THE GLOBAL ECONOMIC SETTING

The pace of economic activity declined in 1991, as world output contracted by 0.3 per cent following 2.2 per cent growth in 1990 and 3.3 per cent in 1989. Among the seven major industrial democracies (the G-7 countries), aggregate real growth slipped to 0.8 per cent in 1991.

Several of the major industrialized countries which experienced a recession, including the United States, the United Kingdom and Canada, did not achieve as robust a recovery as they had expected. High consumer and corporate debt levels had a marked negative effect on confidence and consumption demand and this delayed recovery.

Meanwhile, the fast pace of growth in Japan and western Germany slowed by the second half of the year. France and Italy did not experience recession, but growth was weak throughout the year.

A severe contraction of economic activity in the Central and Eastern European countries and the countries of the former Soviet Union contributed to the negative aggregate world growth rate. The fall in output in these countries reflects the legacy of past policies, the collapse of trade among the former members of the Council for Mutual Economic Assistance and, in a number of Eastern European countries, the adjustments associated with the early stages of radical economic reform.

Output also fell substantially in the Middle East, primarily because of the effects of the Gulf War. Aggregate growth in developing countries was - 3.4 per cent in 1991.

Inflation in the G-7 countries fell, in aggregate, to 4.4 per cent in 1991 from 4.8 per cent in 1990. In the first half of 1992, inflationary pressures have continued to ease in most economies, with Germany as the main exception. Wage demands and the relatively high levels of public spending associated with unification have contributed to ongoing price pressures in that country.

The cumulative current account deficit of the G-7 countries shrank in 1991, partly as a result of Gulf War-related transfers. The current account deficit of the United States fell sharply to a level of $9 billion, from $92 billion in 1990. In the meantime, the Japanese trade surplus doubled to a level of $73 billion. Germany recorded a current account deficit for the first time since 1981.

Negative terms of trade effects contributed to a wider deficit in the developing countries. The deterioration in external accounts was concentrated in the Middle East; in contrast to a surplus on the current account registered in the region in 1990 and 1989, a deficit was recorded in 1991.

Growth in the volume of world trade fell in 1991, to an estimated 3.3 per cent, compared with growth rates of 4.1 per cent in 1990 and 6.7 per cent in 1989. The collapse of trade among the former members of the Council for Mutual Economic Assistance and slow growth among the major industrialized economies were the major factors contributing to weaker expansion of trade.

Progress on reducing inflation allowed room for a reduction in interest rates in several countries. In 1991, short-term rates fell by between 250 and 400 basis points in Japan, the United Kingdom, the United States and Canada, with Japanese rates recording the smallest fall and Canadian rates recording the largest decline. Short-term rates have continued to fall in these countries in 1992. Since the end of 1990, interest rates have remained relatively flat in France and Italy but have increased in Germany.

While there were substantial exchange rate fluctuations due to a number of factors, including interest rate differentials among industrial economies, the overall changes in exchange rates from the beginning of 1991 have been relatively small.