The international environment

Overview

Growth in Western Europe has continued to slow but the North American recovery appears more firmly based

Activity has slowed further in Western Europe and Japan, while the recovery in North America seems to have become more soundly based. For the major six overseas industrialised countries as a whole, these movements have partly offset each other: GDP grew by around 0.3% in the fourth quarter of 1992, and by $1\frac{1}{2}$% compared with a year earlier (Table A).

Table A
GDP/GNP growth in the major six

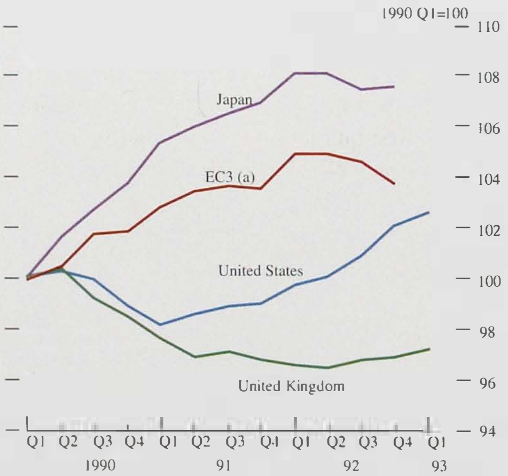
Percentage changes on previous year

	1990	1991	1992	Forecast 1993
United States	0.8	-1.2	2.1	*3.0*
Canada	-0.5	-1.7	0.9	*3.4*
Japan	4.8	4.1	1.5	*0.5*
Western Germany	5.3	3.8	1.1	*-1.5*
France	2.3	0.6	1.2	*0.4*
Italy	2.2	1.4	1.0	*0.2*
Major six	**2.3**	**0.9**	**1.7**	***1.4***
United Kingdom	0.6	-2.5	-0.5	*1.25* (a)
EC12	2.8	1.3	0.6	*-0.3*

(a) FSBR forecast.

The contrast between continental Europe, where recession is intensifying and real interest rates are high, and North America, where a recovery is under way and real interest rates are significantly lower, is striking. Output in Germany, France and Italy fell in the fourth quarter by an average of 0.6% and appears to have carried on falling in the first quarter of this year. For Germany, in particular, the recession appears to be intensifying, with GDP falling by 1.4% between the first and fourth quarters of 1992. In the United Kingdom, however, GDP was flat in the fourth quarter and rose 0.6% in the first quarter of 1993. The slowdown has persisted in Japan where, despite the small rise in GNP in the fourth quarter, private sector activity remains depressed.

GDP levels in the major six economies



(a) EC3 are France, Germany and Italy.

In North America, activity is moving in the opposite direction. The recovery in the United States now appears more firmly based, although the exceptionally strong growth of GDP in the second half of last year did not continue in the first quarter of this. Productivity growth is the highest since the early 1980s and employment is growing more rapidly.

To a large degree, the developments in Western Europe stem from the high real interest rates of the ERM bloc. There is little scope in Europe for offsetting action through discretionary fiscal easing. The latest pronouncements on fiscal policy in Europe —including the 'Solidarity Pact' in Germany—imply widening deficits in the short term because of cyclical factors, to be followed by fiscal consolidation. A similar path is expected in the United States, whereas in Japan the authorities have proposed a more substantial fiscal easing in the near term.

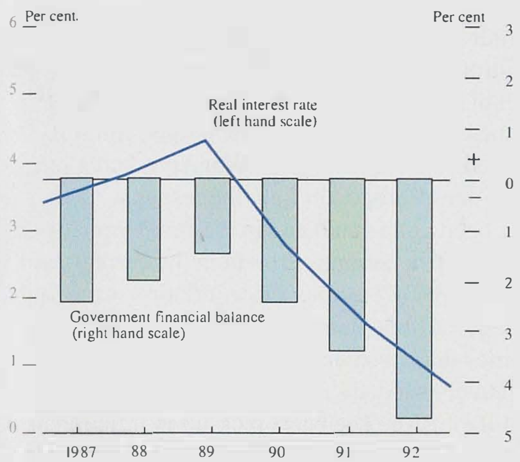
Table B
Exports by destination as a percentage of GDP, 1991

To:	North America	Japan	EC	Memo item: Total exports as a percentage of domestic GDP
From:				
North America	2.9	0.9	1.8	8.9
Japan	3.0	—	1.8	9.4
EC	1.7	0.5	13.3	21.7
United Kingdom	2.3	0.4	10.4	18.0

Source: OECD Statistics of Foreign Trade and Main Economic Indicators: nominal data, current exchange rates.

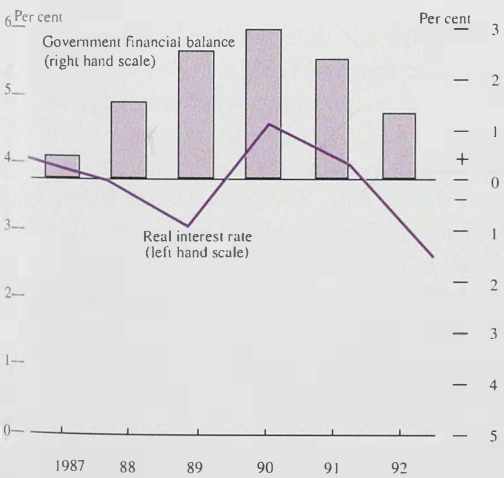
The slowdown in continental Europe will be self-reinforcing because of the close trading links among the Western European economies. Around two thirds of EC countries' trade is with other EC partners. As Table B shows, intra-EC trade also accounts for a relatively high proportion of these countries' GDP. Weaker European activity is already being reflected in the slower growth of trade volumes. For the three major EC economies, annual import volume growth fell from 5% at the end of 1991 to under 3% at the end of 1992. Slower external demand growth has particularly dampened activity in Germany and France—Italy may be less affected because of the improvement in competitiveness following the depreciation of the lira.

Real US short rates and general government fiscal positions(a)



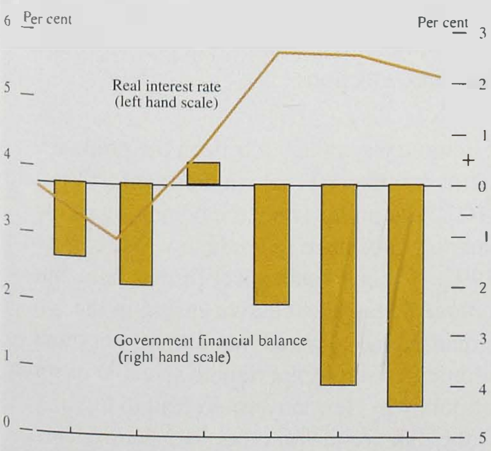
(a) As a percentage of GDP, + = surplus, – = deficit.

Real Japanese short rates and general government fiscal positions(a)



(a) As a percentage of GNP, + = surplus, – = deficit.

Real German short rates and general government fiscal positions(a)



(a) As a percentage of GNP, + = surplus, – = deficit.

For the three major non-EC economies, the growth in goods and services volumes has increased—from 3% at end-1991 to 5½% at end-1992—and net trade raised growth in Japan and Canada in the second half of last year. The effects of relative demand movements have been most marked in Japan where the external surplus is continuing to rise. At the major six level, the changes in growth have, in effect, netted out, leaving world trade growth unchanged at around 4½% at end-1992. World trade growth has also been sustained by the continued expansion outside the industrialised world—particularly in Asia where output growth is still above 6%.

The external stimulus to UK exports will be more limited than this suggests. Although the United Kingdom has strong trade links with countries outside Europe, the EC is still the destination for more than one half of UK exports (Table B).

The growth of output and trade in the major industrialised economies is likely to remain subdued during 1993. North American output is expected to grow by around 3% this year. But in Europe—apart from the United Kingdom—growth is likely to be significantly lower than last year. Output is expected to fall (year-on-year) in western Germany and may be only barely positive in France and Italy. In Japan too, growth is expected to be lower in 1993 than in 1992. Major six output growth is likely to remain around 1½%, and trade growth around 4%.

Inflation in the major industrialised countries has picked up recently but remains in check

In general, domestic inflationary pressures in the major economies are weak. The rise in average consumer price inflation in the major six overseas economies in the first quarter—to 2.9%—partly reflected the one percentage point VAT increase in Germany. In France, inflation remains around 2% and in Italy consumer price inflation has continued to fall (to just over 4%) despite the lira's depreciation. In the United Kingdom, headline inflation remained below 2% in the first quarter. In Japan, the rise in the first quarter largely represents a rebound from an artificially depressed fourth quarter figure; underlying inflation is likely to continue to fall. Headline and core inflation in the United States rose slightly in the first quarter. This rise appears to be transitory, but nonetheless underlines the need to keep a close watch on inflationary pressures during the recovery. In Canada, the pick-up in inflation largely reflects last year's exchange rate depreciation, which has also led to increases in producer prices. Producer prices have risen in Italy and the United Kingdom for similar reasons. But in the other major economies producer prices are still falling or rising only gradually.

Wage pressures are generally subdued. For the major six overseas economies, annual manufacturing earnings growth in the year to the fourth quarter fell below 3% for the first time since 1988. The fall in earnings growth since 1990 has been particularly marked in the United Kingdom with a reduction of two to three percentage points relative to the major six average. With the main exception of Germany (up to the end of last year), earnings growth has fallen in most of the major economies over this period. Slower earnings growth is being reflected in manufacturers' unit labour costs, despite some cyclical fall in productivity growth as a result of the slowdown—notably in Japan and Germany. The United Kingdom's

Table C
Consumer price inflation in the major six
Percentage changes on previous year (fourth quarter)

	1990	1991	1992	Forecast 1993
United States	6.3	2.9	3.1	*2.9*
Canada	4.9	4.1	1.7	*2.0*
Japan	3.6	2.8	1.0	*1.1*
Western Germany	3.0	3.9	3.7	*3.5*
France	3.6	2.6	2.2	*2.8*
Italy	6.4	6.0	4.8	*6.5*
Major six	**5.0**	**3.3**	**2.8**	***2.9***
United Kingdom	9.3	5.6	3.7	*3.75*(a)
EC12	6.0	4.7	3.8	*4.3*

(a) FSBR forecast.

Table D
Unit labour costs in manufacturing
Percentage change on previous year

	1990	1991	1992	Forecast 1993
United States	0.6	1.6	-0.6	*-3.3*
Canada	1.9	-3.6	1.3	*0.5*
Japan	2.5	3.5	8.4	*0.5*
Western Germany	3.5	5.5	5.6	*9.8*
France	3.1	3.5	3.3	*2.4*
Italy	9.2	12.5	4.4	*0.7*
Major six	**2.2**	**3.2**	**2.9**	**0.5**
United Kingdom	7.7	6.6	1.6	*-1.5*(a)

(a) FSBR forecast.

Table E
Effective exchange rates
1985=100; *percentages in italics*

	1992 Q3	1992 Q4	1993 Q1	Changes over previous quarter
United States	60.1	66.3	65.2	*-1.7*
Canada	95.1	95.1	97.1	*+2.1*
Japan	147.8	151.6	164.4	*+8.4*
Germany	124.3	125.0	126.5	*+1.2*
France	108.9	108.8	110.0	*+1.1*
Italy	91.1	83.6	77.8	*-6.9*
United Kingdom	83.7	79.6	79.4	*-0.3*

Note: End-quarter figures.

productivity growth is surprisingly strong, given its cyclical position, although the United States is experiencing a similarly rapid increase.

The outlook for inflation is generally encouraging. With slower activity in Western Europe and Japan and the prospect of steady but not over rapid growth in North America, demand pressures are likely to remain subdued in relation to potential output, limiting both output and commodity price increases. Wage pressures seem to be weakening in Western Europe. In Italy the response to devaluation has so far been quite small and in western Germany recent settlements suggest that earnings growth in the current pay round will be well below 4%. Consumer price inflation is probably past its peak in Germany. Although indirect tax and depreciation effects in some countries may push up aggregate EC inflation, inflation will stay relatively subdued in those countries participating in the narrow band of the ERM. The latest pick-up in inflation in the United States is unlikely to be sustained and low inflation seems well established. Consumer price inflation in the major six is unlikely to be above 3% at the end of the year.

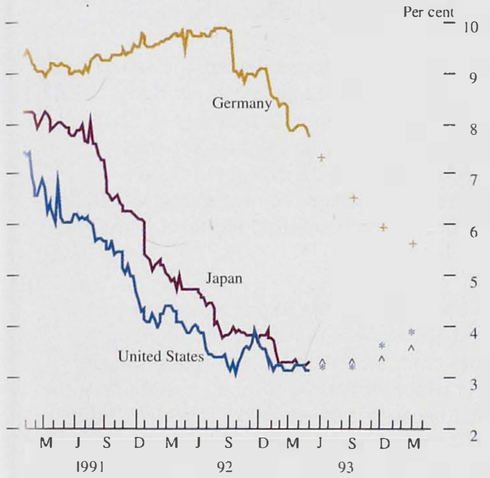
Exchange rates and interest rates

In effective rate terms, the dollar and the deutschmark have stayed fairly steady over the last three months (Table E). The yen, however, appreciated by over 8%, reaching a record high against the dollar on 18 April. The yen has strengthened at a time when Japan's external account surplus is rising and, given patterns of relative demand, may rise further still. The markets took the view that both the US and Japanese authorities would be content to see a stronger yen. The prospect of the April supplementary fiscal package appears to have been one factor encouraging yen purchases in the markets. There has been little economic news to change significantly the markets' perceptions of the likely monetary policy stance in the United States and Germany.

Among the Western European currencies, the main feature has been the depreciation of the lira which fell by about 7% in effective terms in the first quarter, as Table E shows. Pressures intensified towards the end of March with a depreciation of nearly 3% in the last week of the quarter which took it beyond Lit/DM 1,000. This was largely a response to political developments in Italy and the lira has since strengthened somewhat. The French franc traded at around FFr/DM 3.38–3.40 for most of the first quarter, but pressures eased in April after the parliamentary elections.

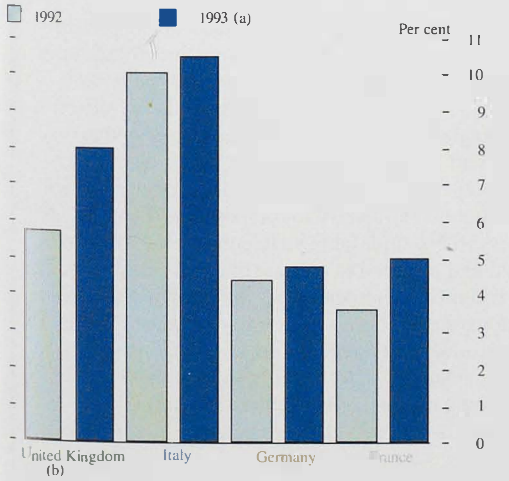
The main development in monetary policy has been the gradual reduction in official and market interest rates in Germany. Official rates have been cut by 100 basis points since the beginning of the year, and three-month market rates have fallen below 8%, compared with 9% at the end of 1992. The markets expect further falls, but the Bundesbank has cautioned against excessive easing in the coming months. The reduction has allowed interest rates in other ERM countries to fall although risk premia remain sizeable in some cases. Further easing of policy in Germany could lead to larger reductions elsewhere as the risk premia on other ERM currencies are reduced. Risk premia have already fallen significantly in France, allowing three-month market interest rates to fall to within 50 basis points of German rates. Such reductions will improve the prospects for output growth, albeit with a lag.

G3 three-month and future interest rates



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

General government deficits as a percentage of GDP



(a) Bank forecasts for Italy, Germany and France.
(b) UK PSBR figures—*Financial Statement and Budget Report* 1993–94.

Table F
Contributions to western German GDP growth

Percentage changes on previous year

	1990	1991	1992	Forecast 1993
Consumption	3.0	2.0	0.5	*-0.3*
Investment	1.8	1.4	0.2	-0.6
Government spending	0.7	0.3	0.4	*0.1*
Stocks	-0.4	-0.5	-0.1	*0.2*
Domestic demand	5.1	3.2	1.1	*-0.6*
Net trade	-0.1	0.4	-0.7	*-0.8*
GDP growth	5.0	3.6	0.3	*-1.5*

In Canada, short-term rates fell 150 basis points during the first quarter. Although short-term rates in the United States and Japan were relatively stable, US long rates (ten-year) fell markedly, with US bond yields falling to 5.8% in early March after the announcement of plans to reduce the fiscal deficit. In Germany, long rates are also relatively important for activity, and fell by 0.6 percentage points. Long rates have also fallen significantly in France and Italy.

Western Europe

Recession is intensifying in most of Western Europe

Output fell in most Western European countries in the fourth quarter. Of the major EC economies, output increased only in the United Kingdom in that quarter. Overall EC growth was 0.6% for 1992 as a whole.

The impact of the slowdown on unemployment has generated widespread concern across the Community and has prompted the introduction of specific labour market packages in France, Italy, Spain, Denmark and Ireland. The fall in activity threatens to push the aggregate fiscal deficit of EC Member States well beyond 5% of GDP in 1993, even though recent falls in interest rates should reduce debt servicing costs. The scope for additional fiscal easing is therefore limited, although the Edinburgh initiative has encouraged Governments to find ways of reorienting expenditure towards capital projects and has established lending initiatives by the European Investment Bank and the new European Investment Fund.

Inflation continues to ease across Western Europe as slowing activity adds to the downward pressure on prices already generated by tight monetary and exchange rate policies. Most sources of domestic inflationary pressures subsided during 1992, with encouragingly low wage settlements and manufacturing sector price increases throughout Europe.

EC output is now expected to fall by ½% this year. EC inflation will be around 4%.

Activity in western Germany has weakened sharply

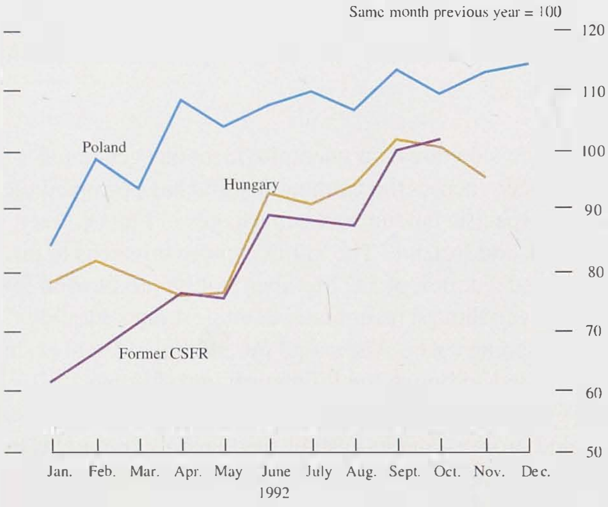
The western German economy weakened sharply in 1992. Despite stronger than expected consumption expenditure in the fourth quarter, a contraction in net trade and machinery investment caused a fall in GDP of 1% from the previous quarter. The final quarter boost to consumption, in anticipation of January's VAT rise, is expected to have proved short-lived and retail sales have fallen in early 1993. The manufacturing sector is experiencing destocking and the end of the unification-driven boom; industrial production fell further in the first quarter from already low levels; and business orders and confidence remain depressed.

Relatively low wage settlements, slowing monetary growth and the 'Solidarity Pact' have enabled some further easing in monetary policy, despite continuing slow progress in reducing consumer price inflation. Inflation has fallen to a preliminary 4.3% in April from its VAT-induced peak of 4.4% in January, with rents and services prices still rising at over 6%.

Prospects for economic recovery in Eastern Europe

During the last three and a half years Poland, Hungary and the former Czechoslovakia (CSFR) have introduced ambitious economic stabilisation and reform programmes. These have met with considerable success, but they also led to a deep and prolonged contraction in domestic demand which, with the loss of important export markets in the former Soviet Union (FSU), caused a substantial decline in output. Over the last year, though, these measures have encouraged the first signs of economic recovery in all three countries (see Chart A).

Chart A
Industrial production



The recovery has been strongest in Poland. In 1992, Polish industrial production increased by 4%. The construction, service and retail sectors also grew strongly, and recorded real GDP expanded by 1%. But the recovery is probably stronger since, as in all the countries of the region, official data do not include all private sector activity. Recovery has been less pronounced in Hungary and the former CSFR: this partly reflects, in the former, the implementation of bankruptcy legislation and, in the latter, the loss of inter-republic trade caused by economic separation between the Czech and Slovak republics.

The main source of additional demand has been strong growth in exports to the OECD. Supply-side reforms, such as price and trade liberalisation and maintenance of current account convertibility, initially helped to ensure the necessary reorientation of both private and state sector tradable production from FSU markets towards the OECD. More recently, the reforms have encouraged private exporters to concentrate on producing goods in which they have a comparative cost advantage. Competitive exchange rates and trade agreements with the EC and EFTA have also helped export growth.

As Chart B shows, the private sector has played a central role in the recovery. Small-scale privatisation programmes encouraged private firms to concentrate on the retail and service sectors. But private enterprise has also recently accounted for an increasing share of manufacturing and construction output: in Poland, for instance, one quarter of 1992 recorded manufacturing output was produced by the private sector.

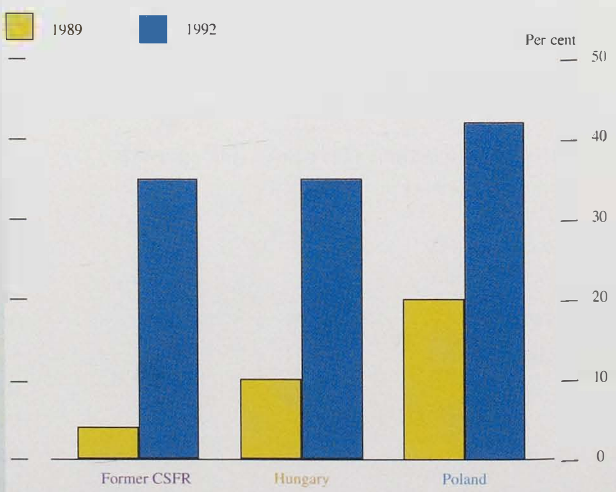
Private sector activity in these countries may now exceed a 'Critical Mass' threshold. Nonetheless, governments have a key role to play in alleviating remaining structural constraints. While these persist, recovery will continue to be fragile.

First, much work remains to be done in developing sound financial structures. Commercial banks are particularly ill-prepared to assist further growth. Their ability to channel savings efficiently to creditworthy investors is severely constrained by the poor quality of their loan portfolios. Programmes to resolve this problem are now under way in all these countries, but these are necessarily long-term in their effects.

In Hungary and Poland bank lending to private enterprise may be restricted by large government borrowing requirements. While these countries continue to implement tight monetary policies, government paper will account for a large share of the available loan capital because it offers banks a riskless, albeit modest, real return. Longer-term investment in all three countries is also discouraged because most of the loans disbursed to private borrowers generally have short maturities and very high collateral requirements (partly due to a lack of credit analysis expertise). Foreign banks will help to strengthen the domestic banking sector in the longer term. But for the present, the absence of well-developed equity markets will severely limit private borrowers' access to alternative sources of finance.

Second, privatisation must be supported by radical changes in management techniques. Large-scale privatisation programmes will transfer a large proportion of state industry to the private sector. But it is also necessary to ensure that newly privatised enterprises are managed effectively; a change in ownership alone is not sufficient to achieve productivity improvements. Even after large-scale privatisation, the residual state sector will continue to contribute significantly to total output. For sustained recovery, these remaining state enterprises will need to be restructured and required to operate in an environment offering proper incentives and penalties; the implementation of effective bankruptcy legislation is therefore essential. All three countries have introduced this legislation, but so far only Hungary has experienced its effects. Although implementation has subdued the Hungarian recovery in the short term, Hungary's economy is now in a stronger position to generate sustainable growth over the medium term.

Chart B
Contribution of private sector to GDP(a)

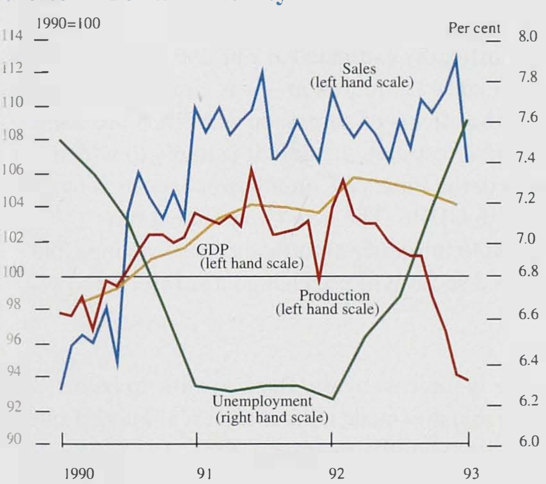


(a) Bank estimate.

The outlook for inflation is more encouraging. Headline figures are expected to fall this year to around 3½% by the fourth quarter. Settlements in the 1993 wage round have been considerably lower than initially feared, averaging around 3.5% despite initial claims of double this in most sectors. Wage settlements have been generally higher in eastern Germany. The rate of catch-up with west German wages seems to be slowing, but this remains a continuing threat to inflation as a whole and to east German competitiveness. M3 grew by around 0.3% (seasonally adjusted annualised rate over the fourth quarter base) in the first quarter of 1993—well down on the strong growth in late 1992—as the economy contracted and some of the special factors which have boosted monetary growth in the past year began to unwind.

Agreement was reached in March on the 'Solidarity Pact' for fiscal consolidation, but only after a serious dispute over the appropriate mix of expenditure cuts and tax increases and the question of how to share the burden of east German reconstruction. The agreement falls some way short of the Government's initial proposals: it achieves only modest expenditure reductions and apportions substantial future VAT revenues to the Laender. The 'solidarity' income tax surcharge will now be re-introduced at a 7½% rate in 1995. As such, the pact does not directly address immediate concerns over the burgeoning general government deficit, which is projected to widen to over DM 150 billion, 5% of GDP in 1993. But in the medium term it does reduce the prospect of a widening of the deficit and allows room for a continued easing of monetary policy.

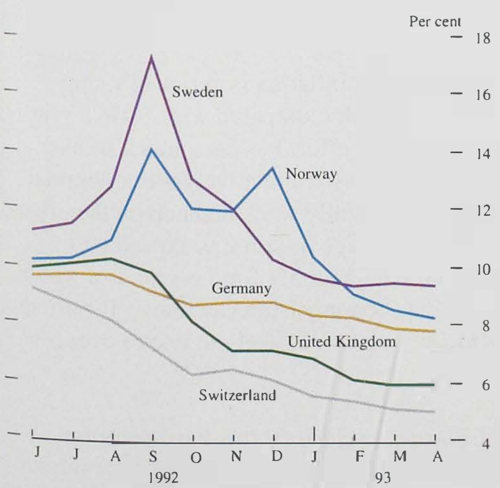
Western German activity



The outlook for activity in western Germany has deteriorated further, with output projected to fall by at least 1½% this year. Capacity utilisation has declined, dampening new investment. Consumption expenditure is expected to fall in 1993, under pressure from a sharp contraction in employment, increasing social security contributions and modest falls in real wages. The weakness in domestic demand is expected to exert steady downward pressure on inflation.

In eastern Germany in 1992 GDP is now estimated to have grown by around 7% and similar growth may be achieved in 1993. But the prospect of a self-sustaining recovery is still some way off. In recognition of this, further commitments to increased transfers, employment promotion and housing reconstruction were incorporated in the 'Solidarity Pact'.

Three-month eurorates



The French economy is sliding into recession; recovery will depend on developments in interest rates

Latest figures show that economic activity in France was less resilient than previously thought throughout most of 1992. Output fell in the fourth quarter, resulting in full-year growth of only 1.2% against an official forecast of over 2%. Business investment fell sharply as weak export market prospects, reflecting weaker demand in Europe, and uncertainties from exchange and interest rate turbulence depressed business confidence further. Unemployment has grown slowly, partly because of extensive labour market measures, but nevertheless rose above 3 million (10.7% of the labour force) in March.

Consumer price inflation rose slightly to 2.1% in the first quarter. The slowdown in activity and the appreciation of the franc largely offset an initial increase in the tobacco tax and a pick-up in food and energy prices. Additional price pressures from further increases in the tobacco tax (expected to add around 0.4 percentage points to inflation) may be less easily contained, but the outlook for inflation is generally encouraging. High productivity and low growth in unit labour costs have so far limited the impact of the effective exchange rate's appreciation on competitiveness.

The substantial widening of the fiscal deficit last year—the general government deficit is officially estimated at FFr 266 billion (3.8% GDP) by the Senate Finance Commission—was largely caused by cyclical pressures. If the effects of automatic stabilisers are not offset by additional fiscal restraint, the deficit is likely to widen further in 1993. Indeed, the Finance Commission expects it to rise to FFr 395 billion (5.4% GDP). The new Government has announced its intention to introduce significant fiscal savings, but the measures announced so far will not change this forecast appreciably.

GDP growth in France is forecast by the Bank to slow to below $^1/_2$% in 1993, with considerable downside risks if high real interest rates persist. Inflation may rise slightly, to around $2^3/_4$%.

In Italy, activity is expected to remain flat in 1993

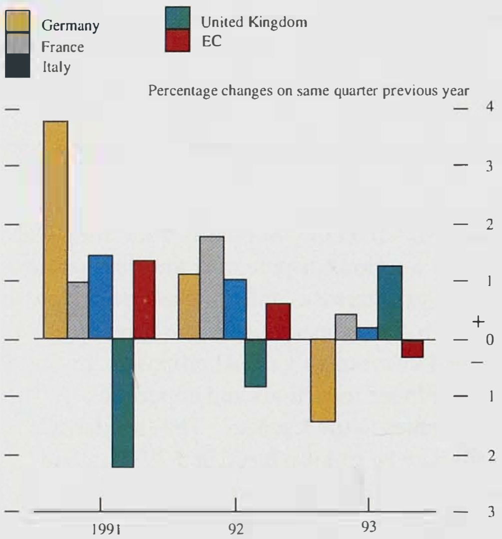
Weakness in almost all components of demand has contributed to the slowdown in Italy. Investment fell 1.7% over 1992; but the dramatic slowdown in consumption, after persistent strength in 1991, has perhaps been more significant. High interest rates and falling real wages have been important factors in this. Political turmoil caused by recent corruption scandals placed the currency under significant pressure, raising the risk premium and limiting the scope for reductions in interest rates.

In 1993, activity is likely to continue to slow, with only 0.2% growth in GDP forecast for the year. Signs are emerging that the sharp lira depreciation of recent quarters is stimulating a recovery in export volumes, but this is expected only to offset weak domestic demand.

As a result of the lira's depreciation, inflation is at risk of rising again, having fallen to 4.2% in March (compared with 5.4% a year earlier). But so far, the depreciation effect has been much weaker than might have been expected because of relatively weak nominal wage growth and the impact of generally weak demand on the prices of imported goods. During 1993, wage inflation is expected to remain modest, perhaps averaging under 3% for the year as a whole. But, unless the weakness of the economy exerts an unusually strong downward influence on prices, inflation is likely to rise to over 6% by the fourth quarter.

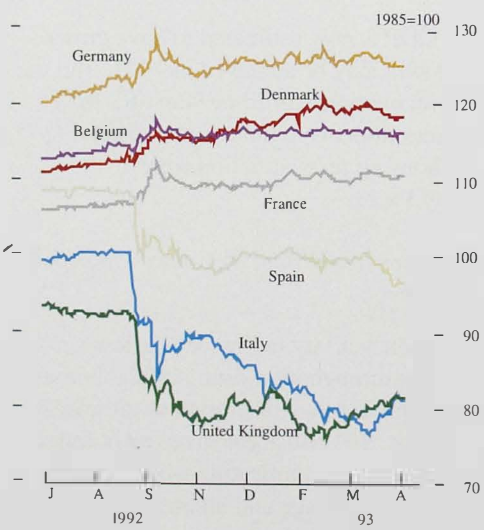
As in much of the rest of Europe, cyclical factors have contributed to a deterioration in the fiscal outlook. The original primary surplus target of Lit 50 trillion in 1993 is projected to be undershot by at least Lit 25 trillion, but this is likely to be partly offset by lower than expected debt interest repayments over the year (reflecting sharper than expected reductions in interest rates since the budget was published). Bank projections suggest that the general government deficit will reach around 11% of GDP this year, up from around 10% two years ago. Additional fiscal measures are currently under

EC GDP growth



(a) Bank estimate.

Effective exchange rates



discussion but seem unlikely to reverse the slippage entirely. Meanwhile, uncertainties over the revenues likely from new tax measures add to the risk of a larger overshoot.

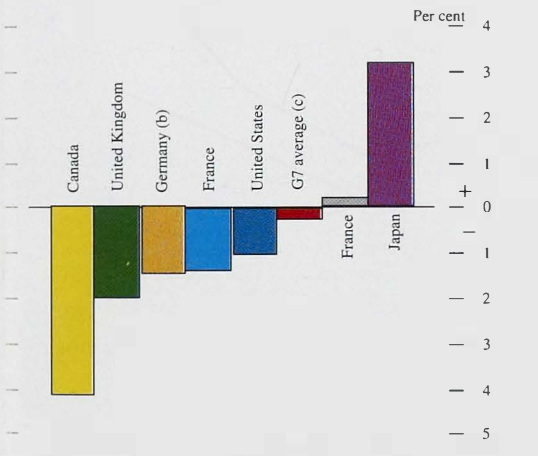
Activity is expected to slow further in Spain

Activity weakened sharply in Spain in the final quarter of 1992, largely because of the continued weakness of investment. GDP growth for 1992 as a whole was 1%. Although the depreciation is expected to boost net trade, this is unlikely to prevent a contraction in output this year. Spanish inflation fell on both headline and underlying measures in early 1993, largely because of base effects from last year's indirect tax increase. Depreciation has so far had little noticeable impact on inflation, though some effect may become more apparent once the effects of last year's tax rise have worked through.

Elsewhere in Western Europe the outlook for activity has also deteriorated, despite significant monetary easing in some countries

Activity weakened over 1992 in the rest of Western Europe, with a general contraction in output in the final quarter. Official forecasts have been revised down recently in Belgium, Denmark and the Netherlands where negligible growth is expected in 1993. The outlook has deteriorated in spite of some easing in interest rate pressures; short rates have generally followed German rates down. Where monetary policy has not been constrained by ERM membership—notably Norway and Switzerland—interest rates have generally been reduced, but the outlook for activity is still poor in 1993.

1992 current account as a percentage of GNP(a)



(a) GDP for Italy, the United Kingdom, France and Canada: + = surplus, – = deficit.
(b) Unified current balance as a percentage of western German GNP.
(c) G7 average GDP weighted.

North America

Growth of 3% seems likely in the United States this year

Although first quarter figures for GDP showed substantially slower growth compared with the end of last year, the United States remains on course for growth of 3% or so in 1993. Growth of nearly 5% (at a seasonally adjusted annualised rate) in the fourth quarter of 1992 provided reassurance that the recovery was gathering momentum, but was not expected to be sustained into 1993. The slowdown in growth to 1.8% in the first quarter reflected slower increases in consumption and investment, and a large fall in government expenditure; stockbuilding grew strongly.

Table G
Contributions to US GDP growth

Percentage changes on previous year

	1990	1991	1992	Forecast 1993
Consumption	0.8	-0.4	1.5	*1.9*
Business investment	0.0	-0.8	0.3	*0.7*
Residential investment	-0.4	-0.5	0.5	*0.5*
Government spending	0.5	0.2	-0.1	*-0.1*
Stocks	-0.5	-0.3	0.3	*0.2*
Domestic demand	0.4	-1.8	2.5	*3.2*
Net trade	0.5	0.6	-0.4	*-0.3*
GDP growth	0.8	-1.2	2.1	*3.0*

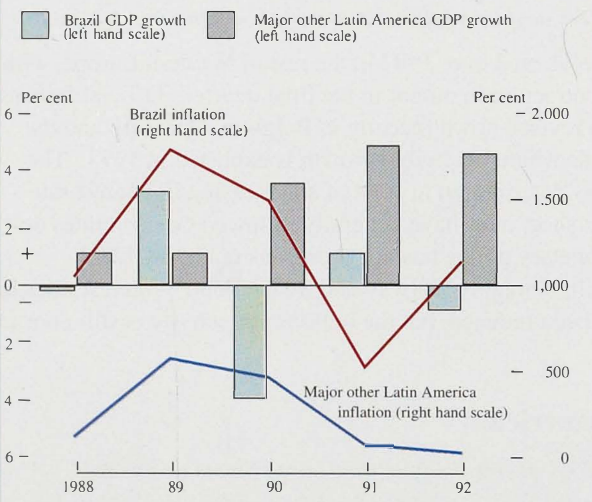
The US recession officially ended two years ago, but it was only towards the end of 1992 that the recovery strengthened to anything like the pace of previous recoveries. Structural adjustment by the corporate sector seems to have been one factor delaying the recovery. During the previous boom, companies built up a significant debt burden, and it is only as the corporate sector debt service ratio has fallen—largely because of lower interest rates—that recovery has become firmer. Corporate restructuring has also had a significant impact on employment which has only recently begun to rise, having followed a path out of recession which has been weak by historical standards.

One counterpart to slow employment growth has been a solid improvement in productivity—productivity growth is at its highest since the early 1980s, and unit labour cost growth has fallen below 1%. These changes have permitted a significant rise in firms' price-cost margins and in the after-tax profits of business (up 17%

Latin America

The attention given to the resurgence of Latin America has masked important differences between the performance of individual countries. Those which stabilised and liberalised their economies earliest have benefited most from faster economic growth, renewed capital inflows and a reduced debt burden. Stabilisation has involved a much strengthened fiscal position and attainment of positive real interest rates through financial reforms. Liberalisation has typically meant the lowering of restrictions and tariffs on imports, privatisation and easing of state regulation of the economy.

Chart A
Latin America: GDP growth and inflation

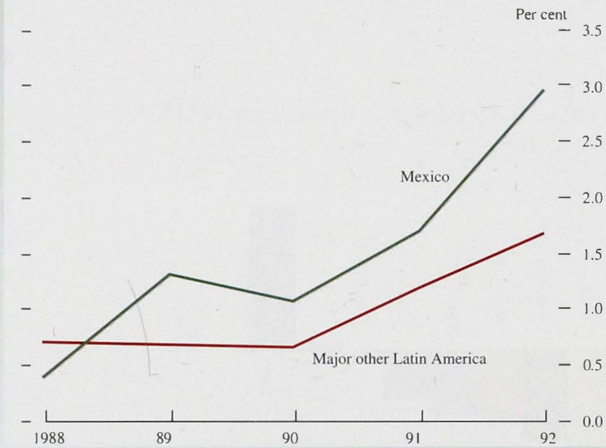


The recent poor growth and inflation performance of Brazil (38% of Latin American GNP) has been markedly out of line with the rest of the region (see Chart A). By contrast, Argentina, Chile and Venezuela have recorded average growth rates of more than 6% in the years 1991–92, while also reducing inflation.

The region as a whole has seen increased capital inflows, contributing both to a surge in imports (up 77%, from $79 billion in 1988 to $140 billion in 1992) and an increase in international reserves (up $55 billion, or 132%, over the same period). These flows include repatriated and foreign capital, attracted by greater economic stability and high real interest rates; but a significant part has been foreign direct investment (FDI).

The overall trend is heavily influenced by Mexico which, though representing only 21% of the region's GNP, accounted for 41% of FDI in 1990–92 (see Chart B) and for 56% of import growth between 1988–92. Mexico has attracted capital not only because of successful stabilisation policies but also because of the prospect of the North American Free Trade Agreement (NAFTA) currently being negotiated. By comparison, the scale of

Chart B
Latin America: foreign direct investment as a percentage of GDP

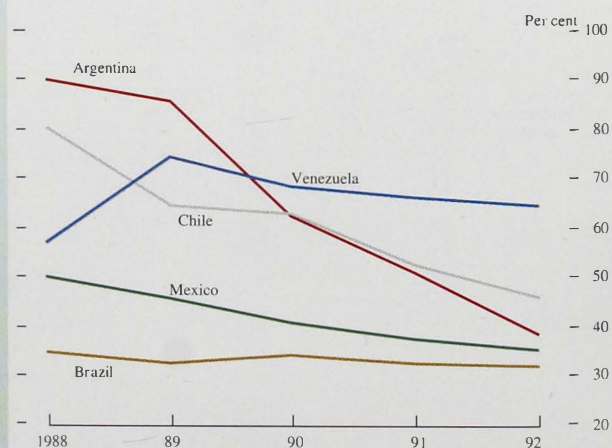


capital inflows into the main South American economies has been modest in absolute terms.

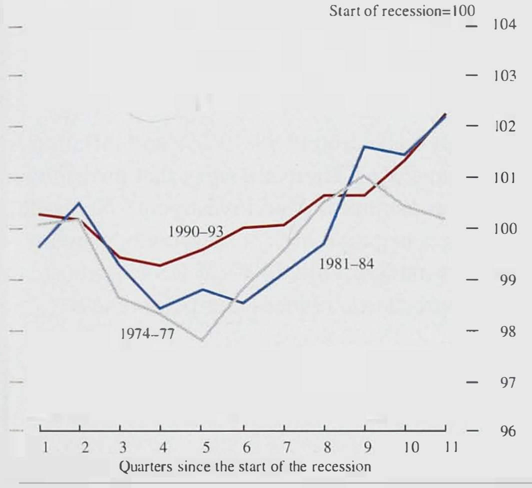
Capital flows have financed widening current account deficits in some countries: notably, in 1992, in Argentina, Venezuela and Mexico. Brazil's experience has been different: it has consistently run a large trade surplus and, relative to its size, has attracted smaller capital flows.

Although the absolute level of the region's external debt is still high—and has in fact increased in US dollar terms since the debt crisis broke in 1982—measures of debt burden have come down in most countries in recent years (see Chart C). Mexico and Venezuela took early advantage of 'Brady' debt reduction deals with commercial banks. The benefits of similar deals with Argentina (recently concluded) and Brazil (being negotiated) are in the pipeline. Other countries (Chile and Colombia) have reduced their debt burden without the need for such debt reduction deals.

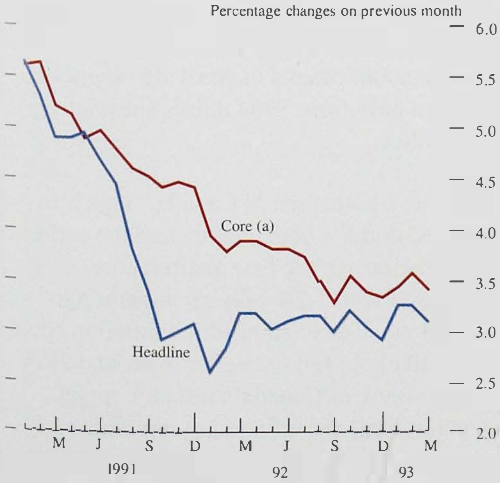
Chart C
Latin America: total external debt as a percentage of GDP



Comparison of US productivity cycles



US core and headline CPI



(a) Excluding food and energy.

in the year to end-1992). The better prospects for profitability and the apparent substitution of capital for labour have been reflected in strong investment growth. The rise in investment has played a central role in increasing the growth rate over the past six months or so.

The weakness of employment growth and its impact on consumption have, however, raised concerns about the durability of the recovery. The growth of non-farm employment has increased since the end of last year, and in the first quarter was at an annual rate of just below 1%—the strongest since 1990. But manufacturing employment has fallen by 1% over the last year. There is also evidence that white collar workers have suffered proportionately more job losses in the latest cycle than a decade ago and that, more generally, labour market restructuring has been spread more evenly across occupations. These may be further factors in explaining why the recovery in incomes and consumption has been unusually weak.

The slow growth in employment and in real personal incomes is one of the main concerns shaping the new US Administration's approach to fiscal policy. The other is the desire to reduce the federal government financial deficit. The concern with employment is reflected in the original intention to provide a small short-term fiscal stimulus (which has since been abandoned) and in the proposed switches in investment programmes. The concern with the size of the deficit, (which reached $290 billion—5% of GDP—in 1992), is reflected in the plan to cut it to $212 billion by 1996. On the basis of the Administration's own figures the ratio of government debt to GDP will, however, continue to rise in spite of the planned deficit reductions. The initial announcement of the fiscal package in February was met with a rally in the bond markets. Between November and April, ten-year rates fell by 100 basis points. Falls of this size in interest rates have a much greater potential impact on activity than the planned short-term fiscal stimulus.

Continued weak growth of the monetary aggregates has also raised some residual worries about the strength of the US recovery. The Federal Reserve Board has lowered its target ranges for both M2 and M3 by 0.5 percentage points; but M2 growth—at minus 2.5% in the first quarter relative to its fourth quarter target base—is still well below the bottom of the new 2%–6% target range. Credit growth has also been weak but picked up slightly during the first quarter of the year. Structural factors such as increased disintermediation, the movement into higher-yielding non-M2 deposits and balance sheet restructuring by the household and business sectors explain part of the weakness in the monetary data. But the underlying weakness of the monetary aggregates remains a concern.

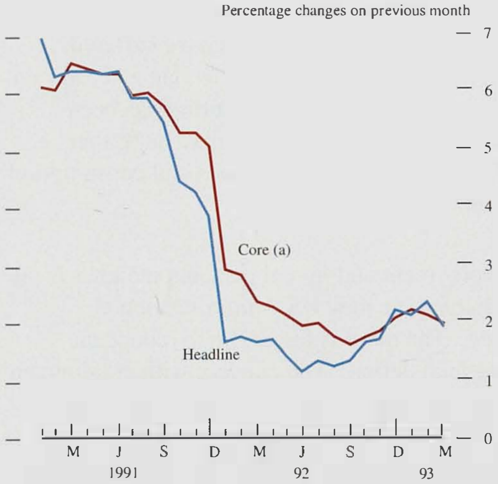
The pick-up in US inflation should prove temporary

After a sustained fall in consumer price inflation of over three percentage points from 1990 to end-1992, both the headline and core rates increased during the first quarter. The headline rate rose by 3.2% in the year to the first quarter, but the ½% increases in prices in the first two months were followed by a smaller rise in March. The increases are widely attributed to special factors: they were concentrated in several sectors (clothing, transport), and they may reflect a shift in the timing of price-setting announcements in a lower inflation environment.

Although commodities prices have risen, particularly for a number of commodities which the United States uses intensively, other cost and price increases remain subdued. The increase in producer prices remains below 2% a year; manufacturing earnings growth is around 2½%; and the rapid growth of productivity has led to a fall in manufacturing unit labour costs in the last two quarters. These indicators suggest that the prospects for inflation are generally good, though the risk of an upturn from demand pressure may increase.

US growth this year is likely to be around 3%–3½% and inflation is expected to level off at around 3%. There are signs that growth will be quite balanced between consumption and investment. Net trade is likely to continue to have a negative impact on growth, as many of the United States' export markets slow (40% of US exports are to the EC) and the dollar's appreciation reduces competitiveness gains.

Canadian core and headline CPI



(a) Excluding food and energy.

Canadian activity has responded to the stronger growth in the United States

Canada's GDP rose in the fourth quarter by 0.9%. This mostly reflected a recovery in net trade, which is likely to continue to provide a strong impetus to growth during 1993. The depreciation of the Canadian dollar—by 5½% from a year ago—and strong productivity growth have improved competitiveness.

With 75% of Canadian exports directed at the United States, developments there will largely dictate the path of Canadian growth this year. As in the United States, the Canadian recovery has been weak by historical standards. Consumption is expected to rise this year by more than the 1% recorded in 1992, but is likely to remain comparatively weak. The slow growth of employment seems set to continue. Annual income growth has fallen to around 2½% and confidence remains quite low. Investment too is likely to grow only slowly. The provincial budget round has produced a tighter fiscal stance. The federal budget announcements in April also suggest a tightening of fiscal stance, but only from 1994 unless substantive changes are made to fiscal policy.

Headline and core inflation have both risen in Canada. This was widely expected following the dollar's depreciation and the earlier pick-up in producer price inflation. In the first quarter, core inflation rose to 2.1% compared with 1.7% only six months ago. Further rises are likely to follow. Canadian headline inflation could reach 3% by year-end but is likely to fall thereafter to around 2½% by mid-1994, in line with the Bank of Canada's inflation target. The longer-term prospects for domestic inflationary pressures are more hopeful—manufacturing earnings growth remains below 4%, unit labour costs are weak and, even with 3% growth this year, a significant degree of excess capacity will remain.

Table H
Contributions to Japanese GNP growth

Percentage changes on previous year

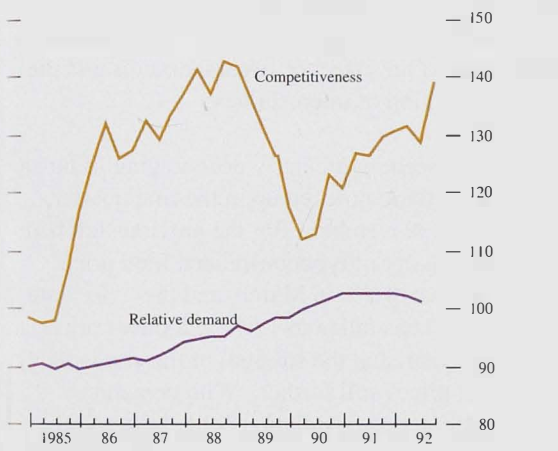
	1990	1991	1992	Forecast 1993
Consumption	2.3	1.3	1.0	*0.4*
Business investment	2.3	1.2	-0.8	*-1.5*
Residential investment	0.3	-0.5	-0.3	*0.2*
Government spending	0.5	0.4	1.0	*0.9*
Stocks	-0.3	0.3	-0.2	*-0.4*
Domestic demand	5.1	2.7	0.6	*-0.4*
Net trade	-0.3	1.4	0.9	0.9
GNP growth	4.8	4.1	1.5	*0.5*

Japan

Private sector activity is weak and the fiscal packages have yet to increase effective demand significantly

GNP rose marginally in the fourth quarter of 1992, giving growth of 1.5% for the calendar year. The main contributions to output in the fourth quarter came from net external demand and from government investment. The latter probably owed more to the March 1992 fiscal measures than the August 'emergency' package. The strong net external sector's contribution reflects the weakness of domestic demand—and hence low import growth—and the comparative strength of export volumes.

Japanese competitiveness(a) and relative demand(b)



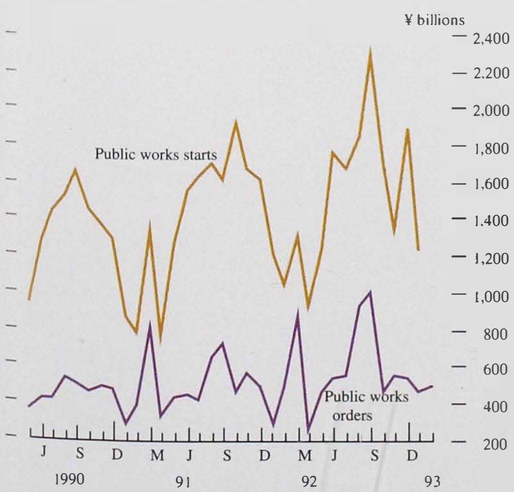
(a) IMF measure of competitiveness based upon a real effective exchange index weighted relative to unit labour costs—a rise indicates worsening Japanese competitiveness.
(b) Relative demand defined relative to rest of major seven industrialised countries.

Private sector activity remains weak although the principal monetary aggregate, M2+CDs, seems to have strengthened. The corporate sector has yet to reduce its net outstanding financial liabilities and the Bank of Japan's Tankan survey indicates that business confidence is at its lowest since 1976 and that investment is likely to fall again in the financial year 1993. Industrial production is nearly 10% below its peak after its rise in February and, although stocks are falling, the stock-to-output ratio remains well above its long-term trend.

Further retrenchment of the corporate sector seems likely. As yet, the labour market has been quite sheltered. Unemployment has risen to 2.3%, employment growth has fallen and overtime hours have been cut significantly. But, despite several 'headline' cases of job cuts and plant closures, the lifetime employment system seems to be surviving the current recession. The weakening labour market, the associated cut in nominal earnings growth—this spring's Shunto wage round has produced average settlements below 4%, the lowest for six years—and the fall in land prices all contributed to a fall in consumer confidence. Personal consumption is therefore likely at most to make a muted contribution to growth this year.

The slow growth of business and personal sector expenditure will continue to depress domestic demand relative to that overseas. Relative demand movements have underpinned the rise in the Japanese current account surplus to 3.2% of GDP. The surplus is likely to rise further this year, despite the appreciation of the yen, so that the external sector may remain the main contributor to growth.

Japanese public works starts



In April, the Ministry of Finance announced a supplementary budget for the financial year 1993 of ¥13.2 trillion (2.8% of GNP). This is larger than the August 'emergency' package, but broadly contains the same mix of central and local authority capital spending. Much of it, as before, is either financed by, or operates through, the Fiscal Investment and Loans Programme. In the April package, ¥1.8 trillion is to be financed by the issue of new central government 'construction bonds' compared with ¥2.3 trillion of the August package. Up to a further ¥3.5 trillion may be financed by new local authority bonds.

If headline expenditure figures represented actual additions to government expenditure, they would imply a strong stimulus to growth. But neither the timing nor the effective size of the additional spending is readily apparent. By February there had been little impact from the August package or the associated supplementary budget, passed by the Diet in December (see chart). On the basis that the effective size of the stimulus is closer to the level of new funding than it is to the headline expenditure numbers, GNP growth of around ½% is expected in calendar year 1993 (1% fiscal year 1993).

The banks all comfortably cleared the BIS capital adequacy ratio requirements in March, with an average ratio expected to be around

9% for the major banks. The strengthening of both the Nikkei index and the yen over the past six months were significant factors. But the banks have also taken active measures to manage their assets and raise capital. Profits for the year to March 1993 will again have been affected by increased provisions and write-offs.

The Nikkei rose to 20,919 on 30 April, its highest since last March. The rise in the index is widely assumed to reflect, to some extent, public sector support measures. But the rally also seems to comprise private sector purchases, notably from overseas, possibly reflecting expectations about the effect of fiscal measures and the likelihood of a further reduction of interest rates.

The prospects for inflation seem particularly encouraging in Japan. Headline consumer price inflation picked up in the first quarter, having fallen below 1% last November. But the previous fall had partly reflected the dropping out of typhoon-related food price factors. The headline rate was 1.2% in March, and the 'core' rate (excluding food and energy) has fallen to 1.6%. Producer prices are still falling, by over 2% a year, and the strength of the yen is likely to depress imported input prices still further. With demand pressures also weak, consumer price inflation is likely to end the calendar year at around $1\frac{1}{4}$%.