The international environment

Overview

The slowdown in western Europe and Japan is likely to be offset by stronger growth in North America

The short-term outlook for the world economy has changed little in aggregate over the past three months, with worsening conditions in western Europe and Japan largely offset by strengthening in North America. Activity in continental Europe was considerably weaker, with Germany moving into recession and Italy and Spain slowing appreciably (see Table A).

The recession in Germany seems set to continue into 1993. Although German market interest rates have fallen since September, their level is likely to remain relatively high until there is progress on fiscal consolidation and inflation, and while monetary growth remains strong. This will have consequences for the rest of Europe through Germany's strong intra-European trade links, and through the constraints its interest rate policy will impose on other countries, particularly members of the ERM.

Assessments of the economic prospects for *western Europe* have been revised downwards sharply. For western Germany, the Economics Ministry now forecasts 'a fall of 0%–1%' in GDP in 1993. This compares with the general expectation of a rise of ½% as recently as November, and a rise of 2½% projected only last spring.[1] Many recent forecasts suggest very slow growth for Italy in 1993; and even in France, where growth is still expected to be between 1% and 2%, there is concern about the strength of business demand.

In general, the deterioration in European growth prospects reflects the slowdown in investment, but with some weakening in private consumption. Business investment—boosted in the late 1980s and early 1990s by the prospect of the single market—has been particularly hard-hit by tight monetary policy, the fall in capacity utilisation and worsening competitiveness. The effect of the exchange rate turbulence since the autumn, though not yet apparent in terms of actual growth, is likely to have been adverse through its impact on consumer and business confidence and hence growth prospects.

During 1992, economic activity weakened significantly in *Japan*. The fall in GNP in the third quarter (see Table A) reflected, in particular, the deterioration in the corporate sector, where high debt levels, past over-investment and falling profits have created strong pressures for retrenchment. Adjustment may have considerably further to go.

In the *United States,* however, recent developments have been more encouraging. Growth in the second half of the year was the strongest since 1988, and seems to be becoming well-established.

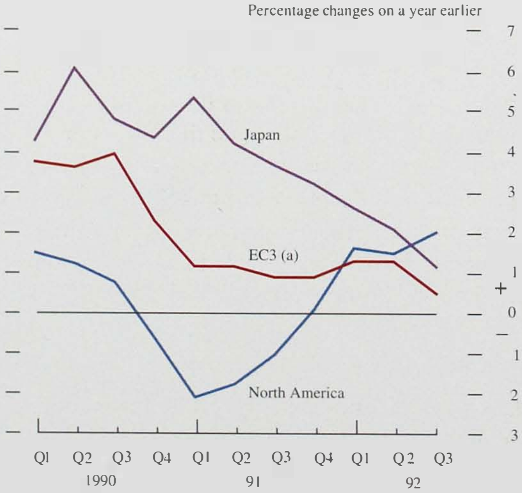
Table A
GDP/GNP growth in the major six

Percentage change on previous period (annualised for part-years)

	1990	1991	1992 H1	1992 Q3	1992 Q4
United States	0.8	-1.2	2.0	3.4	3.8
Canada	-0.5	-1.7	0.6	1.4	
Japan	4.8	4.1	2.6	-1.6	
Western Germany	5.3	3.7	3.3	-1.9	
France	2.2	1.1	2.1	1.9	
Italy	2.2	1.4	2.0	-2.4	
Major six	2.3	0.9	2.2	1.0	

GDP} United States, France, Canada, Italy.
GNP} Western Germany, Japan.

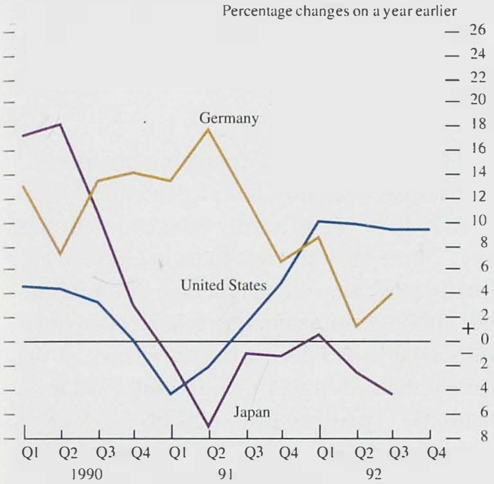
GNP growth is weakening in the EC majors and Japan, but strengthening in North America



(a) EC3 is France, Germany and Italy.

(1) The Economist's Poll of Forecasts: April and November 1992.

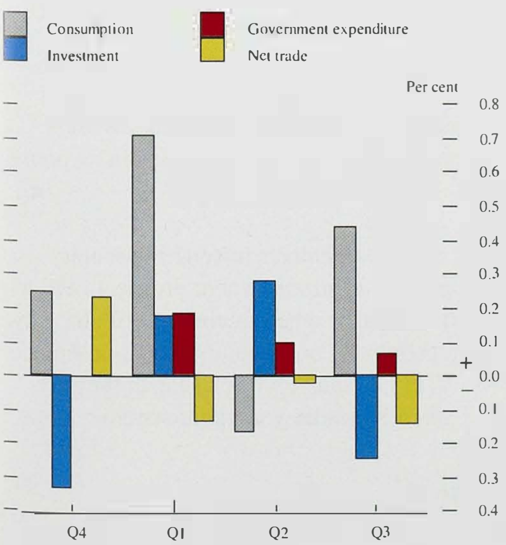
The United States' demand for imports remains quite buoyant



Source: National accounts.

Note: Goods and services import volumes.

The slowdown in the major six has centred on weaker investment



Note: Chart shows contributions to quarterly GDP/GNP growth. Investment here includes stockbuilding.

Table B
Output gaps in the major six

Per cent

	1990	1991	1992 Q3
United States	-0.3	-2.7	-2.5
Canada	-4.0	-7.0	-6.5
Japan	1.3	0.5	-2.8
Western Germany	3.5	3.0	-0.8
France	1.2	-0.4	-1.4
Italy	1.8	1.1	-0.4
Major six	0.6	-0.9	-2.0

Source: Bank estimates of deviation of output from potential.

Other indicators released over the last quarter—non-farm payrolls, confidence, retail sales, the purchasing managers index—have tended to reinforce the impression of a stronger recovery even if the pace of growth in the fourth quarter, 3.8%, is not sustained.

For the *major six* overseas economies as a whole, these diverging developments meant that the (already modest) growth seen in the first half of 1992 slowed only a little more in the third quarter. The size of the US economy is such that even a modest pick-up in growth there can provide a significant stimulus to activity elsewhere. The increase in the growth of *US imports* in the year to the third quarter, for example, added around $^3/_4$ of a percentage point (or $11 billion) to the growth of world trade in goods and services, and an even larger contribution may be expected in the coming year.

Since mid-1990, major six growth has been slow and slightly erratic. This is partly because of the timing of various countries' downturns: North America, Japan and now western Europe. But moderate growth is still likely to be achieved at the aggregate level in 1993. Major six GDP has grown by around $1^1/_2$% a year in the current slowdown, compared with a small fall in output in the recession of the early 1980s. Similarly, *world trade* growth has remained comparatively buoyant. In the current period of slow growth it has remained above 3% a year, whereas in 1980–81 it fell significantly. This buoyancy partly reflects continued growth in the industrialised countries and the stronger growth of the LDCs, and in particular the continued relatively rapid growth of the Asian NIEs and their rising share of world trade. The four Asian NIEs account for just over 2% of world GDP but 6.7% of world trade, and they are currently growing at 6%–7% a year.[1]

The latest movements in major six activity have further widened the estimated aggregate output gap—the difference between the level of actual and potential output—though it is still smaller than in 1982. The output gaps in France, Germany and Italy (Table B) are widening, but this is likely to be balanced by on offsetting narrowing in the United States. The existence of a substantial output gap in the major six (estimated at close to 2% of GNP) should dampen short-run inflationary pressures through the continued weakening in commodities prices and the impact of spare capacity on output prices, though the effect of this will vary across countries. The effect on inflation in North America, for example (where the gap between actual and potential output was largest in the period from the beginning of 1991 to the end of the third quarter of 1992), has been quite marked.

Inflation in the major six economies remains around 3%

The outlook for inflation in the major six is generally favourable. Over the past quarter, annual consumer price inflation has increased only in Germany (where monetary policy remains tight) and Canada. France, in particular, has experienced a significant further improvement (Table C). Producer price inflation in the major six has fallen quite markedly in the last year (Table D) and at an aggregate level there has been further downward adjustment in wage inflation (Table E). The cyclical downturn has had particularly strong effects in Japan where earnings growth has

(1) IMF estimates in October 1992 WEO.

Table C
Annual consumer price inflation in the major six

	1990	1991	1992 Year	Q3	Q4
United States	5.4	4.2	3.0	3.1	3.1
Canada	4.8	5.6	1.5	1.2	1.8
Japan	3.1	3.3	1.7	1.8	1.0
Western Germany	2.7	3.5	4.0	3.5	3.7
France	3.4	3.1	2.8	2.7	2.2
Italy	6.1	6.5	5.4	5.3	4.9
Major six	4.4	4.1	3.0	2.9	2.7

Table D
Annual manufacturing price increases in the major six

Per cent

	1990	1991	1992 Year	Q3	Q4
United States	4.9	2.1	1.2	1.7	1.4
Canada	0.3	-1.0	-0.5	1.5	3.2
Japan	2.0	-0.6	-1.6	-1.4	-1.5
Western Germany	1.7	2.4	1.4	1.0	0.5
France	-1.2	-1.3	—	-0.9	—
Italy	7.4	5.2	—	1.7	—
Major six	3.3	1.4	0.1	0.7	—

Note: Finished goods, except France which is intermediate goods.

Table E
Annual growth of manufacturing earnings in the major six

Per cent

	1990	1991 Year	1992 H1	Q3
United States	3.3	3.3	2.6	2.1
Canada	5.2	4.7	3.8	3.4
Japan	3.6	3.9	2.9	2.3
Western Germany	5.7	7.2	5.8	8.2
France	4.5	4.3	3.7	3.5
Italy	7.2	9.8	7.6	3.7
Major six	4.2	4.6	3.6	3.3

Note: France, Italy rates for all industry.

Table F
Effective exchange rates

1985 = 100: *percentages in italics*

	1992 Q2	Q3	Q4	Changes over last quarter
United States	61.2	60.1	66.3	*+10.3*
Canada	98.4	93.6	95.1	*+1.6*
Japan	140.5	145.4	151.6	*+4.3*
Germany	119.9	126.4	125.0	*-1.1*
France	105.7	110.9	108.8	*-1.9*
Italy	99.0	87.9	83.6	*-4.9*

Note: End-quarter figures.

fallen with the decline in demand for total labour input, which has resulted in reduced hours and slower employment growth. Wage settlements in Germany, although high in 1990–91, appear to be moderating under the influence of tight monetary policy and a slowing west German economy, but this has yet to be fully reflected in earnings growth.

Despite the slowdown in Germany and the worsening prospects for much of continental Europe, *monetary policy* generally remains tight and is unlikely to be significantly relaxed in advance of an easing in Germany. Short-term interest rates in Germany have fallen only marginally since the one percentage point fall in September/October and, although some countries have been able to reduce the differentials established during the turbulence of that period, interest rates have remained higher than in mid-1992 in France, Ireland and Denmark. There are few signs of discretionary policy easing in Europe. Indeed, several countries including Italy, Spain and Greece all adopted packages of fiscal restraint during 1992 to contain upward pressure on their fiscal deficits.

In Canada, exchange rate considerations resulted in the (relatively volatile) discount rate ending the fourth quarter around 250 basis points higher than at the end of September. More recently, however, it has been on a downward path. There have been no changes to official rates in the United States since September. Instead, the focus of discussion has been on shifting the policy mix either towards fiscal injection and/or towards increased spending on capital and longer-term structural issues but with reductions in current spending. In Japan, the Official Discount Rate was cut by 75 basis points to 2.5% on 4 February in response to weakening activity.

These essentially minor policy adjustments have left monetary policy much tighter in continental Europe, where prospects are deteriorating, than in North America where recovery is under way. Real short-term market interest rates are around 8%–9% in France and Italy against 5%–5½% in Germany; while in Japan they are close to 1%, and in the United States they are almost zero.

Exchange rate developments

The *dollar* rose strongly over the fourth quarter, by 13.6% against the deutschmark and by 3.8% against the yen, interrupted only by a period of consolidation during late November-early December. The dollar's recovery reflected the upturn in the US economy and the growing expectation that the German economy would move towards recession, thus prompting expectations of a reduction in German money-market interest rates.

Prior to the Federal Open Market Committee meeting in the United States on 6 October, the dollar fell to DM 1.40 in anticipation of a further easing in monetary policy. The failure of this to materialise provided support for the dollar, which strengthened steadily for most of the ensuing three months. One of the main influences on the dollar was growing evidence that a sustainable recovery in the US economy was under way. In addition, there was an expectation that if Governor Clinton won the presidential election, there would be an expansionary fiscal package. For both these reasons, the market increasingly came to the view that a further easing in US monetary policy was less likely. The dollar may also have benefited from being regarded as a 'safe haven' during the period of ERM tension in the second half of November.

At the same time, weak economic indicators from Germany led to market expectations that German interest rates might begin to come down earlier than had previously been anticipated. This view was encouraged by successive falls in German repo rates to around 8.60% at the beginning of February.

After having fallen back modestly in quiet pre-Christmas trading, the dollar finally broke through DM 1.60 on 28 December, and ended the period gaining further strength from the tensions in Iraq and Bosnia-Herzegovina.

Over the period, the *yen* slipped against the strengthening dollar. The economic slowdown in Japan and renewed weakness in the Tokyo stock market raised the possibility of a cut in Japanese interest rates in December. Nevertheless, conditions in Japan were seen as more stable than in Europe and the yen firmed against the European currencies.

The other main feature of the period was the persisting tension within the ERM, as the market continued to be concerned about possible conflicts between exchange rate commitments and domestic economic objectives (see Operation of monetary policy section for details). The period saw the downward realignment of the Spanish peseta and Portuguese escudo within the ERM on 23 November, the Irish punt on 1 February 1993, and the abandonment of their Ecu pegs by the Swedish krona and Norwegian krone on 19 November and 10 December respectively. Bilateral rates between the deutschmark, Belgian franc and Dutch guilder at the top of the mechanism and the French franc and Danish krone at the bottom have been close to their limits.

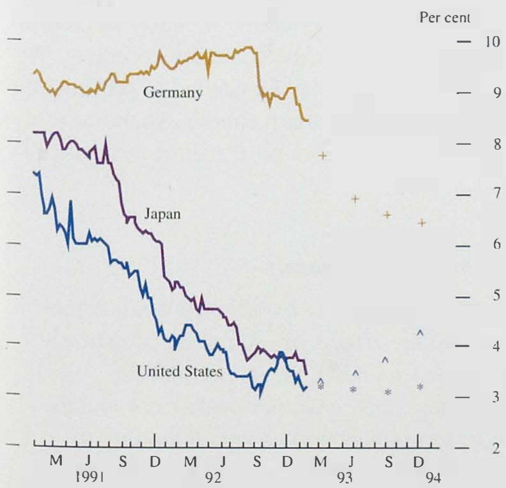
Table G
Main bilateral rates

Percentages in italics

	1992			Change over
	Q2	Q3	Q4	last quarter
\$/Y	125.9	119.6	124.7	*+4.3*
\$/C\$	1.197	1.254	1.269	*+1.2*
\$/DM	1.527	1.410	1.615	*+14.5*
DM/FFr	3.361	3.379	3.410	*+0.9*
DM/Lit	756.3	878.0	914.0	*+4.1*

Note: End-quarter figures.

The market expects a narrowing of German-US interest rates



+ German market future 3-month eurorates.
* Japanese market future 3-month eurorates.
^ US market future 3-month eurorates.

Western Europe

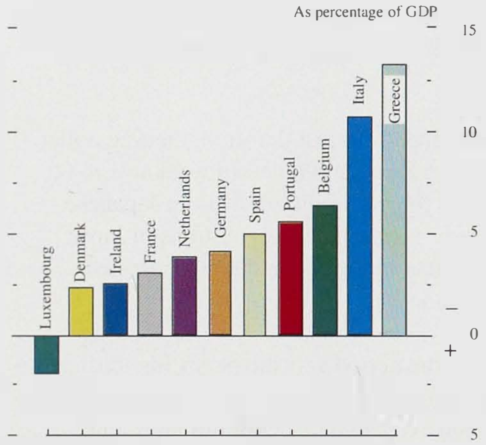
Economic activity is weakening rapidly in much of western Europe

Recessionary forces continue to operate in western Europe. High real interest rates and relatively weak export markets have caused EC growth to fall from around 1.5% in 1991 to around 1% in 1992, with the most marked fall in the second half of the year. The slowdown in activity has been reflected in slackening labour markets: unemployment increased to around 10% from below 9% in 1991. At the same time, there has been progress across the community in reducing inflation. Community-wide CPI inflation fell to around $4\frac{1}{2}$% in December from around $5\frac{1}{2}$% a year earlier.

The general tendency towards slower activity and lower inflation across western Europe masks substantial disparities from country to country. Activity indicators suggest that there was a pronounced slowdown in Germany and Italy in the second half of the year but that growth was more stable in France, Belgium and the Netherlands. While German inflation remained above $3\frac{1}{2}$%, marked reductions were achieved in Spain and Italy, albeit from a higher base.

Nevertheless, a number of common factors are now influencing prospects across Europe. The last six months have seen

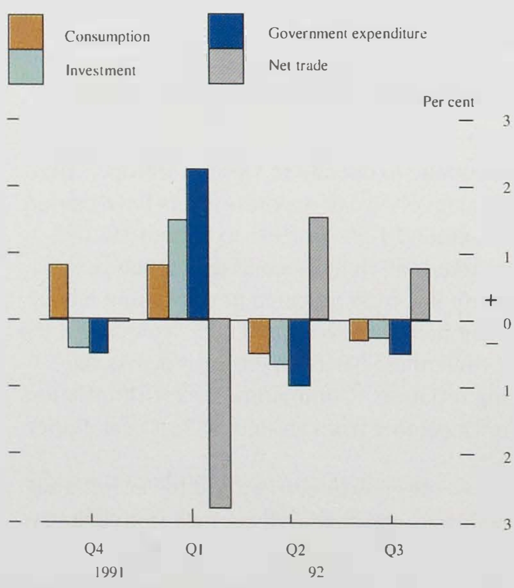
General government fiscal balances in 1992[(a)]



Bank of England estimates.

(a) Deficit – surplus +.

Contributions to quarterly German GDP growth



Note: Investment includes stockbuilding.

considerable volatility in European financial markets. A combination of tight German monetary policy, measures by some countries to maintain their ERM parities and uncertainties about the ratification of the Maastricht Treaty contributed to large speculative movements in the currency markets and a prolonged period of interest and exchange rate turbulence. Belgium and the Netherlands were able to respond to such flows by cutting interest rates. But the effect in other ERM members was an increase in real interest rates and a fall in business and consumer confidence.

This decline in confidence has its roots in many other factors—not least, slowing activity, weakening prospects for real income, subdued orders and weak export market growth. Although this growing pessimism may be an over-reaction to the break in Europe's strong growth of the late 1980s, it poses a clear downside risk to prospects in most European countries.

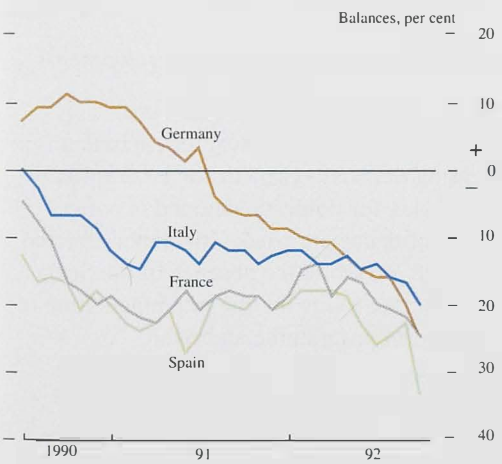
The need for fiscal adjustment is also contributing to concerns about European prospects. Structural problems faced by a number of governments have been compounded by the fall in activity, and have pushed the EC aggregate fiscal deficit to around 5% of GDP. In a number of countries including Italy, Spain and Greece, fiscal packages have been introduced to prevent further escalation of their deficits. The cost of this fiscal containment—at least in the short run—will be weaker domestic demand and, perhaps, a further fall in business and consumer confidence. The fiscal deficit in Germany, although largely reflecting transfers to eastern Germany, may also increase further as the economy contracts. As in Italy, medium-term consolidation may be needed to prevent an escalation of debt ratios, but here too sharp cuts in expenditure and uncertainty over future tax increases pose a short-term risk to confidence.

The German economy has slowed sharply

The German economy has continued to experience weak domestic and external conditions and the effects of protracted adjustment to reunification. Weaker export markets, the strength of the deutschmark, falling business and consumer confidence and the persistence of high short-term interest rates are all tending to dampen prospects. In the third quarter, output fell as all components of domestic demand weakened. Consumption, which had been expected to increase following the ending of the 'solidarity tax' in July, remained subdued, as consumer confidence weakened. Business investment contracted. Although GDP growth for 1992 as a whole has been provisionally estimated at $1\frac{1}{2}$% most of this was generated in the exceptionally buoyant first quarter. The weakness in activity seems set to continue through at least the first half of 1993.

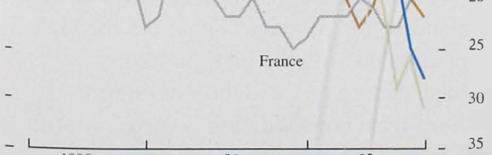
The maintenance of a tight German monetary policy reflects slow progress in reducing headline inflation, continuing high rates of monetary growth and the persistence of a large public sector deficit. Consumer price inflation rose to a preliminary 4.4% in January as the index was raised by approximately $\frac{1}{2}$ percentage point by the increase in VAT on 1 January. Consumer price inflation has remained stubbornly high in spite of high interest rates and falling import prices, unlike producer and wholesale price inflation, both of which have fallen. This difference largely reflects the contribution of rents (which have a high weight in the

Industrial confidence indicator[a]



(a) The indicator is an average of the responses to questions on production expectations, order-books and stocks (the latter with inverted sign).

Consumer confidence indicator[a]



(a) The indicator is an average of the responses to questions on the financial and general economic situation and major expenditures.

index), and service prices which are rising at around 6%. Both elements have proved largely unresponsive to high interest rates. Nevertheless, a general fall in inflation during 1993 looks probable. Recent pay settlements have been at lower levels, but unions in sectors less affected by the rise in unemployment have presented fairly high initial claims.

M3 grew by 9.4% (seasonally adjusted annualised rate over the fourth quarter base) in the final quarter of 1992—significantly above the Bundesbank's target range of 3½%–5½%—with rapid growth in the autumn partly reflecting heavy foreign exchange intervention. Monetary growth should slow this year as the economy contracts, and some of the special factors which have distorted the aggregate in the past year should unwind, increasing the possibility that the higher target range, of 4½%–6½%, will be met. But this is by no means assured, particularly in view of the recent buoyancy of bank lending. The need to reduce inflationary pressures while avoiding an intensification of the slowdown in activity (and compounding existing strains on public finances) continues to pose a dilemma for the authorities.

Eastern German activity has remained weak. Latest estimates suggest that GDP grew by only 6% last year, much less than had been predicted at the beginning of the year. There is little sign so far of a self-sustaining recovery and the eastern German economy remains heavily dependent on transfers from western Germany.

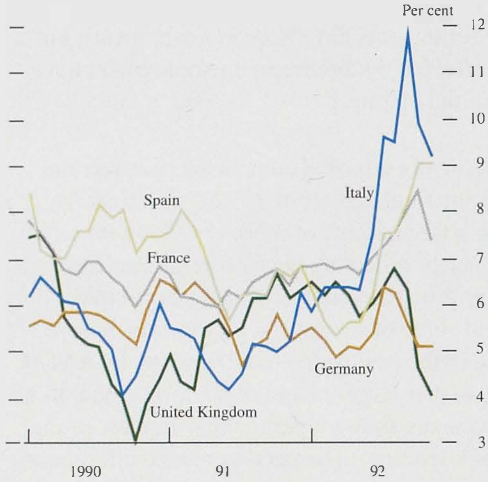
Such transfers, which reached around DM 120 billion in 1992, continue to place a considerable burden on public finances in Germany. The general government deficit, measured on an administrative basis, is expected to rise to around DM 120 billion (4% of GDP) in 1992. The wider public sector deficit, including the Federal Railways, Federal Post Office and the Treuhand privatisation agency, was some DM 180 billion. The government has sought to address pressures on the budget through expenditure cuts. However, slowing western German activity may reduce private sector investment in eastern Germany resulting in an increased demand for fiscal transfers. This may necessitate further spending cuts or tax increases. The need for close co-operation between employers, unions and all levels of government through the so-called 'Solidarity Pact' will be important.

Activity in France is resilient while inflation is falling

The French economy has experienced a period of prolonged exchange and interest rate turbulence. Market interest rates remained high throughout the autumn and early winter in defence of the franc's parity within the ERM. The authorities have succeeded in withstanding speculative pressure while limiting the impact of high money-market rates on the domestic economy.

Activity in France has remained resilient in the face of these developments. GDP growth in the third quarter was slightly stronger than most expectations, although the government's target for full-year growth of 2.1% in 1992 now looks a little optimistic. Despite some weakening in consumer confidence over the year, personal consumption held up well in the third quarter. Weak business confidence, reflecting exchange rate turbulence and subdued prospects for export markets, has contributed to a

Real 3-month euro-rates



contraction in business investment; and net trade (which had been the engine of growth in the previous two quarters) had a contractionary influence in the third quarter.

While the appreciation of the franc against most of its major European trading partners is likely to affect competitiveness, it has contributed towards progress in reducing inflation which fell to 2% in December. This also reflects improvements in unit labour costs and low food prices. Manufacturing price inflation has also been subdued, benefiting from low energy prices.

The French government deficit deteriorated in 1992 and cyclical pressures are likely to cause a further deterioration this year. However, the deficit is modest by international standards and some scope may exist for discretionary adjustment if the authorities judge this to be necessary, and provided the fiscal implications of a slowdown in activity are limited.

Italy's slowdown reflects domestic and external developments

High interest rates and weakening export markets have contributed to a slowdown in Italy where fiscal retrenchment is a further influence depressing demand. Growth for 1992 is likely to be around 1%. The outlook for domestic demand is poor. Business and consumer confidence are weak—the latter affected by the outlook for real wage growth in the absence of the Scala Mobile, an increased tax burden following the implementation of the government's fiscal reform programme and rising unemployment. The depreciation of the lira since September may, however, provide some stimulus to net trade.

In common with its European partners, Italy has continued to make encouraging progress in reducing inflation. Consumer price inflation fell to 4.3% in January, compared with 6% a year earlier. Contractual wage growth declined sharply over the year to 2.2% in December. Prospects for inflation remain uncertain, particularly following the depreciation of the lira since September 1992; but initial indications are that wage and price setters have moderated price setting behaviour in the absence of Scala Mobile, and in the face of weak demand.

The passage of the government's umbrella 'Financial Law' on 22 December is likely to make a considerable contribution to the consolidation of Italian public finances. The measures enable structural reform of pensions, civil service, health and local authority spending and are expected in total to generate the Lit 93 trillion savings required to maintain the deficit at 1992's level of Lit 160 trillion (10.9% of GDP). The authorities have already succeeded in balancing the primary budget but the high level of outstanding debt coupled with the high premium demanded on lira debt have caused an escalation of interest payments. Further medium-term consolidation is therefore still required, but is likely to prove difficult given the current and prospective weakness of output.

Prospects for Spain are similarly subdued

Growth in Spain in 1992 is likely to have been around 1¼% and may fall below ½% in 1993. The slowdown is likely to be led by investment expenditure, reflecting falling business confidence. As in Italy, the authorities appear to be expecting the devaluation to generate a positive contribution from the external sector, but the likely extent of this is hard to gauge. The fiscal tightening, which started with the two percentage point VAT increase in July, may bring the government's target for the central government deficit of Pta 1,560 billion (2.6% GDP) within reach but the general government deficit could be significantly above the government's goal of 4.3%.

Although the Spanish headline inflation rate continues to fall, reaching 5.4% in December, the underlying rate (which excludes energy and food), remains relatively high at around 7%. The devaluation of the peseta and January's rebasing of the index (which will give additional emphasis to services where inflationary pressure has remained strong) will push up measured inflation, but this may be counterbalanced by the unwinding of January 1992's VAT increase.

Elsewhere in western Europe, activity is weakening and headline inflation has fallen

Activity has slowed in Denmark; and in Belgium, the Netherlands and Luxembourg it is likely to slow further this year because of the weakness of German activity. Growth in Ireland is expected to fall to around 1.5% in 1993 following a sustained period of high interest rates. Switzerland and Austria have been affected by the slowdown in their export markets. The Portuguese economy slowed in 1992 but still generated one of the highest growth rates in the EC. The tight policy mix in Greece, designed to accelerate economic convergence, may weaken growth in the short term.

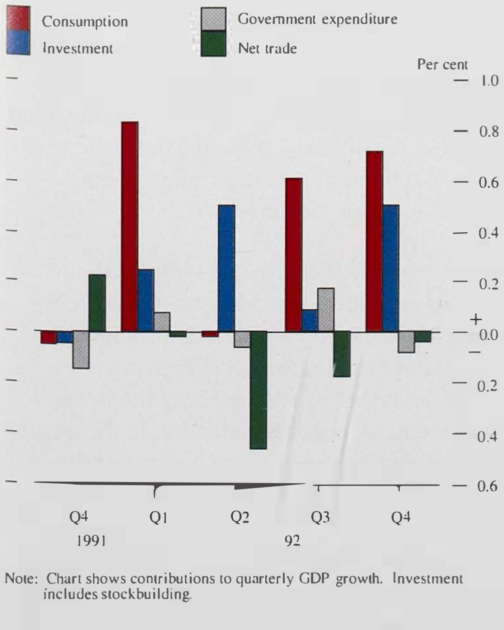
Table H
The Nordic economies: 1992 estimates[a]

	GDP growth	Consumer price inflation	Fiscal balance (as % of GDP) (– = deficit)
Sweden	-1.5	4.0	-14.0
	2.1	*7.2*	*5.4*
Norway	2.0	2.3	- 5.5
	0.4	*4.2*	*1.5*
Finland	-2.5	2.6	-8.0
	5.2	*4.8*	*3.6*

(a) 1989 in italics.

Sweden, Finland and Norway have continued to undergo a period of adjustment (Table H). Financial deregulation in the 1980s fuelled credit growth and inflation, which prompted a subsequent tightening of monetary policies, predicated in each case on a fixed exchange rate (pegged to the Ecu). This resulted in a period of high and, during the turbulence of the final quarter of 1992, volatile real interest rates. Although speculative pressures finally forced each country to abandon its Ecu peg, the period of tight monetary policies secured substantial reductions in inflation. Growth has nevertheless fallen in each country, for a variety of reasons, causing a deterioration in fiscal balances and rising unemployment. The recent floating of exchange rates is expected to provide some stimulus to activity although this may be limited by difficult export markets.

US GDP growth has picked up with the strengthening of consumption



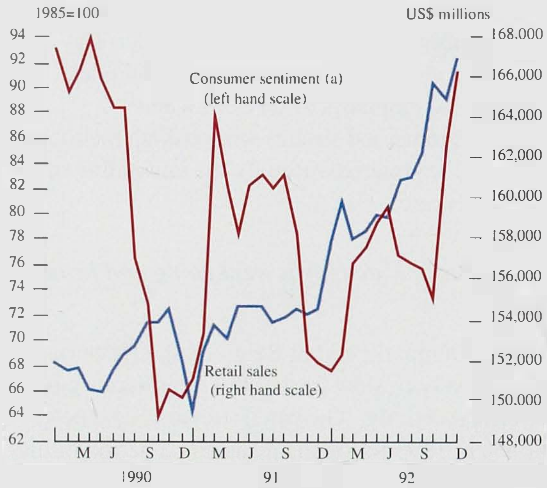
Note: Chart shows contributions to quarterly GDP growth. Investment includes stockbuilding.

North America

The US recovery appears more firmly based

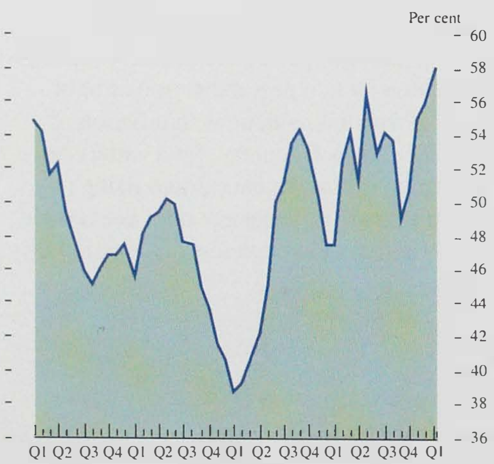
The announcement of the third quarter GDP figures confirmed that both the United States and Canada have grown for six consecutive quarters, albeit at quite a modest pace over the period as a whole. The fourth quarter figures for the United States have shown continued improvement. In both countries, recovery now looks more firmly based, and each is well-placed to achieve sustainable growth without reigniting inflationary pressures (the output gap is currently estimated at around 2½% in the United States and around 6½% in Canada). Nevertheless, neither recovery is yet strong by historical standards, and in each country there are concerns that weakness in the labour market in

In the United States, consumer confidence and spending have risen sharply



(a) Nominal retail sales; University of Michigan consumer sentiment index.

The purchasing managers index has shown a modest recovery since the autumn



Source: National Association of Purchasing Managers.

Note: Diffusion index.

particular may undermine the personal sector's contribution to recovery.

A firm recovery in the United States—which accounts for around 45% of output and around 30% of trade in the major six—would be of major significance for the developed economies as a whole in the coming year. The third and fourth quarter GDP figures and other recent indicators almost uniformly suggest grounds for optimism. GDP rose by 0.9% in the fourth quarter, the fastest growth since end-1988. Private consumption (which rose 1.2%) and fixed investment made the major contribution to growth. Stockbuilding, though weaker than in the third quarter, was positive for the third consecutive quarter.

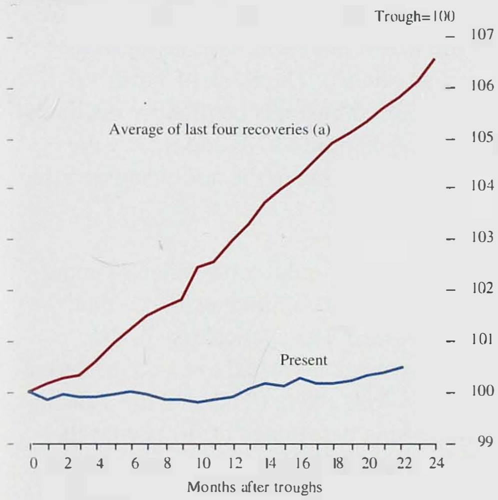
There are risks, however, that growth at the pace seen recently may not be sustainable. The recent rise in consumption partly reflects a fall in the saving ratio; its sustainability will largely depend on whether income growth increases and whether faster employment growth can be established. Other aspects of the personal sector nevertheless look more secure. Consumer confidence has risen substantially since the election in November, while retail sales growth reached 6%–7% (in nominal terms) in the second half of last year—the highest since early 1990. The financial data for the third quarter show that the monthly debt service payment-to-income ratio has fallen to around 16½%, its lowest since 1986—largely reflecting the impact of lower interest rates.

Industrial production rose gradually over 1992 and in the fourth quarter it was growing at an annualised rate of 2%. This represents a much slower recovery from past recessions—as does the recent modest rise in the National Association of Purchasing Managers index. Stock levels are low, however, and the prospects for further sustained increases in production may depend on how robust the recovery in demand—especially consumption—is perceived to be.

Overall, prospects for *employment* seem most likely to determine the strength and durability of the US recovery. Employment growth is recovering, but not by as much as might be expected on the basis of past experience, given the growth in output. Non-farm payrolls rose by 64,000 in December—a modest rise by comparison with previous recoveries when the monthly rise has been three or more times this amount. In manufacturing, the trend in employment remains downward. To a limited extent, the need for more labour has been met by increases in average hours worked, although even this has now flattened off.

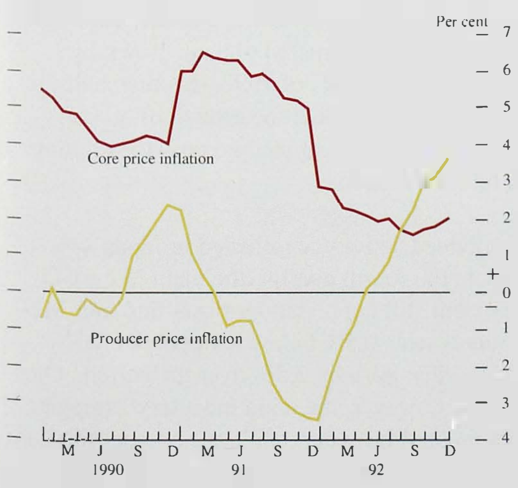
A modest rise in the growth of M2 is consistent with a reduction in the pace of balance sheet restructuring. M2 growth has been picking up since July and M1 deposits, which may be a more reliable indicator of the level of transactions, have grown particularly strongly. M2 nevertheless reached only the lower ranges of its 2½%–6½% band. A possible reduction in the target range for the coming year should be seen in the context of the persistent (structural) rise in velocity as the growth of M2 has been depressed by disintermediation. On the lending side, the modest growth in consumer credit and commercial and industrial loans since September also suggests that balance sheet positions have improved. This is another area where the current upturn appears more firmly established than in recent 'false dawns'.

Non-farm payroll growth is weak by historical standards



(a) Excluding 1980.

In Canada, core price inflation has started to rise



Note: Core inflation excludes food and energy. Rise in January 1991 reflects introduction of goods and services tax.

The recovery in growth in the United States from a low level of activity means that the quickening pace of growth is unlikely to damage inflation prospects in the near future. Consumer price inflation has remained at around 3%–3¼% since the autumn of 1991. The core rate of inflation, meanwhile, (excluding food and energy) remains above that of consumer prices, but it is still falling gradually. Producer price inflation is also flat at around 1½%. The yield curve—an important indicator of inflation prospects—although steep, has flattened slightly since November.

The US economy has also benefited from stronger net trade. In the third quarter, the current account deficit narrowed to $14.2 billion as exports grew quite strongly (by 1.7%). This partly reflected improved US competitiveness (as the dollar weakened over 1990–92) more than offsetting a more recent strengthening in relative demand.

The recovery in *Canada* is distinctly weaker than in the United States, and the inflation rate, although lower, has begun to pick up. GDP rose by 0.4% in the third quarter, led mainly by private consumption and export growth. As in the United States, the main risk to a sustained consumer-led recovery comes from the labour market. The rate of increase in unemployment has fallen since the first half of 1992, but the unemployment rate is now 11.5%. Exports have benefited from the improvement in competitiveness associated with the Canadian dollar's depreciation, but imports have continued to grow because of the strength of domestic demand. The government introduced its Economic Statement in December. This proposes a tightening of fiscal stance relative to the previously envisaged overspend, reducing some elements of current government spending but offering new initiatives on tax credits and training. Monetary policy has been eased with prime rates falling to 6¾% in January.

Inflation in Canada has edged upwards over the past six months but is still, relatively, very low. Consumer price inflation reached 2.1% in December, while the core rate rose to 2.0%. The rise in import prices stemming from the depreciation of the Canadian dollar has begun to feed into producer price inflation, which has risen from around zero at the end of the second quarter to 3.1% in November. Despite the increases, the existence of a large output gap—of around 6½% according to the Bank's estimates—is likely to dampen inflationary pressures over the next year, putting further pressure on margins. As a result, the 3% target for the core rate of inflation seems unlikely to be challenged.

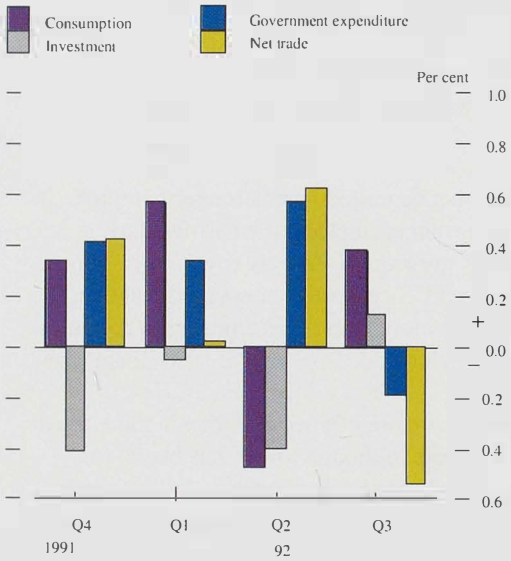
Japan

The Japanese economy continues to slow

Growth in Japan slowed down considerably in the second half of last year and there are signs that further weakness is in prospect. GNP fell in the third quarter—only the fourth quarterly fall since 1975—and indicators such as industrial production, retail sales and the monetary aggregates all showed continued retrenchment in the fourth quarter.

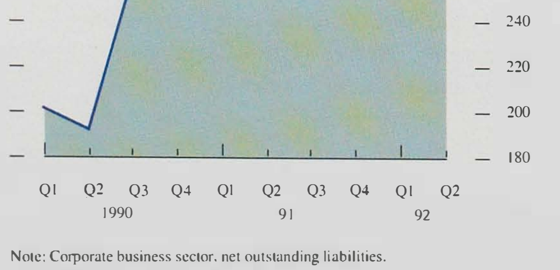
The corporate sector has borne the brunt of the cyclical downturn. In the third quarter, investment led the slowdown in GNP; fixed investment has fallen in each of the last six quarters by a

The fall in Japanese GNP was led by a fall in investment



Note: Investment includes stockbuilding.

The net debt of Japan's corporate sector remains high



Note: Corporate business sector, net outstanding liabilities.
Source: Bank of Japan, Economic Statistics monthly.

cumulative $6^1/_4$%. This is partly a response to over-investment during the 1988–90 boom but also reflects the financial position of the corporate sector. Corporations more than doubled their net financial liabilities during the boom, and have not yet been able to reduce significantly either their net or gross outstanding liabilities. Indeed net indebtedness of companies has continued to increase—although the reductions in interest rates will have lessened the burden in terms of interest payments. The Bank of Japan's November Tankan Survey showed business confidence declining further to its lowest level since the mid-1970s and there were signs that the slowdown was worsening in the non-manufacturing sector.

Industrial production remains weak—it has now fallen by more than 10% from its peak although there is some evidence that month-on-month falls are slowing. The cyclical rise in the stock-output ratio seems to have been arrested towards the end of last year, but the ratio remains well above trend, and the Tankan Survey showed that an increasing percentage of firms viewed stock levels as 'excessive'. These indicators suggest that the corporate sector still faces considerable further adjustment.

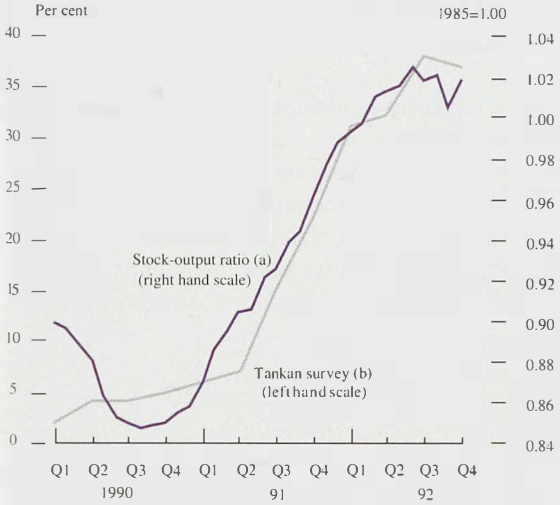
Consumers' expenditure made the main positive contribution to GNP growth in the third quarter but is much less robust than in the past. The personal sector's wealth holdings have been reduced by asset price deflation—real estate prices continued to fall in the third quarter; and the general slowdown has reduced personal income growth. Employment has continued to grow—albeit more slowly than in recent years—while unemployment has risen gradually, and hours worked have fallen. Average hours worked per worker in manufacturing have been in decline since 1989 but the pace of fall has accelerated this year—hours fell by almost $3^1/_2$% between February and November. The growth of earnings and incomes has also slowed; average hourly earnings in manufacturing, for example, are estimated to have grown by around $1^1/_2$% in the first three quarters of 1992, less than half the rate of only two years previously, while the growth of bonus payments has also fallen sharply. Real income growth is falling, notwithstanding the fall in inflation.

This pattern of very subdued activity is reflected in Japan's monetary aggregates. In the fourth quarter, the main M2 + CDs aggregate—to some extent still depressed by flows into non-M2 Postal Savings Accounts—was 0.5% below its level of a year earlier while 'broad liquidity' rose by 2.5% over the period. On shorter-run comparisons, however, the main monetary aggregate was flat-to-falling for most of last year, while the broader measure is also currently flat. These figures again suggest that the emergence from the current phase of weakness may be some way off.

The main stimulus to growth in the coming year is likely to come from the public sector (and to a lesser degree the external sector—see opposite page). The government responded to the downturn with its announcement of a ¥10.7 trillion 'emergency fiscal package' in August, which led to the supplementary budget in December. In the same month, the Ministry of Finance announced the budget for the fiscal year. This envisages a central government deficit of ¥8.1 trillion ($1^3/_4$% GNP) compared with a planned ¥7.3 trillion deficit last year. Once adjustment is made for the cyclical position, the budget appears essentially 'neutral', with the shortfall in taxes funded and expenditure maintained. The Economic Planning Agency has revised its GNP forecast for financial year 1992 from 3.5% to 1.6%, and announced a target of 3.3% for financial year 1993. This forecast recognises that the government sector is likely to be the main source of growth next year.

The slower activity in Japan has had beneficial consequences for inflation. Earnings growth has fallen with the relative slackening of the labour market and the strong yen has contributed to the weakening of import prices. Wholesale prices continue to fall—by 1.4% in 1992. Consumer price inflation fell substantially in the fourth quarter—to 0.7% in the year to November—but this partly reflected the dropping out of 1991's typhoon-related rises in the prices of perishable foods. The 'underlying' inflation rate is closer to 2% although this still represents an improvement over the past year.

There are signs that stock levels are being adjusted in Japan



Source: Bank of Japan Tankan survey.

(a) 3-month average of ratio of stocks of finished goods to industrial production, seasonally adjusted.
(b) Percentage of firms seeing stocks as excessive.

Japan's links with south east Asia

Japanese growth has been buoyed by the contribution of the external sector over the past year. The trade balance rose to around $130 billion (3% of GNP) in 1992, one third greater than a year before. To some extent, the rise reflected the terms of trade effects of a stronger yen and the impact of the domestic slowdown on the growth of import volumes. Nevertheless, export volumes grew strongly despite the worsening in Japan's competitiveness.

Much of the increase in Japan's surplus has resulted from its close links with Asia, and in particular with the dynamic Asian economies (DAEs) of Hong Kong, Singapore, South Korea, Taiwan, Malaysia and Thailand. Around one quarter of the rise in Japan's trade surplus last year reflected trade with its Asian partners, over half of which is with the DAEs.

Table J
Japan's bilateral trade surpluses

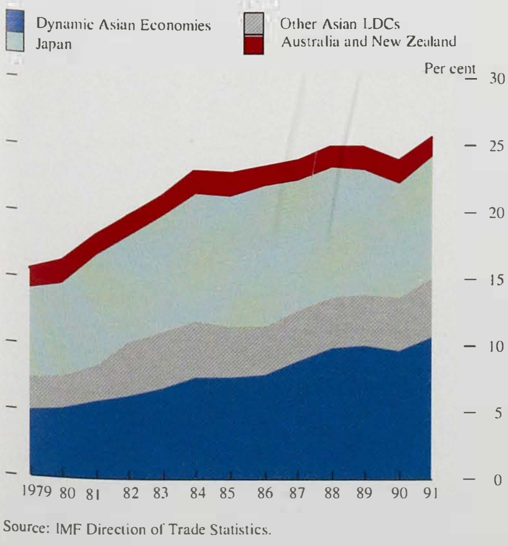
$ billions

	United States	EC	Asia	Total
1991 Q1–Q3	26.4	20.8	26.8	54.1
1992 Q1–Q3	30.4	24.8	33.5	77.5
Change	*4.0*	*4.0*	*6.7*	*23.4*

Source: Bank of Japan, *Balance of Payments Monthly*.

The DAEs experienced 7.5% real GDP growth in 1991, accompanied by over 15% growth in the volume of their imports (including imports for re-export). Asia now accounts for 30% of Japan's exports compared with 20% ten years ago. A large proportion of DAE imports have been capital goods or consumer durables, where Japan competes well on quality, price and geographical proximity. The DAEs contribute to world activity through their continued growth and the associated strong import demand, although the DAEs do not provide the same stimulus to growth in North America and Europe, where they have substantial bilateral trade surpluses.

The DAE's share of world exports continues to rise



Source: IMF Direction of Trade Statistics.

The rapid economic growth of the Asian economies (and especially the DAEs) over the past decade has been led by very strong export growth. Between 1981 and 1991 Asian countries (excluding Japan) doubled their share of world exports to 11% for the DAEs and 4% for other Asian countries. The Asia-Pacific Region's share in world exports as a whole (including Japan, Australia and New Zealand) is now over 25%, compared with 16% in 1981.

Traditionally, Asia's main export markets have been the industrial countries of North America and Europe, where the DAEs have managed to maintain their export market share despite growing economic integration in North America and western Europe. But

Table K
Destination of exports from Asia and Australasia

US$ billions, 1991 (1981 figures in brackets)

	Intra-regional	North America	Europe	Rest of the world
Exports from:				
Japan	113 (40)	99 (42)	70 (24)	31 (45)
DAEs	176 (44)	95 (27)	67 (17)	28 (18)
Other Asian LDCs	90 (30)	18 (10)	28 (10)	16 (20)
Australia and New Zealand	33 (15)	6 (4)	8 (4)	4 (5)
Asia total	**413 (129)**	**219 (83)**	**173 (55)**	**73 (88)**

Source: IMF Direction of Trade Statistics, and Statistical Yearbook of Taiwan.

the strong economic growth within the Asia-Pacific region has led to a rapid expansion in intra-regional trade. Whereas in 1981 just over one third of Asia's exports went to other countries in the region, now the proportion is almost half, comfortably exceeding both North America and Europe combined in importance as export destinations. Only Japan still sells more than half its exports to Europe and North America.

Much of this trade is either investment-related trade in capital goods or intermediate products, or re-export entrepot trade, which would therefore overstate the underlying value added. However, this trade pattern also emphasises the growing extent of regional economic integration, even though regional economic institutions are much less developed than the European Community, the European Free Trade Association or the North American Free Trade Association.