The international environment

- *Growth of the world economy remains modest at around 1½% a year. The US economy has continued to expand, but relatively slowly. In Japan, growth has slipped back further. The slowdown in Germany, and tight monetary policies, have contributed to generally slower growth in Europe.*

- *Inflation among the major six economies was essentially unchanged in the third quarter at 3%–3½%; inflationary pressures remain subdued in most countries.*

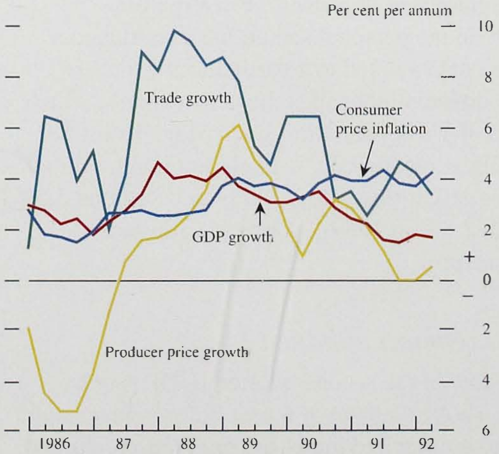
- *Monetary policies are still divergent. In the United States and Japan, monetary policy was loosened further during the third quarter. In Germany, monetary policy remains tight despite the 25 basis point cut in the Lombard rate in September.*

- *Continued high German interest rates, together with speculation regarding the prospects for EMU in the run-up to the French referendum on the Maastricht treaty, led to unprecedented strains in the ERM in September. The lira was devalued and then suspended, at the same time as sterling, from the mechanism. The peseta was also devalued and exchange controls were temporarily introduced.*

- *The differential between US and German short-term interest rates widened over the summer months. This, and expectations of a further widening, caused the deutschmark to strengthen further against the dollar. The interest differential has since narrowed, however, and the dollar strengthened in October. The yen strengthened with the Japanese Government's policy announcements in August and with the increased uncertainty surrounding ERM currencies.*

- *Japan responded to the continued slowdown in its growth with the announcement of a ¥10.7 trillion fiscal package. Italy and Spain have restrictive budgets in the face of slowing economies.*

Growth of the **major six** *overseas economies slowed in the second quarter*



Note: Major six GDP weights: CPI.

World economic growth *has remained modest*

GNP in the major six industrial countries grew by around 1½% (at an annualised rate) in the second quarter. In the United States, GDP growth slowed in the second quarter, but rose again in the third. GDP growth also slowed in the second quarter in Japan, where the slowdown is proving lengthier than previously expected. GNP should, nevertheless, still grow by around 2% this year. In Europe, German GDP fell in the second quarter; and the tight monetary policies elsewhere resulting from ERM discipline have contributed to slower growth in other European countries. World trade grew steadily in the second quarter at around 4%.

Inflation performance in the major six overseas economies has continued to improve with consumer prices rising at an annual rate of 3%–3½%. Inflation in Japan and France fell further in the third quarter and was broadly stable in the United States, Canada and Italy. In Germany the annualised rate of inflation fell over the summer, but progress has been slower than expected. This may reflect lags in the feed-through of import prices to domestic prices.

US growth *increased in the third quarter*

US output growth slowed in the second quarter to 1.5% (at a seasonally adjusted annualised rate) from under 3% in the first

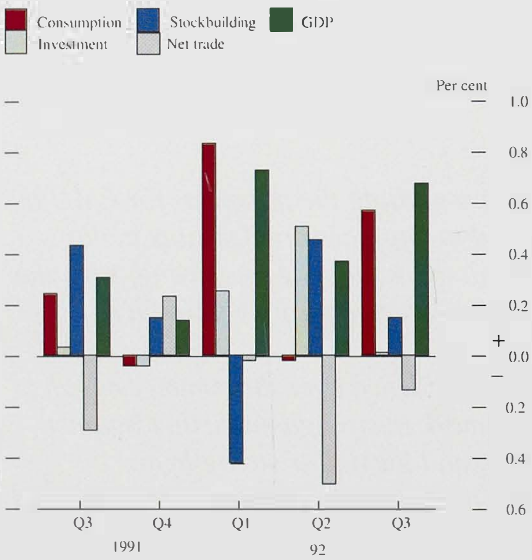
Major six activity and inflation

Percentage change per annum (a)

	1991	1992Q1	1992Q2
GDP	0.9	1.8	1.6
Trade	3.0	4.1	4.1
Producer prices	1.5	-0.3	0.5
Consumer expenditure deflator	4.0	3.1	3.4
Whole economy unit labour costs	4.2	2.8	2.8

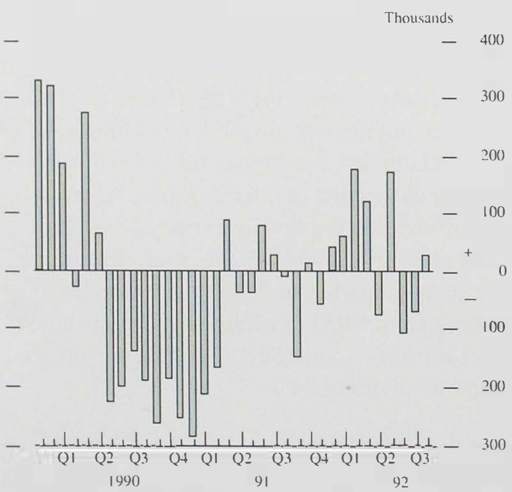
(a) Major six GDP weights.

US growth *rose in the third quarter*



Note: defined as change in component relative to GDP in previous quarter.

Non-farm payrolls *remain weak*



Note: US Department of Labour statistics.

quarter. In the third quarter, output grew by 2.7%, largely because of stronger domestic demand. Consumption rose by nearly 3½%, stockbuilding was less than in the previous quarter (but still made a positive contribution to growth), and business investment was flat following a large rise in the second quarter. Some unwinding of the stock position may be expected, but the third quarter figures suggest an improving output position.

The personal sector faces a number of difficulties which may yet inhibit recovery. Income growth has been weak. Although real personal income in the third quarter was 1½% higher than a year earlier, this wholly reflected higher transfer payments; while the fall in interest rates has reduced interest income by $35 billion since 1990. Employment prospects are also unusually depressed for this stage of the cycle and this has weakened consumer confidence. Non-farm payrolls rose by 27,000 in October but have yet to show signs of sustained growth. The unwillingness of firms to expand permanent employment primarily reflects expectations of continued sluggish demand. Uncertainties over likely changes in healthcare costs and government regulations may also have encouraged firms to increase hours worked rather than employment. Finally, household finances are still fragile with households continuing to reduce their outstanding credit. Households' cash flow has nevertheless improved, and the Federal Reserve estimates that around one half of the increase in debt servicing ratios during the earlier expansion has been reversed.

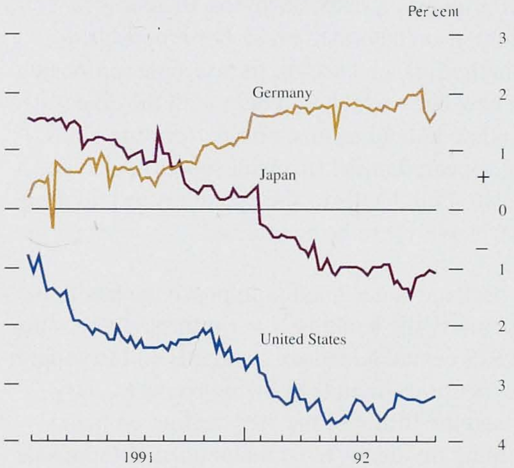
The corporate sector has improved its balance sheet position more quickly. Debt reduction has been more marked in the corporate sector, with a fall in business sector liabilities relative to nominal income. Post-tax corporate profits have also improved, with a 1.3% rise in the second quarter, following a rise of over 11% in the first. Profit margins have strengthened with unit labour costs rising more slowly than prices.

The prolonged weakness of economic activity, against a background of subdued inflation and slow monetary growth, prompted a further easing of monetary policy in the third quarter. The 0.25% cut in the federal funds rate, to 3%, on 4 September was the twenty-fourth policy easing in three years. The easing has no doubt underpinned current levels of growth. But structural imbalances, particularly in the personal sector, have restrained a stronger recovery. The cuts have led to a particularly wide short-term interest rate differential against the deutschmark, which has contributed to the dollar's depreciation since May. Room for manoeuvre on fiscal policy, meanwhile, is likely to remain limited. The federal government deficit this year is likely to be around 5.5% of GDP (compared with 2.6% in 1989), of which a substantial portion is structural in nature.

In Canada, *activity remains subdued*

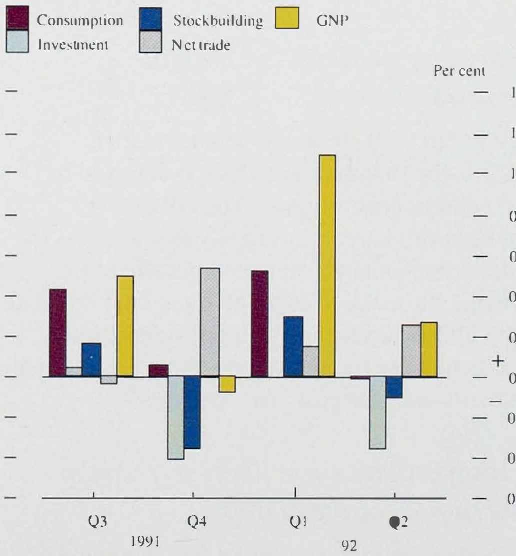
Canadian growth was slow in the second quarter. GDP rose by 0.2%, taking it to 0.6% above its level of a year before. Investment fell by 3% in the second quarter and industrial production returned to around the level seen in the trough in early 1991. Destocking continued, with manufacturers' stock levels falling to their lowest level for over three years, indicating that the adjustment may now be largely complete. The rise in personal sector consumption in the second quarter—the first since 1991—has provided tentative signs

The **yield curve** *remains very steep in the* **United States**



Note: 3-month money-market rates less 10-year Government bond rates.

Japanese GNP *slowed considerably in the second quarter*



Note: calculated as US chart.

of recovery. But consumer confidence remains depressed by weakness in the labour market, with unemployment now above 11.0%. And housing investment is still subdued with the level of housing starts appearing to flatten in the third quarter. Mortgage rates have fallen to a twenty-five year low of 8.5%.

Canada's policy of low interest rates has been disrupted by the sharp fall in the Canadian dollar. This, in turn, has reflected uncertainties over the outcome of the constitutional debate—although market reaction to the 'no' vote was muted. The authorities raised the bank rate by three percentage points to nearly 8% in early October to prevent too rapid a depreciation. If the pressures on the currency subside, a return to lower interest rates is likely in view of the weakness of activity and low inflation.

The **Japanese** *economy continues to slow down . . .*

GNP in Japan rose by 1.1% (at a seasonally adjusted annualised rate) in the second quarter. This was slightly stronger than had been expected, but was still considerably lower than growth in the first quarter of 4.3%. In the latest quarter, with no growth in domestic demand, the net stimulus came from the external sector. This reflected a smaller fall in exports (3%) than in imports (5%), suggesting that relative demand was more significant than competitiveness in improving the external position. Consumer spending was flat in the second quarter, and corporate investment is still in retrenchment though some signs of recovery are apparent within residential investment.

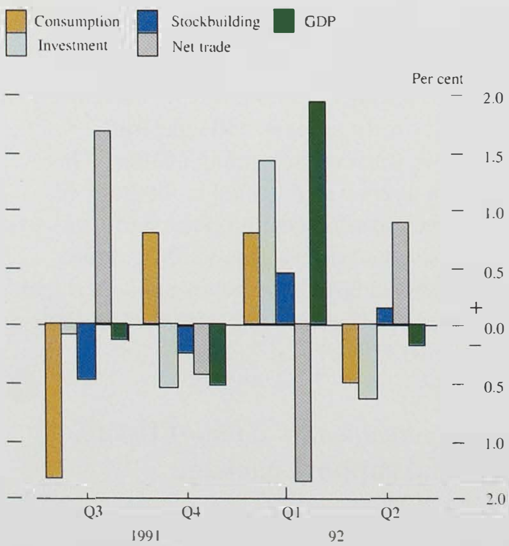
Other indicators for Japan suggest that the downturn may have further to go. The provisional figures for September show a rise in industrial production and a fall in stocks, leading to the largest monthly fall in the stock:output ratio for three years. This suggests that the corporate sector may be making some progress in its cyclical adjustment, but the stock:output ratio still appears to be 15% or so above trend. The slackness of domestic demand has generally prolonged the adjustment process, and industrial production is likely to remain weak in the coming quarter. This demand squeeze on manufacturers was reflected in the Bank of Japan's August Tankan survey in which the proportion of firms who consider stock levels excessive had risen again, to 38%. More generally, the survey—conducted before the policy announcement in August—showed a further deterioration in business confidence to its lowest level since the mid-1970s.

. . . prompting the announcement of a major **fiscal stimulus** *and a* **financial support package**

The announcement of a large fiscal expansion package on 28 August had a marked impact on market confidence, with the Nikkei index rising initially by over 4,000 points from its six-year low (of 14,309) ten days earlier. The headline package announced a ¥10.7 trillion stimulus (2.3% GNP), somewhat larger than anticipated. ¥8.6 trillion of this represents additional public spending and ¥2.1 trillion represents increased private industrial investment, funded via the Fiscal Investment and Loans Programme. Details of the financing and of some of the precise measures have yet to emerge, but the impact on GNP is likely to be substantial. Assuming the measures are fully implemented, GNP growth is likely to be around 2% in financial year 1992, while the main impact of the package—involving a boost to growth of up to one percentage point—is likely to emerge in the 1993 financial year. The package, which includes the advance of public sector purchases of land, was primarily a response to the weakness of domestic demand. But it also elaborated on earlier proposals to combat the problems in the financial sector, for example, proposing the establishment of a new body which will help with the disposal of banks' real estate collateral held against non-performing loans. The proposals initially appeared in the financial support package announced on 18 August. Full details of the operation and funding of the scheme, however, have yet to be announced.

The financial support package is designed to improve the health of the financial, and particularly the banking, system through measures to help banks achieve BIS capital adequacy standards and to support the stock market. The measures include allowing banks to carry share holdings at cost and the lifting of the 40% ceiling on banks' payout:profit ratio (helping dividends to be maintained without sale of shares). As the provisional September figures show, the banks' attempts to improve their capital adequacy have been quite successful with the ratios of city banks and long-term credit banks mostly in the range 8.5%–9.0%, reducing their vulnerability to further falls in share prices. In October, the Ministry of Finance increased its official estimate of the bad debts of the major twenty-one banks to ¥12.3 trillion (over 2% of GNP). The authorities have signalled their recognition of the depth both of the economic slowdown and of the financial sector's difficulties with the latest policy initiatives.

Western German output *fell in the second quarter*



Note: calculated as US chart.

In **Germany**, *activity has weakened in both the* **corporate** *and* **personal** *sectors . . .*

Western Germany's GDP fell by 0.3% in the second quarter, following growth of 2% in the first quarter (which is believed to have been bolstered by seasonal distortions). The fall in GDP, although less than had been expected, was broadly based across the main components of domestic demand. In the corporate sector, machinery and construction investment each fell by around 4%, and manufacturing and agricultural production also fell significantly. Industrial production was broadly flat; personal sector consumption, which has slowed markedly over the past year, fell by 1%.

. . . and high **real interest rates** *are likely to restrain growth in the* **western** *part of the country*

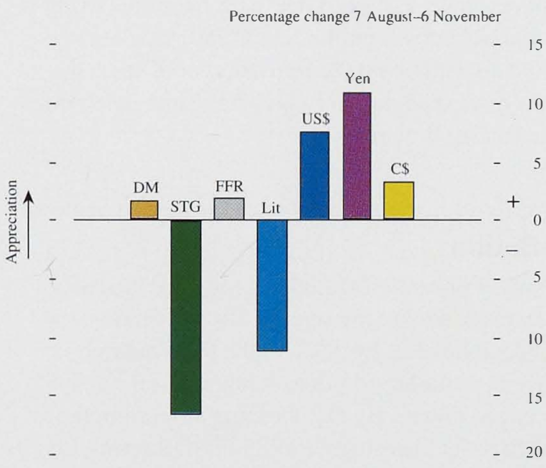
Machinery orders fell during the third quarter by 2%, to around 5% below their level of a year ago. Business confidence, although still well above its level in the recession of the early 1980s, has also weakened further. In contrast, German consumer confidence, according to the EC survey, recovered in the third quarter. This movement may partly reflect the removal of the 7½% 'solidarity' tax surcharge. Some stimulus to personal sector spending could come from falling inflation, which will raise real earnings growth. But this could be offset by falls in employment; unemployment was 6.5% in September.

Real short-term interest rates in Germany have risen over the last quarter to stand some six percentage points above those in the United States and four percentage points above those in Japan. The 25 basis point cut in the Lombard rate (to 9.5%) and the 50 basis point cut in the discount rate have guided market rates down by about 80 basis points to below 9%. Further easing will depend on the Bundesbank's assessment of monetary and inflation conditions, which are likely to be influenced by the slowdown in growth. The general government deficit was lower than expected in the first half of 1992 and is generally projected at around DM 120–130 billion for the year as a whole, compared with DM 110 billion in 1991.

Activity *has weakened elsewhere in* **Europe**

In the other large European countries, activity remains subdued. In France, GDP growth slowed in the second quarter to 0.2%, down from 0.9% in the first quarter but still enough to keep the annualised growth rate above 2%. Domestic demand was particularly weak as consumption fell. Indicators of activity in the third quarter suggest that there may have been a further weakening: business and consumer confidence both fell and industrial production remained flat.

Changes in **effective exchange rates**

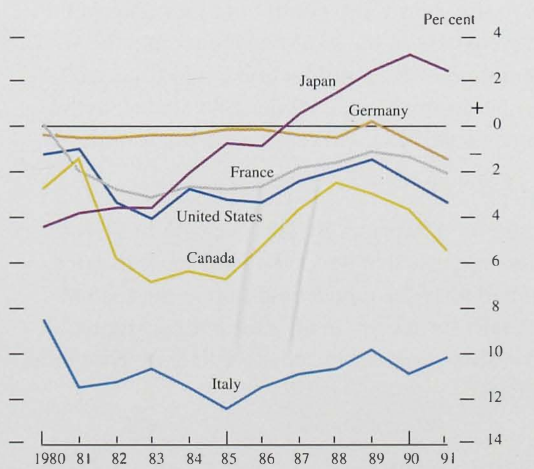


French real short interest rates, which had ranged between 6% and 7% since late 1989, rose sharply with an increase of 2½% in repo rates in September as the authorities strove to defend the franc against severe speculative pressure before and after the Maastricht referendum. The French government announced a tight budget for 1993, with planned real spending rising by only 0.6% and with a target government deficit of FF 165 billion (2.2% of GDP)—close to this year's projected outcome. The proposed package includes a small reduction in the tax burden faced by companies and households. In the recent past, actual deficits have tended to exceed their targets, and the target is itself based on a forecast of 2.6% growth next year (stronger than our own projections—see the note on page 368).

High **interest rates** *are depressing activity in* **Italy** *and* **Spain**

In Italy, growth is likely to weaken over the coming year. GDP rose by 0.2% in the second quarter, compared with 0.6% in the first. The positive contributions to growth from government and personal spending offset falls in investment and net trade. The latest industrial production figures show that the pick-up in the early part of the year has not been maintained. A sharp rise in interest rates over the third quarter is likely to have damaged further the prospects for investment, which fell quite sharply in the second quarter. Orders are depressed, confidence is low and measures to restrain wage growth will further dampen demand.

Italy *is planning a tighter* **fiscal position** *in 1993*

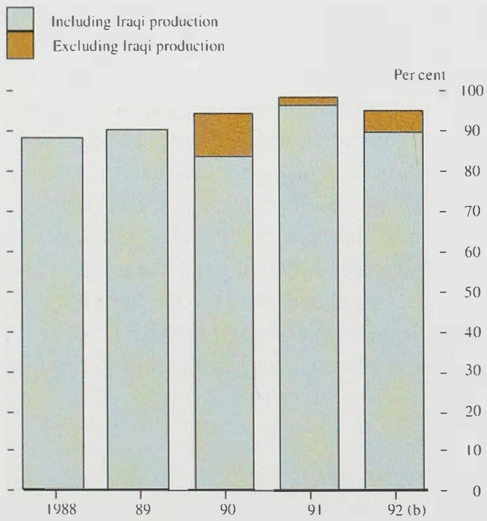


Note: general government deficit (–) surplus (+): Bank estimates.

Official interest rates were raised sharply in September in the defence of the lira. The discount rate was increased by 1.75 percentage points to 15%, while repo rates rose, sharply at times, to stand close to 21% on 22 September. Real short-term rates were around 12% by end-September. In the middle of the month, the Banca d'Italia ceased its intervention in support of the lira. This followed a 7% devaluation of the lira, which has now fallen by 16% from its previous central DM parity. For a detailed account of tensions within the ERM see pages 383–87. The Italian authorities are keen for the lira to re-enter the ERM. The timing will depend, among other things, on progress on the 1993 budget, and, possibly, on the approval of the EC loan. The budget includes cuts in health and pension provisions (causes of previous budget expansion) and a freezing of government expenditure at 1992 levels. Fiscal savings (relative to base) of around Lit 90-95 trillion are envisaged in order to contain the deficit at this year's expected level of Lit 150–160 trillion (which is, nevertheless, 10½% of GDP). The 'Delegation Law' on structural reforms in health, pensions etc was passed on 22 October. This facilitated a marked easing in market rates and a one percentage point cut in the discount rate (to 14%) on 23 October. The 'Decree Law' covering the remaining two thirds of the budget is likely to be passed shortly.

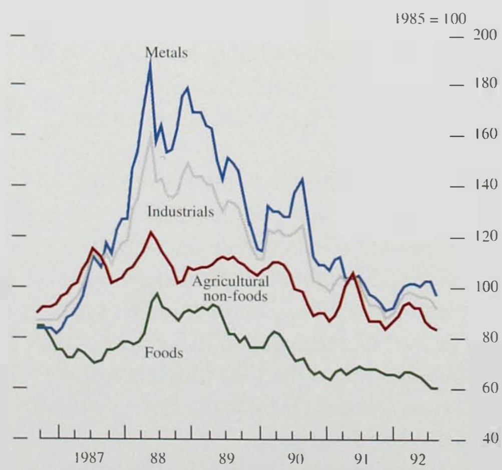
The outlook for Spain has deteriorated. Output this year is expected to grow by only 1¼%, and is likely to slow further next year. This primarily reflects the impact of persistently high interest rates (market rates rose to over 14% before the peseta's devaluation within the ERM), and a significant tightening now under way on the fiscal side. Despite a supplementary budget in July, the deficit is still likely to exceed the 2.6% target for this year. The Cabinet has now approved the 1993 budget, which is intended to cut the central government deficit to 2.3% of GDP with measures to cut defence spending and hold down public sector pay. Spain's defence of the peseta also involved the introduction of special deposits designed to limit speculation (which have had deleterious effects on domestic financial markets).

OPEC oil production *is close to capacity* (a)



(a) OPEC capacity includes Iraq.
(b) Bank of England estimates.

Non-oil commodity *prices fell in the third quarter*



Commodity *prices generally contributed to downward pressures on* **inflation**

Real oil and commodity prices fell slightly in the third quarter, following the modest recovery in the second. In SDR terms, the all-items commodities index fell by 4.9% in the third quarter. There was little change in dollar oil prices while non-oil commodity prices edged down. By October, the all-commodities price index had fallen to its lowest since 1985 in SDR terms, and its lowest since 1987 in dollar terms. The depreciation of sterling, however, meant that sterling commodities prices were at their highest since August 1991.

The world oil price rose slightly to $19.50 per barrel in the third quarter. The rise reflected forecasts for a colder winter than in recent years, together with continuing concerns over future disruption to supply on a number of fronts, particularly the uncertainty surrounding Former Soviet Union production. Although conditions remain rather tight and this may limit downward pressure in the short term, continuing increases in OPEC capacity, continued weakness in the world economy and the possibility of a resumption of Iraqi production could trigger a marked downturn in prices once seasonal demand abates, in the absence of confidence that OPEC will reach agreement limiting excess production.

The fall in non-oil commodity prices by just over 4% in SDR terms over the third quarter suggests that the downward trend in prices since 1987 has resumed after the modest pick-up in the second quarter. The largest falls have been in agricultural non-foods, prices of which have been particularly sensitive to slow growth in the developed countries.

US inflation *remains steady . . .*

Inflation in the United States remains modest, with consumer price inflation at 3% in the third quarter. There are few upward pressures on prices in the short run: the output gap remains large so that output will remain below potential for some time, even as the recovery gathers strength. Monetary growth has also slowed: M2 growth fell to 1.8% in the third quarter. But the usefulness of M2 as a guide to monetary conditions remains in doubt since its slow growth partly reflects disintermediation and balance sheet restructuring. The exceptionally steep yield curve, however, suggests that markets remain concerned about longer-term inflationary prospects.

Canada continues to experience the lowest inflation in the G7. In September consumer price inflation stood at 1.3%, while core inflation (excluding food and energy) was at 1.6%, around half the target rate for end-1992. Although the recent depreciation of the Canadian dollar carries inflationary risks and producer price inflation has recently picked up, these upward pressures seem likely to be contained by the low level of activity and, in particular, the weakness of the labour market.

. . . while in **Japan** *there has been a modest further fall in* **inflation** *. . .*

The fall in inflation in Japan this year continued in the third quarter, when the rate of increase in consumer prices dropped to 1.9% (compared with over 2% in the second quarter). Wholesale price inflation has been negative for over a year, and in September was still falling by more than 1% a year. The appreciation of the yen has contributed to lower import prices, while the relative weakness of the labour market, as employment growth has slowed and hours worked have fallen, has reinforced the downward pressure on prices. The rate of growth of hourly earnings in manufacturing fell to around 2½% in the second quarter (compared with over 4% a year earlier), indicating the cyclical responsiveness of pay in Japan.

. . . and a continued slowdown in **monetary growth**

Monetary growth has continued to slow in Japan. M2 + CDs fell by 0.4% in September, while M3 rose by 2.8%. M2 growth has continued to be depressed by the portfolio shifts into Postal Savings deposits, although real M3 growth (which includes such deposits) is still historically low. This partly reflects the strong links between monetary growth and those sectors which have been particularly affected by the current downturn (notably real estate and financial services), and is less directly indicative of wider developments in the economy. Corporate lending is still slowing—to 2.3% in the second quarter compared with around 9% at the height of the boom. The slowdown mainly reflects a lack of corporate demand, although banks are exercising greater caution and raising their margins.

In **Germany,** *inflation gains have been less than expected, but the* **outlook** *is more promising*

Consumer price inflation in Germany fell in the third quarter to 3.6% (compared with 4.5% in the second). The fall reflects the base effects of last year's petrol tax increase and lower import prices resulting from the strength of the deutschmark. The gains from the strong deutschmark have yet to feed through fully to domestic prices and service sector inflation has been quite buoyant, possibly reflecting demand effects from the east. The outlook for underlying inflation is nevertheless quite good. Producer and wholesale price inflation have moderated, while the falls in price inflation and the weaker labour market appear to have influenced wage demands. Settlements in the first half of 1992 were around 5%–6% (compared with 7% in 1991) and initial claims in the 1993 round are lower than last year. The outlook for a continued fall in inflation is therefore promising, although the increase in VAT in January will add around 0.6 percentage points to inflation. The yield curve is highly inverted as long yields have fallen sharply, partly reflecting capital inflows and possibly the change in policy direction.

The rate of growth of the monetary aggregates continues to concern the German authorities, although factors directly affecting inflation (including the exchange rate and capacity utilisation) are now being more closely monitored. M3 growth picked up slightly to 9.1% in August (annualised relative to a fourth quarter base). Recent foreign exchange intervention has boosted M3 growth. But the main source of monetary expansion has been lending to the private sector, much of which has been associated with the developments in eastern Germany. This has been running at 11%–12% per year. The rapid pace of monetary growth in Germany to some extent also reflects a number of special factors—the inverted yield curve, uncertainty over interest income taxation and the demand for deutschmark money holdings in Eastern Europe. Its reliability as an indicator of monetary conditions may therefore be temporarily weakened. This suggests that less weight will be given to its performance in setting interest rates.

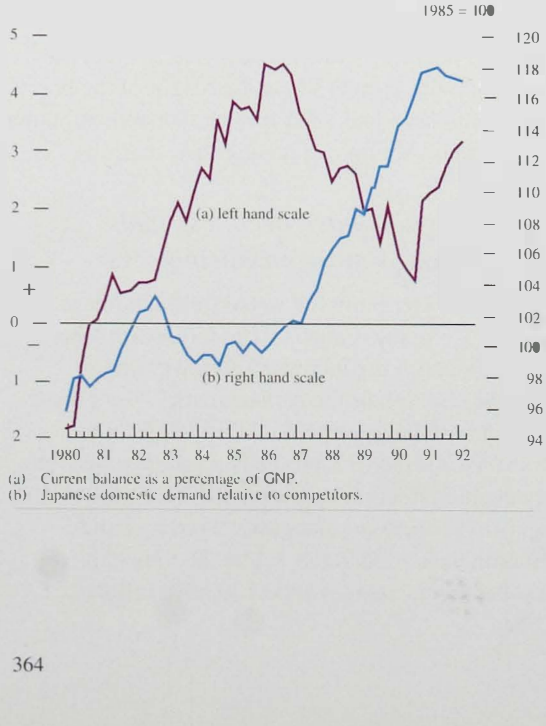
Inflation in **France** *has continued to fall . . .*

In France, the third quarter saw some further progress in reducing inflation, with the annual rate of increase of consumer prices falling to 2.6% in September. The latest falls partly reflected exceptional reductions in energy prices. But underlying inflationary pressures are likely to remain subdued with weak domestic demand, wage restraint apparently firmly established, and the appreciation of the franc in effective rate terms.

. . . but it is unchanged in **Italy** *and higher in* **Spain**

In Italy, there was little further progress on inflation during the third quarter. Consumer prices rose by 5.3% in the year to the third quarter, unchanged from the second quarter, though significantly better than the rate of almost 6½% recorded a year earlier. The agreement of the unions in July to abolish the 'Scala Mobile' (suspended last November) was a major advance in securing wage restraint; contract wage inflation has fallen from over 10% a year ago to 4.3% in August. These gains have yet to be fully reflected in the consumer price index, but the depreciation of the lira by 16% between the beginning of September and mid-October raises doubts whether a further fall in inflation can be sustained. Consumer price inflation in Spain rose to 5.8% per year in September, partly as a consequence of the two percentage point increase in the VAT rate at the beginning of August. Underlying inflationary pressures remain and will have been exacerbated by the devalutation of the peseta, although the profile will be improved by the unwinding of this year's two VAT increases and wage moderation.

The **Japanese trade surplus** *has increased with the change in relative demand*

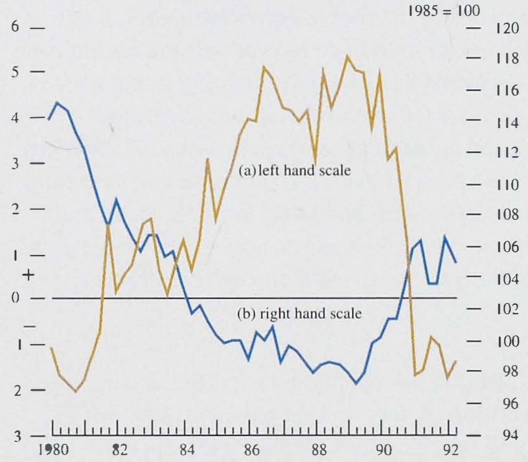


(a) Current balance as a percentage of GNP.
(b) Japanese domestic demand relative to competitors.

Relative **demand** *movements have widened the* **US trade deficit** *. . .*

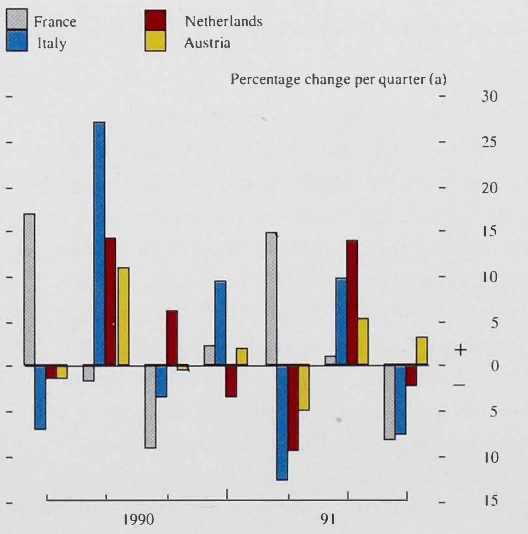
World trade growth has increased in the first half of the year to an annual rate of around 4%, partly because of the rise in US activity. The contribution of net trade to US growth was negative in the first

The **German current account deficit** *has narrowed as relative demand has weakened*



(a) Current balance as a percentage of GNP. Unified balance from July 1990.
(b) German domestic demand relative to competitors.

Weaker **German** *demand since reunification has had trade implications for its* **neighbours**



(a) Nominal trade flows.

half of the year. Since then, the US trade deficit has continued to widen—to $7.8 billion in July (compared with an average of $6.9 billion in the second quarter). The widening deficit seems to reflect changes in relative demand movements rather than in competitiveness.

. . . and increased the **Japanese** *surplus*

The Japanese trade surplus also continues to grow in line with relative demand movements. Part of the Japanese corporate sector expressed concerns regarding competitiveness as the yen rose above ¥/$120 in September, but it appears that most Japanese exporters will still be highly profitable at these rates. The first seven months of 1992 saw a 40% rise in Japan's trade surplus—to over $70 billion—compared with the same period of 1991. Behind this increase lay an 8% rise in export values and a 6% fall in import values.

In **Europe,** *the slowdown in* **Germany** *has reduced the growth of its trading partners*

The current account deficit in Germany was DM 26 billion in the year to July—slightly larger than during the same period in 1991. The trade surplus rose to DM 14 billion, almost twice its level in the same period last year. Growth in both export and import volumes has been subdued, but the impact of Germany's relative demand position in depressing imports has outweighed the effect of the appreciation of the deutschmark on exports. The strength of German net external demand had strong ripple effects in parts of Europe in 1990–91, but not with the United States or Japan. These are illustrated in the chart of the growth of exports to Germany, which shows that France, Netherlands, Austria and Italy have all benefited quite significantly at times. The effect has, however, diminished recently.

Slower growth in Germany contributed to a modest weakening in recent months in the trade positions of France and Italy. These are, nevertheless, still quite strong by historical standards, as weak domestic demand has reduced import growth in both countries. Recent exchange rate movements indicate that Germany, France (and Japan) should experience beneficial terms of trade effects on their visible trade balances in the short run, while countries such as Italy can expect some adverse effects. In the medium term, there will of course be competitiveness effects running in the opposite direction. But in most cases, relative demand effects are still likely to be dominant.

In **Russia,** *inflation has risen to 20% per month*

In Russia, there has been slippage from the end-year economic targets agreed since the approval of the IMF's $1 billion First Credit Tranche Drawing in August. The authorities have come under intense political pressure from the industrial lobby to ease policy, especially from Civic Alliance, who have now produced their own alternative reform programme which envisages a more gradualist approach to reform and a temporary return to state-controlled prices. Inflation has risen to around 20% per month, and the resulting capital flight has led to a sharp depreciation of the rouble. A tightening of policy and further structural reforms, notably on energy pricing, will be needed before the prospect of a full IMF programme, and with it access to the full $24 billion G24 aid package, becomes realistic.

The formulation of monetary policy remains complicated by a lack of co-ordination of policies in the rouble zone. Estonia, Latvia, Lithuania (and, in effect, Ukraine) have now all left the rouble zone. But monetary policy between those states remaining in the zone is not uniform. The 9 October CIS Summit, held in Kirgistan, discussed this issue—and agreement was reached by six CIS states (Russia, Belarus, Kazakhstan, Kirgistan, Uzbekistan and Armenia) to create a single monetary system and to set uniform credit and monetary policies among them. Russia has now given rouble zone states until the end of the year to define their own credit and monetary policies.

On the external front, Russia has openly declared that it can only meet some $2.5–3.0 billion of debt service payments due in 1992 and has been consulting with the Paris Club at intervals to try to negotiate a rescheduling package. Matters are, however, complicated by the joint and several liability of all Former Soviet Union (FSU) states to service this debt and by Russia's desire to take on 100% of the FSU's external debt obligations in return for other FSU states relinquishing their equivalent claims on FSU external assets. Some states have already signed up to this agreement.

Short-term prospects for **activity** *remain difficult in* **Eastern Europe**

Short-term prospects for economic recovery remain gloomy throughout Central and Eastern Europe. In Hungary, output is expected to decline this year by between 2% and 5%, and is unlikely to stabilise until later next year. Indicators in Poland continue to suggest that economic activity is no longer in decline, primarily owing to a marked improvement in export performance. In the Czech and Slovak Federal Republic (CSFR) official projections point to a modest expansion of activity during the fourth quarter of 1992. Prospects in Poland and the CSFR are, however, uncertain, partly because of slower than expected progress in some areas of structural reform. In particular, the Polish and Czechoslovak authorities have not yet implemented effective bankruptcy legislation, a necessary condition for a fundamental improvement in medium-term supply performance. The introduction of this legislation will, nevertheless, inevitably lead in the short term to further rationalisation before evidence of longer-term benefits are seen. To date, legislation of this sort has only been implemented in Hungary, and this accounts for some of the decline of output in this country.

Fiscal pressures remain strong in all countries of the region. These reflect continued shortfalls in revenue and sharp increases in public current expenditures. Tax reforms proposed for next year in most of these countries should improve revenue flows in the medium term. But governments continue to face the need to restrain, or reduce, current expenditure to limit deficits so as not to give renewed impetus to inflation. The success of the authorities in meeting this objective will have an important bearing on their ability to maintain access to external financial assistance.

The Czech and Slovak Republics have now formally agreed to separate, with effect from 1 January 1993. Agreement in principle has also been reached to establish a free trade area and a customs union post-separation. But other issues still remain to be resolved, including future currency relations. It has been proposed that the present Koruna currency area should be maintained for an interim period before the introduction of independent currencies, whose value would be fixed in terms of one another. But the extent to which this will be feasible will depend very much on the degree of convergence between the two republics.

The outlook for the other **less developed countries** *is improving*

Despite slow industrial country growth and weak commodity prices, economic growth in less developed countries (ldcs) has been strong, but with significant regional variations. Success has been owing in part to the effects of lower world interest rates and debt reduction operations (which have been strictly implemented), although there have been technical complications in the recent Argentine deal, and political factors may still affect the future of the Brazilian agreement.

The decisive factor, however, behind the improved outlook for many ldcs has been the adoption of a framework of credible and consistent fiscal, monetary, and exchange rate policies, along with complementary structural reforms. Implementation of these policies has been possible because of a developing consensus inside many ldcs about the need for adjustment and recognition that there are few feasible alternatives.

These adjustment efforts have received a vote of confidence in the form of large and growing capital inflows into many Latin American countries (as well as into Asia and the Middle East). The flows represent both returning flight capital and new investment from outside. Significantly, the composition of these flows is different from those of the early 1980s (although not of the 1920s), with foreign direct and portfolio investment and private bonds becoming more important. Such financing may prove more stable for the recipients than the bank credit flows of the late 1970s and early 1980s, but only if recipient countries maintain stable macroeconomic conditions. Such flows are also the result of external conditions, in particular of lower activity and interest rates in the United States. As a result capital has flowed into a large number of countries, despite substantial differences among ldcs in both domestic policies and economic prospects. To the extent that some of these inflows are speculative in nature, policy adjustment will be required to guard against the destabilising effects of any sudden reversal.

In contrast to Latin America, the economic performance of Africa is extremely weak—in part owing to the drought in South and East Africa which is the worst this century—but also because of continued high debt burdens. Further debt reduction initiatives along the lines of Trinidad terms are likely to be necessary for the poorest and most heavily indebted countries.

World economic prospects—latest Bank forecast[1]

Introduction

Activity in the major six overseas economies is forecast to rise by $1\frac{1}{2}\%$ this year—half a percentage point lower than our forecast of six months ago—and by 2%–$2\frac{1}{2}\%$ next year. Output is expected to rise most strongly next year in the United States and Japan. A further slowdown in the German and Italian economies is likely to result in European Community[2] GDP growth of 1% in 1992 and 1993, the same as in 1991. World trade in 1992 is expected to grow at the same rate as in 1991, and to rise to 5% in 1993. The slow increase in activity will restrict any resurgence in inflationary pressures. As a result, major six consumer prices are expected to rise by around 3% this year and next.

Activity

GDP growth in the major six overseas economies in the first half of this year was slightly higher than in the second half of last year, largely because of stronger than expected growth in Germany and Japan. This improvement is unlikely to be sustained, however, and it now seems probable that there will be no significant rise in major six growth until the second half of 1993. Output in Japan is expected to be flat in the second half of this year, before improving in 1993 as the effects of the planned increase in government expenditure begin to feed through. In Germany, the economy is expected to weaken, owing to a deterioration in Germany's net trade position (caused by the recent appreciation of the deutschmark), a fall in business investment and the effect on the personal sector of worsening employment prospects. Growth in North America is not expected to increase significantly in the short term, despite the current low level of real interest rates, because of the weak employment situation and the continued adjustment of corporate and personal sector balance sheets. Overall, although growth in the major six economies in 1992 is expected to be stronger than in 1991, it will remain generally subdued (see Table A).

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

Percentage changes over previous year

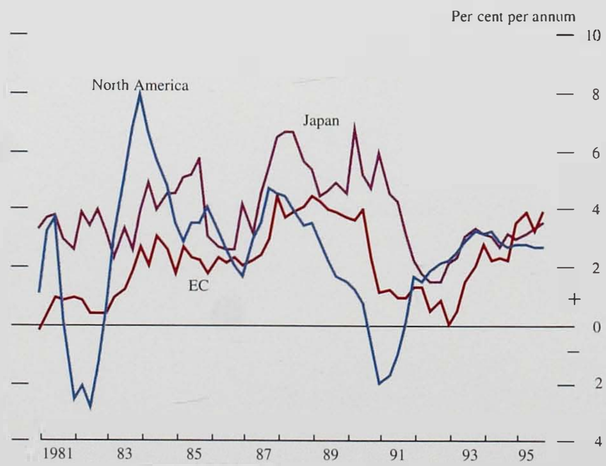
	1991	1992	1993	1994
Domestic demand	**0.3**	**1.7**	**2.3**	**2.8**
of which:				
Private consumption	0.8	1.8	1.7	2.5
Business Investment	-0.4	-0.1	2.0	3.3
Residential Investment	-5.8	4.1	5.3	3.8
Public expenditure	1.9	1.4	3.3	2.9
Stockbuilding (b)	-0.2	0.1	—	0.1
Net external demand (b)	0.5	-0.1	—	—
GDP/GNP	**1.0**	**1.6**	**2.2**	**2.8**

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

After exceptionally strong GDP growth in the first quarter of the year, western German output contracted marginally in the second quarter. Growth is not expected to recover in the second half of the year. The sharp slowdown in investment during the last three quarters is likely to continue in the short term in response to the lagged effect of tight monetary policy and the reduction in investment subsidies. While the recent appreciation of the deutschmark effective exchange rate and the sluggish state of world demand are likely to result in a deterioration in Germany's underlying net trade position. Consumption may benefit from the ending of the solidarity tax surcharge in July which has boosted personal disposable income. But a significant portion of the increase in disposable income is likely to be saved because of the weak state of employment prospects. As a result, it seems likely that GDP growth for 1992 will be around 1%. Growth prospects are not expected to improve significantly until world demand recovers and monetary conditions are loosened further. Even then, however, there are likely to be substantial lags in transmission.

In the United States, domestic demand growth rose in the first half of this year as lower interest rates helped to increase investment growth and tax rebates temporarily boosted disposable income and consumption. Despite a sharp deterioration in consumer confidence in July and August and renewed declines in employment, domestic demand growth continued to improve in the third quarter. In addition, the sharp fall in recent months in the yield on ten-year government bonds may further stimulate business and residential investment. GDP is projected to grow by $1\frac{3}{4}\%$ this year and by $2\frac{1}{2}\%$–3% next year, following a fall of 1% in 1991. The main downside risk to this projected

Chart 1
Growth of GNP



(1) These forecasts have been produced by the Bank's world economy forecasting team, with help from country analysts, using the Global Econometric Model supplied by the National Institute of Economic and Social Research.
(2) All Euro ean Community figures quoted in this article exclude the United Kingdom and are UK trade weighted.

recovery would be a failure of consumer and business confidence to break out of the vicious circle of expectations. With confidence low, demand and, hence, growth are constrained; and with low growth, confidence remains depressed.

Reflecting the recent modest improvement in US activity, Canadian exports have risen strongly. Despite this improvement in net trade, GDP growth has fallen with a marked slowdown in the growth of domestic demand. The recent fall in Canada's effective exchange rate is likely to result in only modest further net trade gains in the second half of this year. With domestic demand expected to remain sluggish, GDP is likely to grow by around 1% this year. By 1993, the improvement in Canada's net trade position should have improved the employment situation, thus boosting consumption and output.

As in Germany, Japanese activity was stronger than expected in the first half of this year as strong consumption growth in the first quarter offset a deterioration in investment. This growth, however, exaggerates the underlying strength of the economy. Capital expenditure may have further to fall as the corporate sector adjusts to its strong investment during the boom. Although income gearing will have improved with the reduction in interest rates, it will probably remain a depressing influence, especially as the effects of asset price deflation continue to influence corporate demand and the lending stance of banks. Consumption is also likely to be subdued by a decline in net wealth and by slower growth of real personal disposable income, reflecting the effects of lower profits on both bonuses and dividend receipts. These factors suggest that GDP growth for 1992 will be around 1³/₄%. Improvements in personal sector net wealth and the planned fiscal stimulus are likely to raise growth to around 2¹/₂%–3% in 1993.

French activity in the first half of this year was boosted by a strong contribution from net trade, while domestic demand remained depressed. Weaker activity in Germany, however, is likely to lower the trade sector's contribution to growth through the rest of the year. In addition, there are few prospects of a significant improvement in the domestic economy in the short run; personal sector financial wealth has fallen and personal disposable income growth remains low. Strong growth in the first half of the year should, nevertheless, ensure that GDP growth for 1992 as a whole is only a little below 2%. Similarly, Italian growth prospects are expected to deteriorate in the second half of the year, driven partly by developments in Germany and partly by the negative impact of high real interest rates upon business investment. As a result, growth in 1992 is likely to be around 1%. In 1993, the economy's prospects are expected to deteriorate further, owing to fiscal retrenchment and a further weakening of real personal disposable income growth caused by the continuing effects of the abolition of the Scala Mobile wage indexation and an expected rise in inflation following the lira's depreciation. Overall, European Community growth is likely to be around 1% in both 1992 and 1993.

Inflation

As expected, weak demand pressures in the major industrial economies have lowered inflation. Consumer price inflation in the major six overseas economies was 3% in the first quarter of 1992, down from 4¹/₄% a year earlier. Further improvements in inflation are unlikely in the short term as downward pressures from demand ease in some countries and indirect tax changes take effect in others. Overall, inflation is expected to average about 3% in both 1992 and 1993 (see Table B).

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

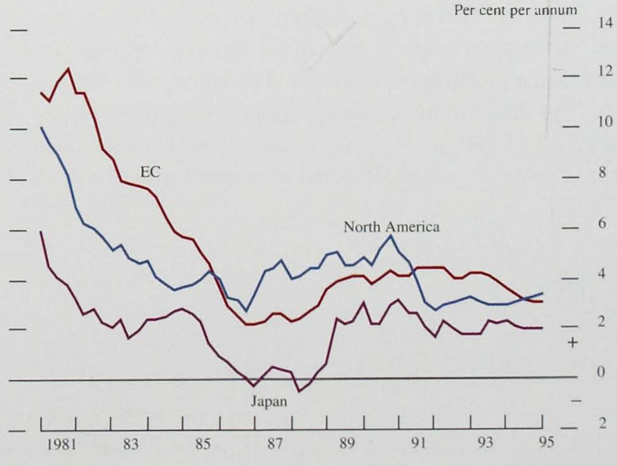
	1991	1992	1993	1994
Import prices (a)	-2.2	-1.6	1.6	1.8
Unit labour costs (b)	4.2	3.1	2.1	2.6
Wholesale prices	1.5	0.4	1.9	2.4
Consumer prices (c)	3.8	3.1	3.0	2.8

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

In Germany, there are signs that inflationary pressures are abating. The trend-setting IG Metall wage settlement provided increases of 5.8% for this year and 3.4% for the last nine months of next year—well below the levels seen in 1990 and 1991. Measured consumer price inflation fell by one percentage point in the third quarter of this year to 3¹/₂%. Further improvement in CPI inflation will probably be delayed by the increase in VAT from 14% to 15% scheduled for January 1993. But the trend of underlying German inflation is likely to continue to be downward.

In France, weak demand and low growth in earnings and unit labour costs are likely to keep French inflation below that in Germany both this year and next. Similarly, no increase in inflation is expected in the Netherlands and Belgium. The slowdown in Spanish activity since the beginning of the year suggests that Spain will continue to make progress in reducing its inflation rate. In Italy, however, the recent exchange rate fall—unless reversed—is likely to raise inflationary pressures in 1993. These pressures could raise the differential between Italian and

Chart 2
Increase in consumer prices



German inflation to as much as four percentage points, up from its level of $1^1/_4$ percentage points in 1992.

The sluggish recoveries in Canada and the United States have resulted in both economies operating well below potential. In addition, weak employment conditions have depressed earnings growth and reduced wage inflation pressures. With no prospects of a strong recovery in demand in either country, inflation is unlikely to rise significantly over the medium term. In Japan, weak demand and falling import prices have reduced consumer price inflation relative to 1991. As land prices continue to fall and demand remains weak, it seems unlikely that inflationary pressures will re-emerge in Japan in 1993.

Commodity prices

Mirroring the slowdown in world trade, the sharp decline in commodity prices in 1991 helped to reduce inflationary pressures in the major industrial economies. Prices of metals have shown some signs of recovery over the last six months. Other commodity prices, however, remain subdued and are likely to rise only gradually in 1993 in line with world demand. Less developed countries' food prices may be given a boost if agreements are reached at talks of the International Cocoa Organisation and the International Coffee Organisation in November.

Following two years of very sluggish growth, demand for oil has picked up in 1992. This increase in demand, combined with falling non-OPEC production, has raised oil prices by over 10% in US dollar terms in the last year. The higher oil price, however, is unlikely to generate significant inflationary pressures in the major industrialised nations given the general weakness of domestic demand. Demand for oil is expected to increase in 1993 as activity in the industrial world rises. OPEC production is forecast to be able to meet this increased demand, albeit at continued high capacity utilisation levels. Because of the restructuring of the Russian oil industry, non-OPEC supply is unlikely to play a significant role in the next two or three years.

Trade

The Japanese current account surplus has continued to expand, despite a slowing in the overall growth rate of its export markets. This is explained by some recovery in the United States, continued growth in the Far East markets and the slowdown in Japanese demand. The trend rise is likely to slow, but the current account surplus is still likely to be around 3% of GNP in 1992. By contrast, the United States' current account deficit is expected to widen further in 1993 as domestic demand continues to increase and export market growth remains generally subdued. The unified German current account deficit has not narrowed as quickly as envisaged six months ago. This is probably because German producers are finding it difficult to recapture lost market share, having reorientated production towards east Germany in the period immediately following reunification. The slowdown in the German economy should ensure, however, that the current account deficit diminishes in 1993. As inflation has slowed in France, the competitiveness of French exports has improved. The French trade balance has turned around dramatically over the last year, moving into surplus for the first time since 1986, and ensuring that the French current account will return almost to balance in 1992. Italy's current account deficit is unlikely to narrow much this year, despite recent exchange rate movements, as terms of trade effects are likely to dominate in the short run.

Public sector finances

The recently announced ¥10.7 trillion fiscal package in Japan, aimed at boosting economic activity, is likely to reduce Japan's general government surplus from $2^1/_4$% of GNP in 1991 to balance in 1993. This increase in government expenditure is likely to provide the largest single contribution to growth in 1993. In Germany, the recovery in the east German economy has been slow in gaining momentum and is likely to result in the general government deficit reaching $4^3/_4$% of unified GDP this year. By 1994, public sector debt in Germany is expected to approach 50% of unified GDP.

In the United States, the federal government deficit deteriorated steadily into the first half of 1992. Rising health and social security expenditures have added to the United States' fiscal pressures. The deficit is expected to reach $5^1/_2$% of GDP in 1992, and $5^3/_4$% of GDP in 1993. Unless specific actions are taken to reduce the deficit, it is unlikely that the deficit:GDP ratio will decline significantly over the medium term.

In Italy, the recent sharp increase in interest rates and the slowing of the economy is likely to result in a further deterioration in the public sector position, leaving the deficit at around $11^1/_2$%–12% of GDP in 1992. 1993 should see some improvement as interest rates are lowered and expenditure is restricted under the latest emergency fiscal package. The fiscal deficit is also expected to deteriorate in France as tax receipts are depressed by slow economic growth. For 1992 as a whole, the French general government deficit is likely to approach 3% of GDP, declining thereafter as activity picks up.