,* **inflationary** *pressures remain*

Headline inflation in Germany has fallen rapidly from its peak of 4.8% in March, to 3.3% in July. Much of this reduction reflects price rises last year dropping out of the annual calculation—notably the increases in indirect taxes and the pick-up in service sector inflation, particularly related to housing. Underlying inflation may also have eased a little, but this year's wage round is likely to generate continuing cost pressures for employers. Although average industrial pay increases have fallen to 5.7% this year from 7% in 1991, they remain high given the weak state of the economy.

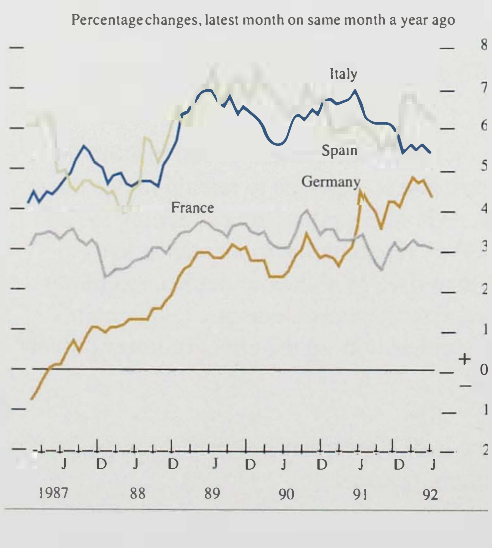
The effect of recent settlements on unit labour costs will depend on productivity growth. Bank of England estimates suggest

Inflationary *pressure remains a problem in* **Germany**



(a) Unit labour costs (whole economy) = average earnings / productivity

European inflation *rates remain high given the state of activity*



productivity for the whole economy is unlikely to increase by more than 1.5%–1.75% over the coming year. If so, this would imply a rise in whole economy unit labour costs of 4%–5%. This would be below the 1991 increase of 5%, but would be higher than during the 1980s when unit labour costs in western Germany increased by an average of around 2% per annum.

Money supply growth remains strong. In June, M3 was an annualised 8.7% above its fourth quarter target base, well outside the 3.5%–5.5% target range. Special factors such as uncertainty over the withholding tax and the shape of the yield curve explain some, but by no means all, of the overshoot. The overshoot seems primarily to be associated with a surge in bank lending which was growing at over 12% per annum in the early part of the year. A particularly buoyant component of bank lending has been credit for restructuring in eastern Germany, much of which is at subsidised rates of interest. Although the investment financed in this way will ultimately boost the supply capacity of eastern Germany, the authorities remain concerned about a potential build-up of liquidity.

Elsewhere in **Europe** *inflation is broadly stable or declining, although still high given the state of activity*

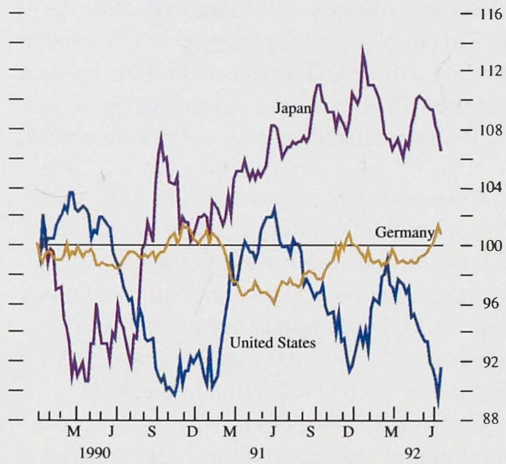
French consumer price inflation remains moderate, at a little over 3%. Continued pay restraint and the Government's policy of supporting the franc suggest that inflation is under reasonable control, although monetary growth is showing signs of revival. In May, M3 grew at an annual rate of 6.5% above its fourth quarter base, outside the 4%–6% target range. Italian consumer price inflation eased slightly in June to 5.5%, down from 5.7% in May. By the end of the year, consumer price inflation is forecast to fall to around 5%, as large price rises last year fall out of annual calculations. The medium-term inflation outlook is more encouraging, with average earnings growth expected to fall from around 10% last year to 5% this year as wage indexation comes to an end (contractual wage inflation fell to 3.7% in May, from 6.7% in April, and a further step reduction is expected in November). In Spain, recorded consumer price inflation has eased from a peak of 6.9% in March to 6.2% in June, but underlying inflation has been more stubborn.

The **US dollar** *weakened over concerns about the pace of recovery . . .*

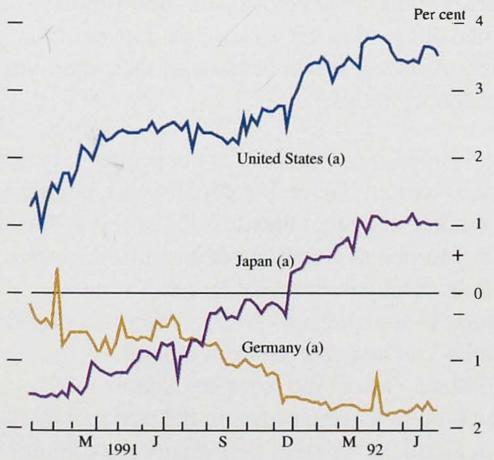
The US dollar appreciated in effective terms during the first quarter of the year. Since then, however, evidence of slower growth and monetary policy easing in April and July have weakened the dollar to levels recorded towards the end of last year, and close to its record low against the deutschmark. The yield curve steepened slightly in response to the latest policy easing, with a significant premium for higher future inflation still built into the price of longer-dated securities.

In effective terms, the yen appreciated during May but has weakened since then. The yen gained largely from the US dollar's weakness, but in late July gave up some of its gains against the dollar. The yen has lost ground against the deutschmark, as interest rate differentials widened.

The **dollar's** *effective exchange rate has weakened in recent months*



The **three major economies** *have very different* **yield curves**



(a) Long-term minus short-term interest rates.

. . . *while the* **deutschmark** *was strengthened by expectations of a rise in relative* **interest** *rates*

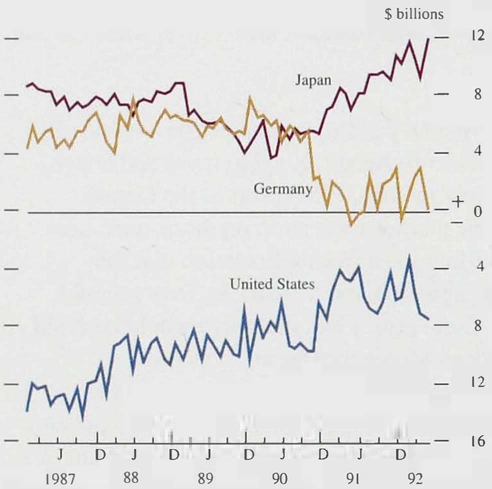
The deutschmark remained firm during the second quarter, reflecting adverse sentiment towards the dollar and pressure on the higher-yielding ERM currencies following the Danish referendum. More recently, the cut in the US discount rate and the rise in the German discount rate have drawn attention to interest rate differentials between the United States and Germany, and supported the strength of the deutschmark. The German yield curve is inverted, but stable; both short and long-term interest rates have been at around their current level since the end of last year.

Within the ERM, the higher-yielding currencies have generally lost ground against the deutschmark, Belgian franc and Dutch guilder over the past few months. The result of the Danish referendum focused the market's attention on those currencies which had been benefiting most from speculation that the 'convergence criteria' agreed in the Maastricht Treaty would mean a tightening of fiscal policy and that there would be rapid moves towards European Monetary Union. Economic fundamentals came under greater scrutiny. The Italian lira experienced particular pressure in the lower half of the narrow band because of political uncertainty ahead of the formation of the Amato government and the need for strong budgetary action to address the growing fiscal deficit. Despite the announcement of a short-term fiscal package and proposals for structural fiscal reforms in July, the Banca d'Italia found it necessary to raise the discount rate for a second time in a month to 13.75%. Short-term market interest rates rose above 17%.

In Spain, short-term rates exceeded 13% after the Banca d'Espana tightened intervention rates in the face of declines in the peseta exchange rate relative to the deutschmark within the upper half of the wide band and concern over the impact of a rise in the standard rate of VAT on inflation. The tax increase was incorporated in a fiscal package designed to limit the overshoot in this year's budget deficit. The French franc remained fairly close to its central rate against the deutschmark; short and long-term market rates have edged up slightly over the month. After an initial rise in short-term interest rates to protect the krona following the referendum, the Danish authorities have been able to relax monetary policy slightly. The escudo exchange rate relative to the deutschmark has fallen by 3% since the Danish referendum.

In Europe, bond yields have risen sharply since the Danish referendum on 2 June, particularly in those member states perceived to be most reliant on the discipline of EMU—and specifically the convergence criteria embodied in the Maastricht Treaty—for an improved economic performance. Ten-year bond yields in both Italy and Spain are around 1½ percentage points higher than before the Danish vote, with current differentials against Germany of 6% in Italy and 4.3% in Spain. Yields in France are also over half a percentage point higher, at around 9.1%, although the differential against Germany has risen rather less, reflecting a firming in German yields to 8.1% following the German discount rate increase.

External accounts *have moved broadly as expected*



External accounts *are moving broadly as expected* (1)

The US current account deficit narrowed in the first quarter to $5.3 billion from $7.2 billion, mainly reflecting an improvement in the trade balance. However, monthly data show that the trade balance has deteriorated more recently, widening in each of the three months to May. This may reflect the pick-up in US growth relative to its major trading partners. The Canadian trade balance has benefited from stronger US activity and competitiveness gains as the Canadian dollar has depreciated against its US counterpart.

The Japanese current account surplus rose to 3.1% of GNP in the first quarter from 2.6% in the final quarter of last year, with most of the rise coming on the non-trade side owing to large end-financial-year payments. In the first quarter, export volumes (goods & services) rose by 1.6% and import volumes by 0.6%, underlining the modest rise in the external surpluses expected this year. The second quarter saw a slight reduction in the trade surplus on a balance of payments basis, effectively because of a temporary pick-up in oil imports as import duties were reduced at the beginning of April. Tensions stemming from the widening gap between the US and Japanese external balances persist.

On the Japanese long-term capital account, the underlying pattern has remained broadly unchanged for the last year or so, with substantial net long-term capital inflows to Japan. Short-term capital flows have turned outward in net terms, with Japanese banks curtailing lending overseas largely because of their desire to improve BIS capital adequacy ratios.

Western German exports to eastern Germany are expected to be broadly flat this year, and western German companies are hoping to regain some of the market share that they lost in the rest of the world in 1991 when they turned to supplying demand from eastern Germany. Strengthening activity in France, Germany's most important trading partner, is assisting a recovery in German export growth. But less stimulus can be expected from other parts of Europe and the United States, where the recovery is more subdued. While the pick-up in foreign orders in the past months could mark a revival in Germany's export performance, the trade surplus remains far lower than in previous years. The current account deficit rose slightly in the first quarter partly owing to an increased deficit on the tourism balance and higher interest payments to foreign investors.

The French trade balance moved into surplus in the final quarter of last year, reflecting weak import demand and rising demand for exports underpinned by substantial improvements in price competitiveness. The first six months of this year have registered a cumulative trade surplus of FF 17 billion compared with a deficit of FF 30 billion for 1991 as a whole. The Italian trade balance has deteriorated in recent months because of a loss of competitiveness.

Fiscal pressures have increased in **Poland, Hungary** *and the* **CSFR** . . .

Inflationary pressures in Poland, Hungary and the Czech and Slovak Federal Republics (CSFR) have continued to moderate,

(1) The annual 'World payments trends' article, which contained the identified deployment of oil exporters' funds table, has been discontinued. A version of this table recording developments in 1991 is, however, available on request from Group 8, Financial Statistics Division, Bank of England.

while output in Hungary and the CSFR remains substantially below its level in the same period of 1991. Only in Poland are there even tentative signs of an end to the decline in economic activity. Fiscal pressures in all three countries have increased, with the risk of crowding out private sector activity. In Poland, the recent decision by parliament to approve the government's target of a 1992 budget deficit equivalent to 5% of GDP is a positive development and one which should assist the Polish authorities in their negotiations with the IMF regarding a new facility.

All countries in the region have made some moves towards introducing structural reforms, but, with the exception of the CSFR, only modest progress has been made. The privatisation programme in the CSFR, begun in June, is perhaps the most radical of all the privatisation approaches and could provide the basis for a comprehensive restructuring of the enterprise sector. However, in the CSFR, as well as in other countries, attention needs also to be given to the resolution of the problem of bad loans within the banking sector. The pace of structural reforms in the CSFR will depend on the outcome of current discussions concerning the future status of the federation.

. . . and the pace of reform in **Russia** *appears to have slowed*

In Russia, the Government's economic reform programme has come under increasing internal criticism from those advocating a more gradualist approach. Output has continued to fall and, if policies remain unchanged, monthly inflation, which was estimated to be in the region of 20% in mid year, is projected to reach much higher levels by the end of the year. The money supply has increased rapidly as credits have been injected into the economy to help alleviate inter-enterprise debts. This situation has been further exacerbated by the credit creation policies of several other republics. Negotiations are under way to find a workable solution to controlling monetary policy in the rouble zone. Agreement on this issue may alleviate the pressure on some other republics to introduce their own currencies, thereby avoiding further disruption of inter-republican trade. Measures to tighten monetary policy, lower the fiscal deficit, unify the exchange rate and liberalise energy prices will still be needed if the reform programme is to be kept on track and if full access to the $24 billion package of Western financial assistance is to be assured. Approval by the IMF Board of a $1 billion First Credit Tranche during August is an indication that the first steps in this process have been taken. However, further progress on structural reforms will also be necessary. Although the privatisation law was passed in June, along with the Government's privatisation programme for 1992, the Supreme Soviet failed to approve the President's decree on bankruptcy.

Despite the debt deferral agreements (which were extended at the end of June for a further 90 days), the Former Soviet Union continues to experience difficulties servicing those debts which fall outside these agreements. This reflects both the unwillingness of exporters to submit foreign exchange to the centre and the fact that the purchase of critical imports has been given precedence over debt servicing. The new foreign exchange surrender requirements introduced on 1 July may go some way to addressing this problem.

Growth prospects for debtor **less developed countries** *look more promising . . .*

A decade on from the onset of the LDC debt crisis, growth prospects for the LDCs have improved. One factor has been the reduction in the external debt servicing burdens of LDCs as a result of lower US dollar interest rates. Debt reduction—through the implementation of Trinidad terms by the Paris Club for official debt of the poorest countries or 'Brady-style' for commercial bank debt—has also contributed. The most important explanatory factor, however, behind the improved performance of LDCs has been the adoption of sound economic and structural adjustment policies. Significant regional variation exists. For example, some LDCs, particularly Egypt and in Latin America, have experienced substantial capital inflows as a result of repatriation of capital flight or regained access to the international capital markets, while others, particularly in sub-Saharan Africa continue to experience severe financing difficulties, in spite of their adjustment efforts.

. . . while the newly-industrialised economies of the **Far East** *have continued to grow rapidly*

In the Far East, the newly-industrialised economies (Hong Kong, Korea, Singapore and Taiwan) have continued to enjoy strong real GDP growth, ranging from 3.9% in Hong Kong to 8.4% in Korea for 1991. In the region as a whole, the pace of growth is expected to be sustained, although individual country experience is likely to differ—whereas growth in Hong Kong is projected to accelerate, the Korean economy is expected to decelerate as the authorities seek to dampen inflationary pressures. In Australia and New Zealand, there are tentative signs of a muted recovery, largely owing to a turnaround in the stock cycle and improved export performance.