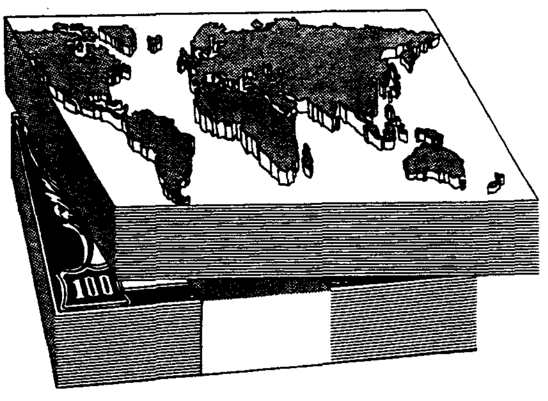
McFarland, Mark and Ashcroft, Brian and Brooks, Richard and Draper, Paul and Dunlop, Stewart and James, Tony and Lockyer, Cliff and Love, Jim and Malloy, Eleanor and McGregor, Peter and McRory, Eric and O'Brien, Vanessa and Stevens, Jim and Swales, Kim and Yin, Ya Ping and , Fraser of Allander Institute (1992) The world economy [December 1992]. Quarterly Economic Commentary, 18 (2). pp. 1-4. ISSN 0306-7866 ,

THE WORLD ECONOMY



MACROECONOMIC TRENDS

In the second quarter of 1992 GDP/GNP growth averaged 0.5% in the main four world economies. The position of the USA, Germany and France improved but growth slowed dramatically in Japan. Table 1 sets out growth rates for each country and provides a provisional estimate for the USA in the second quarter.

Table 1 Growth of GNP/GDP

	1991q4	1992q1	1992q2	1992q3
United States	0.1%	1.6%	1.6%	2.7%p
Japan	0.1%	1.1%	0.3%	
Germany	-0.5%	1.9%	-0.2%	
France	0.1%	1.0%	0.1%	
Italy	0.4%	1.4%	n/a	
UK	-1.1%	-0.5%	-0.2%	0.0%p

Industrial production recovered in the first quarter in Germany and in United States. Production has declined in France and collapsed in Japan, as can be seen in table 2.

Consumer Price inflation remained reasonably stable over the three quarters. The major inflationary gains were achieved in Japan and Italy.

Table 2 Growth of Industrial Production

	1991q4	1992q1	1992q2
United States	-0.5%	1.3%	2.0%
Japan	-1.6%	-4.6%	-6.2%
Germany	0.1%	1.3%	1.1%
France	1.7%	1.1%	0.1%
Italy	-0.7%	-0.3%	n/a
UK	-0.8%	-1.3%	-0.2%

Table 3 Consumer Price Inflation

	1991q4	1992q1	1992q2
United States	3.0%	2.9%	3.1%
Japan	3.2%	2.1%	2.5%
Germany	4.5%	3.3%	3.5%
France	2.9%	3.1%	3.1%
Italy	6.1%	5.6%	5.5%
UK	4.2%	4.1%	4.2%

The unemployment position in Italy, France and the United Kingdom remains acute, especially in the latter. Unemployment has also been rising steadily in the United Stats but not the same levels as these European economies

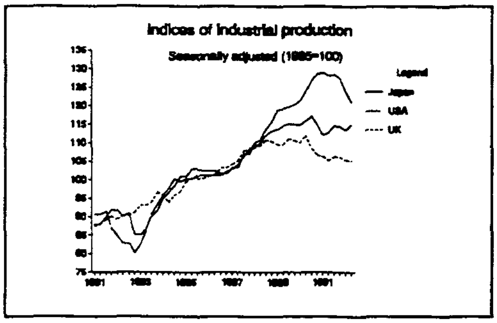
Table 4 OECD Unemployment Rates

	1991q4	1992q1	1992q2
United States	6.9%	7.1%	7.4%
Japan	2.1%	2.0%	2.1%
Germany	4.3%	4.3%	4.5%
France	9.9%	10.1%	10.3%
Italy	9.9%	9.9%	n/a
UK	9.7%	10.2%	10.5%

THE UNITED STATES

The world economic slowdown has led to only a few countries experiencing outright recession or two successive quarters of negative growth. In fact in the USA growth has been positive, although sluggish, since the small nine-month downturn experienced after the end of the Gulf War.

Optimistic hopes of a recovery were rewarded in the third quarter with GDP growth of 2.7%. This is a provisional figure and is based on incomplete information - in some cases only July's information was available. The main contributions came from consumer spending and defence spending which grew by 3.4% and 7.0% respectively. Growth was also boosted by a large rise in corporate inventories.



However euphoria should be contained since there are many conflicting indicators and *experts* tend to believe that most of this growth occurred in the first two months of the quarter, leading to fears that the outcome will be in the 1.5% - 2.0% region, the quarterly average for 1992H1. It is unlikely that growth can be sustained in defence spending given the end to the Cold War and the cuts promised by President elect Clinton. These fears are perpetuated by a renewed fall in the savings ratio from 5.4% to 4.3%.

Industrial Production rose by only 1.1%, 1.0% and 0.6% in the period June - August 1992, after peak growth of 2.5% in April. The rise in Housing Starts came to an end in October. Consumer confidence also weakened again in August as the index fell from 72.6 in June to only 56.4. Trade is another area where the USA shows protracted signs of weakness, mainly due to the slowdown in traditional export markets in Japan and Europe. In the second quarter exports grew by 4.5% while import trade expended by 11.4%.

Consumer spending should receive a boost from the apparent peak in unemployment in June 1992. The OECD unemployment rate fell slightly in July and August, but reversed direction in September the largest rise for three months. In June it peaked at 7.7% of the workforce, falling to 7.5% in August, rising again to 7.6% in September. The vacancy rate indicator, after showing fairly erratic behaviour, has risen from 59.9 to 61.3 in August.

Money Supply figures for October are encouraging. After Narrow and Broad money growth dipped to 11.0% and 1.6% in June they have both recovered to rates of 14.3% and 2.3% in October. Both short and long term interest rates rose in the last month following expectations of imminent rises in rates as the recovery consolidates. Fortunately the rise in imports came on the back of renewed consumer demand and may signal an end to the lack of retail demand that has for so long failed to lift the U.S. from moderate to sustained growth rates.

President elect Clinton hopes to reduce the Budget deficit, which currently stands at a gargantuan $290bn, through increased *fairness* in taxation. In addition a fiscal stimulus of $30bn - $40bn is planned via temporary investment tax credits, acceleration of public infrastructure projects and possibly a cut in capital gains tax on some forms of investment. The US authorities have also set out plans to boost export trade to some 15% of Gross Product from the current 10% level.

A mild increase in inflationary pressure was evident in September. While Consumer Price inflation fell from 3.2% to 3.0% from July to August, the increases in Producer Price inflation and unit labour costs imply some form of resurgence. Over the three months to August unit labour costs fell on average by 0.3%. In September they rose by 0.6%. Producer prices over the four months to September were higher than at any time in 1991/1992.

JAPAN

The lack of synchronicity in the *World Recession* can best be seen when one compares the US and Japanese economies. Like the UK, the USA was at the front of the queue when the world slowdown began. In contrast, the Japanese economy only began to falter in the second half of 1991 and it is not until recently that talk of outright recession emerged. The main features of Japan's malaise are the decline in business orders, falling asset prices and a record 63% increase in personal defaults depressed consumer spending, which grew at only 2.4% in 1991. In addition average land prices have fallen in 1992 for the first time since records began in 1975.

In the second quarter of 1992 Gross National Product rose by 0.3% compared to 1.1% in the three months to March, again buoyed up by a Current Account Surplus resulting from deficient domestic demand. At home, industrial Production fell by 6.2% in the second quarter. The acuteness of this can be seen in contractions of 3.8%, 6.1% and 7.6% in the period from June to August. Retail sales volume, as noted in Commentary Vol 17 No.1, has been very erratic and as yet shows no signs of disclosing a turning point in the fortunes of the Japanese consumer and their willingness to respond positively to lower interest rates and a re-emergence of growth in the housing market, the latter a lantern showing potential recovery in the financial system.

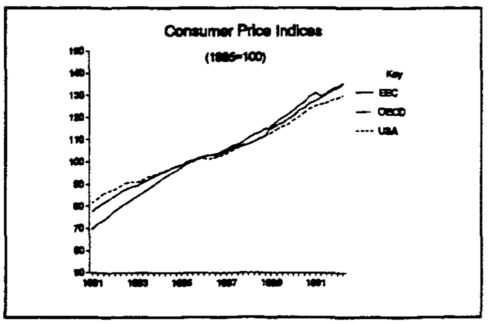
On the investment side, the proposed Y10,000bn or 2.3% of GNP fiscal stimulus in the Supplementary Budget, which was delayed by political wrangling between fiscal conservatives and politicians anxious to elude recession, is expected to keep growth just above 1.0% in the present year.

In the labour market, the OECD standardised rate rose to 2.2% of the workforce in July and the vacancy rate indicator rose to 126.9 after it's 8.6 point fall between May and June. Price inflation in Japan seems a distant worry. Although Consumer prices inflation increased by 2.2% in September from 1.8%, producer prices fell by 0.8%, the most substantial decline in the current downturn.

The politically inflammatory Current Account Surplus rose to circa $75bn in 1991. In 1992H1 it totalled $56.2bn, up 94% on the same time last year, a record for any half year. Recovery in the US A and the recent depreciation vis-a-vis the dollar will certainly hamper efforts to bring it below $110bn for 1992 as a whole.

GERMANY

The economic decline in Germany has been quite spectacular since Unification in 1989. German GNP growth has fallen from 5.0% in 1990 to an estimate of only 1.0% in the current year. The main reason for the fall in 1992 has been the weakness in consumer spending and the collapse of investment in the face of historically high interest rates. Growth in consumer spending turned from +1.4% in the first three months to -0.9% in the second quarter. Total investment, which grew by 8.7% in the first, fell by 4.2% in the second.



The main problems facing the German economy are the consequences of excessive M3 targeting and the fiscal legacy of unification.

The Bundesbank's compulsive pursuit of 2.0% annual inflation led to the 1992 target range for M3 of 3.5 - 5.5%. In error the bank did not adequately account for the effects of unification and the downfall of the former Communist Bloc. The resulting demand for credit in the east, resulting from the abolition of price controls, added new impetus to the growth of broad money and produced what was essentially a fake explosion in inflationary expectations within Germany. The resulting high interest rates have crippled investment and consumer spending. In addition Broad Money expanded in response to the defence of the weaker ERM currencies in the run up to Black Wednesday and the latest series of mishaps for the Punt, Escudo and Peseta. It seems that the Bundesbank is intending to use a wider spread of indicators to monitor monetary policy, including currency inflows and international competitiveness.

The effects of unification are twofold. Firstly, the level of unemployment in Eastern - and to some extent Western - Germany has rocketed. Unemployment in the Eastern Lander rose to 17% in January, when employment schemes were withdrawn, and has fallen to a mere 13.9% in the last year. However employment schemes and early retirement are producing what is essentially a phantom decline in the count with no real growth in employment and skills formation. Secondly, high real interest rates are being endured as the Public Sector deficit creeps over DM100 in 1992. Most commentators are certain that taxes will have to increase if Germany is not to breach 60% of GDP debt ceiling agreed in the Maastrict Treaty.

Current price inflation is much lower than the CPI peak of 4.8% in March 1991. In October the index grew by only 3.7%, a slight increase on previous years. Recent wage claims in the west have been in the region of 5-6%, well below their starting level.

Germany's current account is still in deficit, due primarily to the absence of growth in its export markets and the revaluation of the Deutschmark following ERM realignments.

Growth this year is expected to be around 1.0% in Germany as a whole. In Eastern Germany growth projections have been shaved from initial estimates in excess of 20% to singles figures. Certainly the withdrawal of the Unification Tax and the VAT harmonisation in January, which should bring forward siome expenditure, should keep German grow in the blsck for 1992 anyway.

EUROPEAN MONETARY SYSTEM

The events surrounding Black Wednesday have continued in the aftermath of the French Referendum. Following the vote it was hoped that, given Danish capitulation to a revised treaty, currency turbulence would ease and the remaining ERM countries could move towards Political and Monetary Union. Unfortunately the marginal YES decision incited further speculation against the French Franc and the remaining weak currencies within the system, namely the Krona, the Punt, the Escudo and the Peseta. The attack on the Francfort brought heavy and sustained intervention from the Bundesbank who acknowledged that the ERM without the Franc would cease to exist. In the event Bundesbank invervention proved enough and the Franc moved towards the middle of its 2.25 band.

In the past month however instability has returned to the Mechanism is three separate guises. Firstly, the Irish Punt is on the verge of devaluation following one, the indecisive general election in the Republic of Ireland and two, the competitive disadvantage rendered by the devaluation of Sterling, the currency of its main trading partner. The monetary authorities responded promptly and raised interest rates by nearly 20 points to 30%. Secondly, the Scandanavian experiment with shadowing the ERM is over for the time being. The Swedish Krona, like its Finnish counterpart, withdrew and floated in November; a decision taken by the central bank and not the government, who apparently disagree with a floating exchange regime. The implication drawn from the government statements at the time is that, unlike their neighbours, full membership is a central policy objective. Thirdly, the devaluations of the Portuguese Escudo and the Spanish Peseta in September were obviously not enough to convince the financial markets. The usual procedure of a weekend devaluation took place in late-November and both currencies were realigned downwards by 6%. This devluation was asymmetrical since the Portuguese authorites, who believed their fundamentals to be sound, agreed to devalue only because their main trading partner Spain would gain an unacceptable competitive advantage.

The future for the ERM and the European dream seems to be heading towards a series of concentric circles centred on the *Hard ERM* or D-Mark zone comprising Germany, France, Belgium and the Netherlands. The rest of the current members plus Austria, Switzerland, the Scandanavian countries, Greece and of course the United Kingdom will take their places in the outer rings, their position depending on the credibilty of respective monetary policies. Those with impressive records, such as Austria and Switzerland will probably join the inner core and those whose credibility is suspect or unconvincing will cling on to the skirts as the rest move toward monetary and political stability. It has been argued by Karl Otto Phol that the best solution is for the core to forget Maastrict and move directly to full union. Of course every participant would benefit from an arrangement which produces greater stability in the centre and consequently reduces turbulence in the outer regions. However the political acceptability of a super-strong monetary club in Northern Europe is somewhat doubtful.

WORLD TRADE

The end is potentially in sight for the six year long Uruguay Round of World Trade talks, whose aim was to produce far reaching reforms in world trade patterns and increasing the level of free trade. An agreement would obviously benefit the northern countries to a considerable extent.

Question marks over the compatibility of the reformed CAP program and the new GATT proposals led to protectionist threats from the USA, which will come into force in mid December if Eurpoe does not bow to their demands. The main disagreement centred on the European subsidy programs which the USA challenged on the grounds that European exports were being given a unfair leg up into the New World. The media spotlight has focussed on the Oilseed exports from France which themselves amount to $1.5m in all. By the end of November a solution would appear to have been reached and given that the French do not over-ride the wishes of the rest of the European Community the marathon Uruguay Round can come to its far reaching and beneficial conclusion.

THE MEDIUM TERM OUTLOOK

The future of the world economy depends to a great extent on interest rate reductions in Europe and the satisfactory conclusion of the GATT trade talks.

If German inflation falls quickly, and NIESR expect a CPI of only 2% in 1993, interest rate reductions will be a must in order to avoid the spiralling deflationary problems that exist in the UK a present. The Japanese authorities seem determined to stave off recession and the likelihood is that the fiscal stimulus coupled with low interest rates will remove the recessionary psychology which is breeding in the Far East. The United States seems stuck with a annual growth rate of under 2% for this year. However its inability export markets are in recession and with them coming back on stream we should see a resurgence of +2% growth next year.

The prospects for Scotland are especially dependent on these trade and German. One third of UK exports go the the Hard ERM countries and the continued slowdown in Europe is hindering export expansion. The successful conclusion of the GATT trade talks will provide an obvious stimulus for Scottish exporters to break into new markets, especially the Pacific Rim countries which are emerging as the World's fourth economic trading block.