

The OECD economies look set to continue the solid growth seen in the latter part of 1994 into 1995. There is strong momentum in US output and acceleration in Europe. Some recovery had been evident in Japan but it may be disrupted by the effects of the earthquake. Despite rising commodity prices, generally restrained rises in labour costs have helped hold down inflation rates. Monetary policy was tightened further in the US and some other economies but was held steady in Germany and Japan. After the turbulence of early 1994, financial markets settled in the latter half of the year until events in Mexico caused some disturbance. The US dollar had strengthened somewhat in the December quarter but then weakened in January.

Inflation eased slightly in China as food prices grew less rapidly, but strong capital inflows continue to expand the money supply. A key challenge for China will be the reform of state-owned enterprises so that monetary policy is able to moderate, without halting, output growth and so rein in inflation.

OECD Economies

Sustained growth

Driven by strong trade growth and vibrant industrial production, the global economic upswing continued to gather pace over recent months. The US has strong momentum, the European economies are accelerating and Japan is emerging from recession (Chart 1). These positive trends are likely to continue in 1995. According to the IMF, the world economy is expected to grow by 3.6% in 1995, compared with 3.1% in 1994.

US GDP continued to grow strongly, rising by 1.0% in both the June and September quarters and slightly faster in the December quarter. The main factors driving output growth during 1994 continued to be private consumption and investment (Chart 2). Since other industrial economies have joined the recovery, net exports have become less of a drag on the US economy. As developing and transitional economies also recover, net exports could add to demand in 1995. However, the increase in stocks may presage some moderation in output growth in 1995. Consumption growth may be moderating; retail sales were weak in November and December.

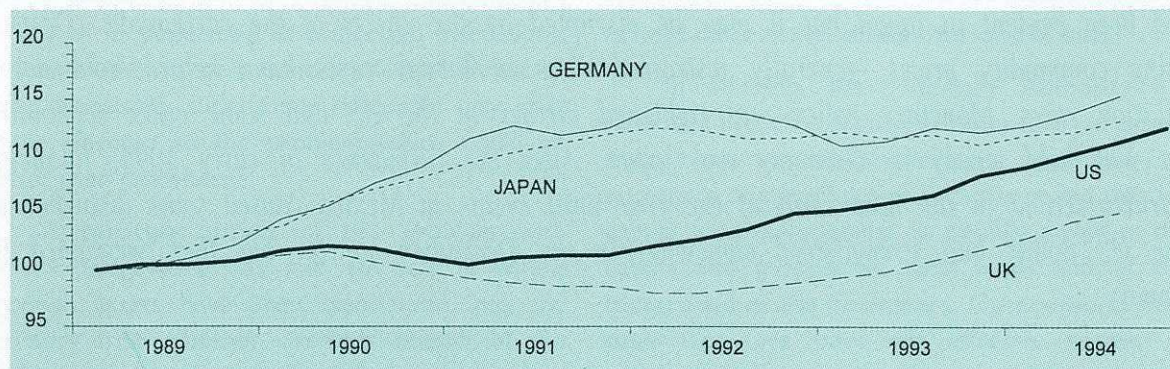
As capacity utilisation rose to a 15 year high in December 1994, the strong activity generated more job opportunities. The unemployment rate

reached a low of 5.4% in December but bounced back to 5.7% in January 1995. This latest increase is unlikely to reflect any marked weakening in the demand for labour as private sector employment and average hours worked both rose. As the labour market improved over recent months, consumer confidence surged to its highest level since 1990.

With stronger global demand boosting the export industries, most European countries have performed better than expected this year (Table 1). Despite these favourable signals from the economy, unemployment rates in Europe have remained high; the average rate across the EU is currently around 12%. Weak domestic consumption, in response to this unfavourable job environment, is likely to moderate the pace of economic recovery in these countries.

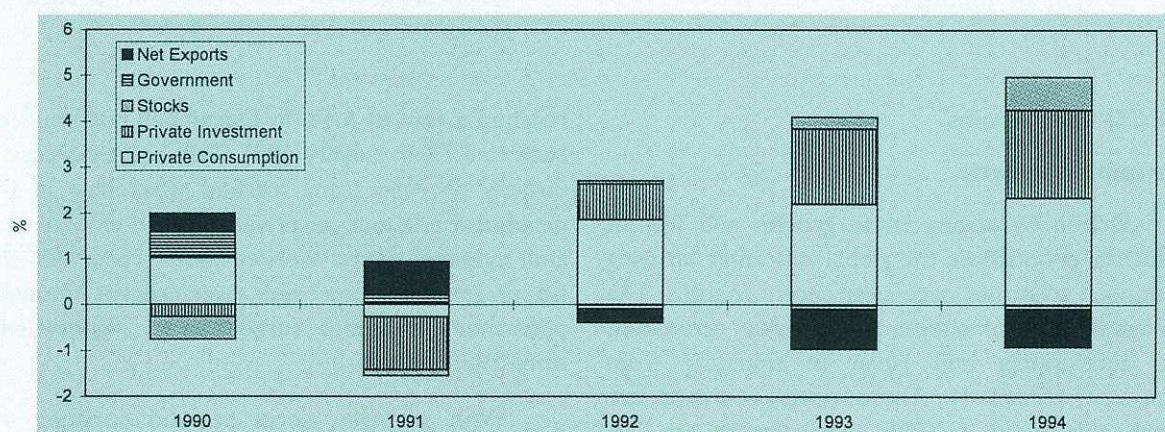
The UK, which had been the first large European economy into recession, has also been the first to emerge. Boosted by fast export growth and domestic capital spending, the UK economy has been growing strongly since the beginning of this year and unemployment has fallen. Exporters will likely benefit from the recovery in continental Europe and Japan, but the new taxes on tobacco, petrol and alcohol and higher mortgage rates may restrain household expenditure.

Chart 1
Real GDP (March 89=100)



Source: DATASTREAM

Chart 2
United States: Contributions to GDP Growth



Source: DATASTREAM

Table 1:
Real GDP in Europe (annual percentage change)

	1992	1993	1994		1995 forecast in Dec 94
			forecast in Dec 93	estimate in Dec 94	
Germany	2.2	-1.1	0.8	2.8	2.8
France	1.2	-1.0	1.1	2.2	3.1
Italy	0.7	-0.7	1.7	2.2	2.7
United Kingdom	-0.5	2.0	2.9	3.5	3.4
Spain	0.8	-1.0	0.8	1.7	2.9
Netherlands	1.4	0.4	0.6	2.5	2.9
Sweden	-1.9	-2.1	1.5	2.3	2.3
OECD Europe	1.2	-0.1	1.5	2.3	3.0

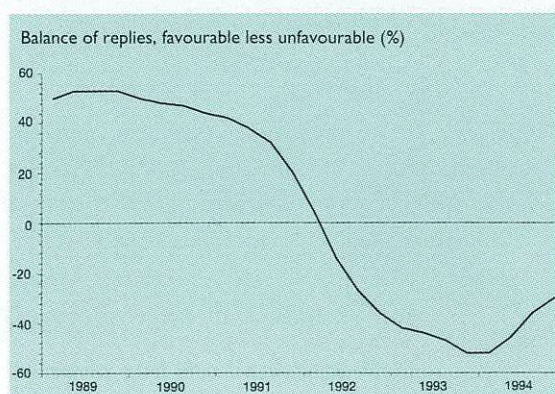
Source: OECD Economic Outlook December 1994.

Led by exports and investment, the German economy has performed far better than expected during 1994. However, private consumption has remained weak. A tax restructuring, including the reimposition of the 7.5% solidarity tax surcharge, an increase from 12% to 15% in the insurance tax and a rise in the wealth tax were imposed in January 1995 in an effort to improve the German budget balance. This is likely to slow consumption further.

In Japan, the economy started to emerge from recession in 1994 but the recovery has been weak. Real GDP grew by 0.9% in the September quarter while the June quarter was revised up from a fall of 0.4% to a rise of 0.2%. Output probably grew in the December quarter but the earthquake will have affected the March quarter of 1995. Factors holding back the Japanese recovery include the large amount of capacity installed in the late 1980s, still high levels of debt on business balance sheets, caution by banks in light of their bad debt experience, the high Yen and disruption to port activities (and to a lesser extent production) following the earthquake.

The shock of the recession and the need for price cuts by many companies continued to keep business confidence subdued. While the latest *Tankan* survey showed business sentiment continuing to improve (Chart 3), particularly in the manufacturing sector, more respondents still viewed conditions as poor than saw them as favourable.

Chart 3
TANKAN Business Survey
– Business Conditions



Source: DATASTREAM

Strong world growth has boosted overseas demand and there has been a pickup in domestic consumption following the income tax cuts. However, even the OECD forecasts, which are among the more optimistic, are for the Japanese economy to grow by 2.5% in 1995, which is slower growth than it recorded in any year from 1976 to 1991.

The Japanese currency appreciated by about 6% in trade-weighted terms during 1994. The higher yen is hurting medium to small-sized Japanese companies. It has also led to the shifting of production to other Asian countries where costs are lower. The huge trade surplus with the US is likely to remain until the recovery in Japan becomes solid enough to absorb more US exports.

Meanwhile, the tight fiscal policy around the world, especially in those countries aiming to meet the Maastricht convergence criteria, is going to restrain the pace of growth in forthcoming years. Government debt is high relative to GDP (by peacetime standards) in most OECD countries, suggesting that the general trend towards fiscal retrenchment will remain in place, although the US and UK could prove exceptions.

Among the other OECD economies, output is growing strongly, and unemployment rates falling, in Australia, Canada and New Zealand. In Mexico, output had been growing strongly but an economic package announced following the sharp depreciation of the peso in December is likely to slow growth in 1995.

Prices

Another indicator of the recovery in output, and a sign it is being shared with developing countries, has been the rise in commodity prices. The *Economist* index of these prices rose by 26% in SDR terms during 1994. So far, however, producer prices have not accelerated to any marked degree. The IMF expects overall inflation for the industrialised countries to be 2.6% in 1995, marginally higher than in 1994.

Despite the obvious concerns of the market, inflation has remained well under control, even in the more cyclically advanced economies. Even in the US, where the output gap has been closed and the unemployment rate is below its average rate for the past 30 years, earnings rose only 0.3%

during 1994. The CPI rose by 0.1% in October, 0.3% in November and 0.2% in December, leaving the annual rate below 3%.

In most other industrialised countries, inflation is being held in check by at least some excess physical capacity (Chart 4) and high unemployment. Indications of wages show moderation. For example, unit wage costs in Germany dropped 2% over the first three quarters of 1994 while those in the UK saw little change.

Inflation is not threatening Japan. The labour market is weak; there was no growth in employment during the year to October. Producer prices continue to fall and the strong yen is checking imported inflation. The consumer price index, generally thought to overstate inflation, rose by only 0.7% during 1994. This virtual price stability is expected to continue for some time until economic growth becomes firmly established.

Monetary Policy

While current inflation rates remain low, concerns about potential inflation have led the monetary authorities in several countries to preemptively tighten policy. Central bank interest rates have been raised in those countries where the economic recovery has progressed furthest.

During 1994, the US Federal Reserve raised its key Fed funds rate six times by a total of 250

basis points and a further increase of 50 basis points occurred on 1 February 1995. The November rise of 75 basis points was the biggest increase since May 1981. This assertive action was favourably received by the financial markets as reflecting the Fed's firm determination to combat potential inflation. US monetary policy is certainly no longer stimulatory but is not extremely restrictive.¹

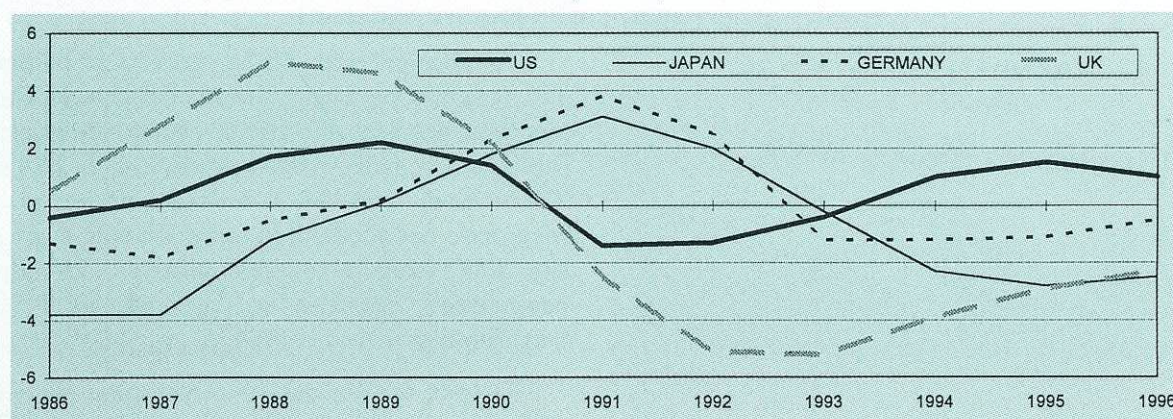
In Germany, with inflation dropping well below 3% and the growth of M3 finally moving within the target of 4.0-6.0% by the end of the year, the Bundesbank kept its interest rates unchanged during the second half of 1994 and early 1995. This was not only intended to boost confidence in financial markets and to attract funds into the longer end of the bond market, but also to stimulate economic growth. Despite improved exports, domestic demand has been sluggish and unemployment has remained high.

In Japan, even though there are signs that the Japanese economy is growing, these are not strong enough to confirm a solid expansion. The sluggish job market, the absence of inflation, the strong yen and the effects of the earthquake suggest the Bank of Japan will keep nominal interest rates low for some time.

Financial Markets

After the turbulence of early 1994, financial markets settled down in the latter part of the year

Chart 4
Output Gap



Figures for 1995 and 1996 are OECD forecasts

Source: OECD

1 Following the January rise, the real Fed funds rate is now just over 3%. The long term average is about 2%. This was also its average in the 1960s, a period of relatively low and stable inflation. In the 1970s, when inflation accelerated, it averaged close to zero and in the 1980s, as inflation was reduced, it averaged over 4%.

as markets drew comfort from the quick response of central banks to the cyclical upswing. Bond yields generally showed little change during the December quarter while the exchange rates of major currencies moved within a relatively narrow range.

As US short rates were increased, bringing them higher than the corresponding rates in Germany and Japan for the first time in five years, the appetite of international investors for US dollar-denominated assets increased. As a result, the US dollar strengthened against most major currencies between October and late December.

Overall, the yield on 10-year US Treasury bonds rose by 20 basis points in the December quarter and there were smaller increases in other countries. Despite actual and prospective rises in interest rates, share prices in major markets remained stable in the December quarter:

Around the end of the year there was a period of weakness associated with rumours about the effect on the dollar of measures to support the Mexican peso. The US dollar appeared to have shrugged off these concerns in the first week of January but sentiment deteriorated again in mid-January. About this time the release of weaker retail sales data led some in the markets to doubt whether the Fed would raise rates any further. Since then the US dollar has been relatively stable against major currencies.

The weakness of the Mexican peso raised doubts in some minds about investment in "emerging" markets, or those with high debt, more generally and there were drops in equity prices and exchange rates in a number of countries.

The earthquake in Japan led to initial concerns in financial markets about insurance companies liquidating portfolios to meet claims and government needing to increase borrowing to rebuild infrastructure. Upon reflection, the exposure of insurance companies was not that high and there was little sustained impact on Japanese bond yields.

Developments in China

Inflation and the Exchange Rate

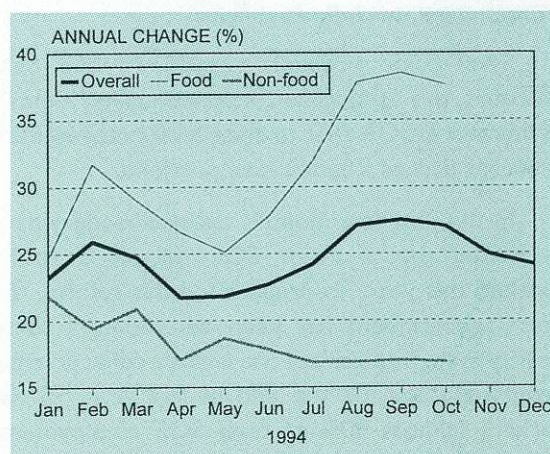
The various measures of annual inflation all fell marginally in November and December but

remained around 25%. The effects of one-off factors in mid-1994 including the southern floods, droughts in other regions, and the increase in prices paid to farmers for grain and other foodstuffs started to dissipate and food prices (which constitute about half the indices) grew more slowly (Chart 5). Ongoing policy reforms, such as fully funding the fiscal deficits from bond sales, will assist in reducing inflation, which has been named the number one economic priority.

The target of the People's Bank of China (PBoC) is to bring inflation down to 15% in 1995. Achieving this is likely to require more restraint in monetary conditions than has been evident in 1994. The main reason for the rapid growth in monetary aggregates is the continuous inflow of foreign direct investment, which amounted to US\$35 billion in 1994, up by about a third from the previous year. This would be equivalent to an increase of around RMB300 billion in the money supply. Therefore, if capital inflow remains strong in 1995, the authorities will face the difficult choice between rapid growth in money supply (and so continued high inflation) and appreciation of the RMB (which would hurt the trade balance).

After the unification of the RMB, the Chinese currency remained very stable against the US dollar throughout 1994, appreciating by 2.5%. After two years in the red, a trade surplus of US\$5 billion was recorded in 1994 (Chart 6). However, the

Chart 5
China Inflation: 35 Cities Cost-of-living Index



Source: China's Latest Economic Statistics
China Monthly Statistics

trade prospects in 1995 are clouded by the current dispute with the US over protection of intellectual property rights. (Exports to the US account for almost one-fifth of China's total exports).

The PBoC increased the discount rate by 24 basis points and the interest rates on loans for fixed assets by 72 basis points in January 1995, the first interest rate increase since 1993. This is a small step towards reducing the expansion of credit.

Output Growth

The State Statistical Bureau estimates that real GDP grew by 12% in 1994, only slightly slower than in 1993, with industrial production rising by 18% but adverse weather conditions resulting in a decline in grain output. The volume of retail sales grew more slowly by 7%. This is helpful in terms of mobilising savings for development but may indicate that some output is being added to stocks of unsold goods. While the State Economic and Trade Commission and the State Planning Commission expect output to grow by 9% in 1995, in line with the current five-year plan, the Chinese Academy of Social Sciences is projecting 10.5% growth.

The State-owned Enterprises Reform in 1995

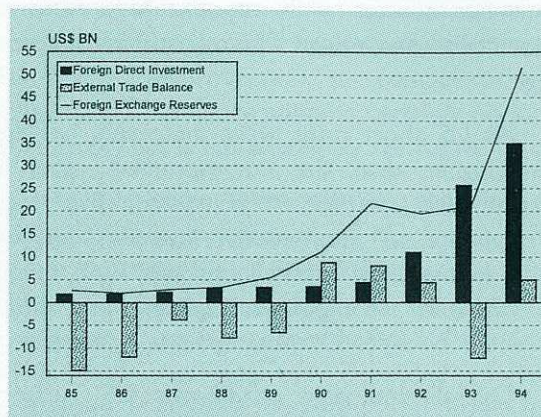
The persistent losses of state-owned enterprises (SOEs) will hamper further progress in China's economic reforms. In 1994 reports suggest over a third of the SOEs were still operating at a loss, amounting to perhaps as much as 1% of GDP. State efforts to assist the loss-making SOEs render the task of reining in growth in credit and the money supply much more difficult.

The major problem related to the SOE reform is the "triangular (inter-company) debts". Furthermore, SOE debt to state banks represents a significant part of a bank's loan portfolio.

In the past few months, national leaders have re-iterated that a major SOE reform is to be launched this year. To prepare for this reform, the central government has been developing a social security system to replace the welfare role currently played by SOEs. By the end of last year, 95 mn workers (almost 90% of total SOE employment) had subscribed to unemployment insurance.

The goal of the reform programme is to build up a modern enterprise system. 100 large and

Chart 6
China: Trade Balance, Foreign Direct Investment and Foreign Exchange Reserves



Source: Statistical Yearbook of China 1993; Reuters.

medium-sized SOEs have been selected to be pioneers. In these pilot firms, the shareholders' meeting, the board of directors, the board of supervisors and managers will supervise each other. The income of senior managers is to be linked to their management performance and the income of employees to their work.

This change was made possible by the implementation of the new Company Law in last July. This law has also provided the necessary legal framework for the transformation of SOEs into limited liability companies and joint-stock limited companies, and this transformation is expected to continue in 1995. It will allow bankruptcy proceedings to be initiated where necessary.

Implications for Hong Kong

The rises in US interest rates, which translated directly into higher rates in Hong Kong, will restrain demand and hence inflationary pressures during 1995. The slow down in food prices in China has also helped to cool down inflation in Hong Kong since August.

Continued strong growth in China and recovery in the OECD economies will stimulate Hong Kong's trading activities. Based on OECD forecasts, demand in Hong Kong's trading partners should rise by 5-6% in 1995. Resolution of China's entry into the World Trade Organisation, which is likely some time in 1995, should provide further stimulus.

The sharp fall in the Mexico peso led to adverse investor reaction to emerging markets, and on January 12/13, there was a ripple in the Asian currency and capital markets. Decisive action by regional central banks and monetary authorities quickly returned conditions to normal. In the medium term, though, if the events in Mexico lead international investors to be more discerning about investment in non-OECD economies, and to favour economies with low debt and sound fiscal policies, this will work in Hong Kong's favour. ☺

— prepared by the External Department