The international environment

- *Output continued to rise in the United States in the second quarter; but the recession deepened in continental Europe.*
- *Inflation pressures are subdued in the major economies largely reflecting weak demand. Weak income growth and high unemployment continue to depress confidence.*
- *Trade imbalances are again becoming more pronounced, although changes in relative demand and competitiveness may even these out over the longer term.*
- *Canada, the European Community, Japan and the United States reported to G7 leaders on a package of tariff cuts that could form part of a Uruguay Round agreement.*
- *Short-term interest rates were cut slightly in Germany and more substantially in some other European countries, though exchange rate tensions recurred in late July.*

Table A
GDP growth in the major six

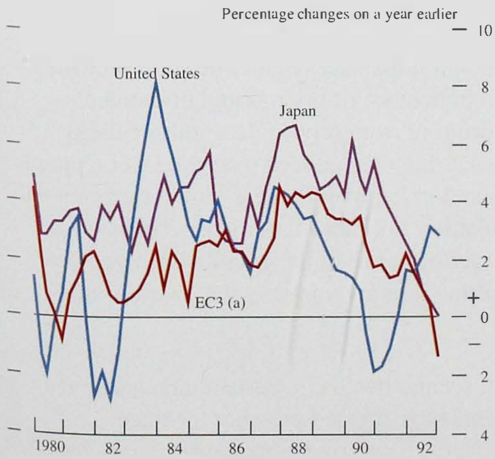
Percentage changes on previous year

	1991	1992			1993
	Year	Year	Q3	Q4	Q1
Canada	-1.7	1.2	0.7	1.3	1.7
France	0.5	1.2	0.9	0.4	-0.6
Italy	1.3	0.9	0.7	-0.3	-0.9
Japan(a)	4.1	1.5	0.9	0.5	—
United States	-1.2	2.1	2.1	3.1	2.6
Western Germany	3.7	1.2	0.9	0.4	-2.9
Major six	**0.8**	**1.6**	**1.4**	**1.6**	**1.0**
Memo:					
United Kingdom	-2.5	-0.5	-0.4	0.2	0.9
EC 12	1.2	0.6	0.4	-0.1	. .

. . not available.

(a) GNP.

Chart 1
Real GDP growth



(a) GDP weighted average of France, Germany and Italy.

Overview

The cyclical positions of the major industrialised countries are still very different (see Table A and Chart 1). Growth in North America and the United Kingdom is better established than a year ago, and the Japanese economy grew in the first quarter. But major continental European economies, particularly Germany, have weakened.

Growth in the major economies may take longer to become firmly established than in earlier recoveries. The tentative nature of US growth during the last two years supports this. High personal and company sector indebtedness in Japan, the United States and the United Kingdom, and high short-term interest rates in continental Europe, are still restraining consumer confidence and business investment. And structural changes in labour markets, such as greater use of temporary and part-time staff, may mean that employment, and therefore income, expectations are now less certain. Continued weak growth in continental Europe may also restrain export-led growth in the United Kingdom (and, to a lesser extent, in the United States).

The likelihood that world growth will remain modest means that upward pressure on inflation should be less than in previous recoveries; in a number of countries, inflation is more subdued than it has been for many years (see Table B).

Interest rates were unchanged in the United States and Japan, and Germany cut its discount and Lombard rates

In the United States, rapid economic growth in the fourth quarter and a rise in inflation early in the year led to market expectations that the Federal Reserve might soon tighten policy. But slower growth in the first and second quarters, and lower inflation since May, have allayed earlier inflation concerns. After rising in April, long bond yields ended the second quarter at an historic low. Official interest rates in Japan have not changed since February.

Table B
Consumer price inflation in the major six

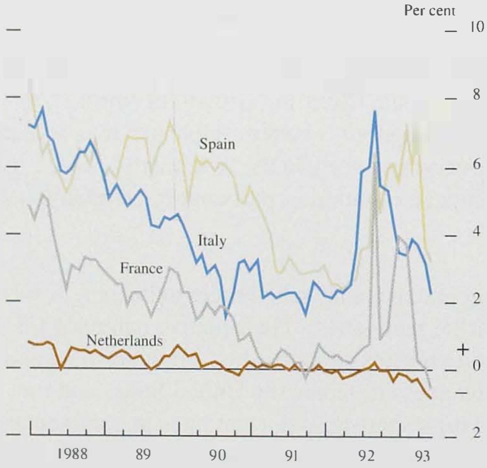
Percentage changes on previous year

	1991	1992		1993	
	Year	Year	Q4	Q1	Q2
Canada	5.6	1.5	1.8	2.1	1.7
France	3.2	2.4	1.8	2.1	2.0
Italy	6.5	5.3	4.8	4.3	4.1
Japan	3.3	1.7	1.0	1.3	0.9
United States	4.2	3.0	3.1	3.2	3.1
Western Germany	3.5	4.0	3.7	4.3	4.2
Major six	**4.1**	**2.9**	**2.7**	**2.9**	**2.7**
Memo:					
United Kingdom(a)	6.8	4.7	3.7	3.4	2.8
EC12	5.1	4.3	3.8	3.5	. .

. . not available.

(a) Retail prices excluding mortgage interest payments.

Chart 2
Short-run interest differentials to end-June(a)



(a) Three-month eurocurrency rate less German rate.

Table C
Current account balances in the major six

Percentage of GDP / GNP

	1991	1992			1993
	Year	Year	Q3	Q4	Q1
Canada	-4.3	-4.0	-3.9	-3.4	-3.4
France	-0.5	0.2	0.2	0.7	. .
Italy	-1.9	-2.1	-1.9	-1.7	. .
Japan	2.3	3.1	3.0	3.3	3.7
United States	-0.1	-1.1	-1.2	-1.6	-1.4
Western Germany	-1.3	-1.5	-1.2	-1.8	. .
Memo:					
United Kingdom	-1.1	-2.0	-1.5	-2.4	-2.7

. . not available.

The yen appreciated steadily through most of the first half of the year, rising around 13% against the US dollar, but weakened a little in late June and early July because of domestic political developments.

High short-term interest rates in continental Europe, associated with the pressures of German reunification, continue to be the major factor prolonging the European slowdown. But a period of calm in the ERM, during which the deutschmark weakened a little, allowed several European countries to reduce short rates independently of Germany. Official interest rates were cut by more than two percentage points in many ERM countries in the second quarter. Chart 2 illustrates the narrowing of short-term interest differentials with Germany; in some cases, the differential became negative.

In mid-June, French official rates were reduced below German rates for the first time in 26 years but the move was temporary. Germany later lowered its discount rate by 50 basis points, French rates were cut by less and the two official rates were then equal. Market and official rates in France subsequently edged up as the French franc came under renewed pressure in the ERM. Real interest rates in Germany are lower than in France (measured using current inflation).

Recent trade imbalances largely reflect changes in countries' relative demand

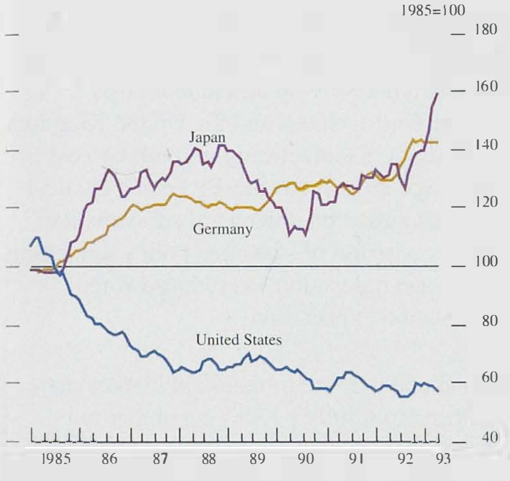
Table C shows that current account imbalances are still large in the major economies. Japan's surplus, at 3¼% GNP, is one of the largest. Corresponding deficits are spread widely among the remaining major economies, and there is little to suggest that current trade imbalances are unsustainable or that they might destabilise financial markets.

Changes in relative demand are a major determinant of flows of goods and services. Accordingly, the largest bilateral imbalance, between Japan and the United States, widened slightly during the second quarter as Japanese relative demand slowed down. Last year, around a half of the increase in Japan's surplus may have reflected its slowing relative demand. The aggregate Canadian deficit continued to narrow this year helped by growth in its main export market, the United States (the destination for three quarters of Canada's visible goods exports last year).

Persistent current account imbalances matter because they may represent a long-term imbalance of savings and investment between countries, resulting from private decisions or fiscal policy. Such imbalances may be reduced over time (for example by changes in policy and/or competitiveness) but at the potential cost of short-term volatility in financial markets. Trade imbalances may also reflect a misalignment of exchange rates though there are differing interpretations of the 'equilibrium' exchange rate.

Deepening recession, secular decline in certain industries, and currency misalignments have created pressure for trade restrictions in recent years. But protectionism and 'managed trade' are not the best ways to reduce trade imbalances. Such measures can stall the necessary adjustment so that the root causes of trade imbalances are not tackled or are even exacerbated.

Chart 3
G3 real effective exchange rates (a)



Source: IMF.

(a) Nominal effective rates adjusted for changes in relative unit labour costs.

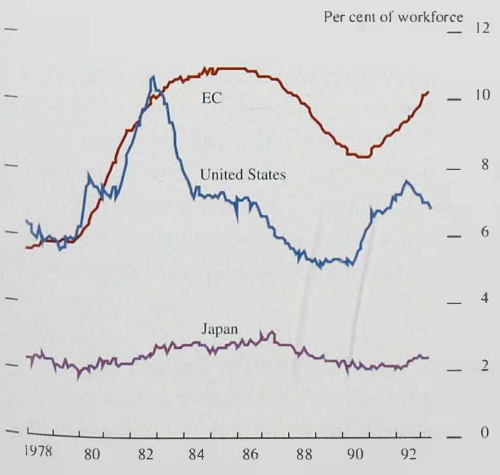
Table D
Effective exchange rates

1985=100; *percentages in italics*

	1991 Q4	1992 Q4	1993 Q1	1993 Q2	Change over previous quarter
Canada	102.0	95.1	95.9	93.8	*-2.1*
France	104.3	108.8	110.7	107.7	*-2.7*
Italy	99.5	83.6	76.8	82.1	*6.9*
Japan	141.9	151.6	165.8	182.4	*10.0*
United States	60.8	66.3	65.2	65.2	—
Western Germany	120.5	125.0	126.5	121.4	*-4.0*
Memo:					
United Kingdom	91.5	79.7	79.5	80.6	*1.4*

Note: End-quarter figures.

Chart 4
Unemployment (a)



(a) OECD standardised rates.

Protectionism, by reducing the volume of world trade, may also reduce aggregate world income.

The progress made toward freer trade in the 'quad' trade talks in July (among Canada, the European Community, Japan and the United States) was therefore encouraging. The quad countries reported to G7 leaders on a package of tariff cuts on a range of manufactured products which could form part of a Uruguay Round agreement. The subsequent G7 summit accorded the highest priority to the successful completion of multilateral trade negotiations in Geneva.

In the long term, open markets and competitiveness are also important prerequisites for reducing trade imbalances. Changes in exchange rates therefore, notably the appreciation of the yen and depreciations of the Canadian dollar and Italian lira, may help reduce imbalances. More importantly, the United States and Canada have made considerable gains in underlying competitiveness; as Table E shows, US and Canadian manufacturing unit labour costs have fallen for more than a year.

Recession has deepened and unemployment has risen throughout most of Western Europe

Slow growth has led to increased concern about high and rising unemployment in Western Europe. Chart 4 shows that in the European Community and Japan unemployment is higher than a year ago; the EC unemployment rate was 10.2% in April, a rise of one percentage point over the year. In parts of Europe, unemployment has risen more quickly than in past recessions both because of a sharp fall in business confidence last autumn and because of more flexible labour market practices. Whether 'equilibrium' unemployment is rising, as the skills of the long-term unemployed decay, remains an open question. After the recession of the early 1980s, EC unemployment fell, but only slowly and not to its pre-recession low.

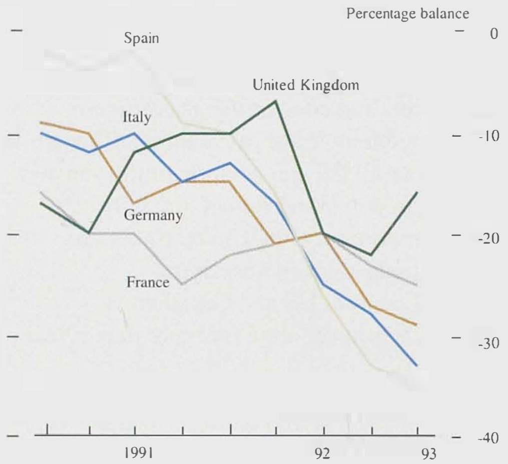
A number of EC initiatives have been launched to address high unemployment, and G7 countries agreed at their recent summit to discuss ways of tackling unemployment at a meeting in the United States in the autumn.

Fiscal policy has provided some countercyclical support in Europe. The subsequent expansion of fiscal deficits has necessitated corrective budget measures in some countries. In others, discretionary policy easing has added to the effect of automatic stabilisers (such as increased welfare payments). The aggregate general government fiscal deficit of EC Member States is likely to rise well beyond 6% of GDP this year, compared with just over 5% in 1992.

Weak demand and wage pressures are helping to keep inflation in check

Inflation pressures are muted in the major economies; the 12-month increase in consumer prices in the major six was 2.7% in the second quarter, little changed from the first (see Table B). The short-term outlook for inflation also seems relatively benign; cost pressures in the United States and Germany have eased from earlier in the year. In the rest of Western Europe underlying

Chart 5
EC consumer confidence indicators (a)



(a) Responses to questions on the financial and economic situation.

Table E
Unit labour costs in manufacturing

Percentage changes on previous year

	1991	1992		1993
	Year	Year	Q4	Q1
Canada	-2.2	-2.6	-2.4	-2.6
France	2.1	1.1	3.3	3.8
Italy	13.4	5.5	8.7	. .
Japan	4.0	9.8	10.7	5.6
United States	1.3	-1.0	-2.5	-2.2
Western Germany	4.3	5.6	7.7	8.2
Major six	**3.0**	**4.1**	**4.3**	**. .**
Memo:				
United Kingdom	3.3	0.7	-1.2	-2.7

. . not available.

Table F
Contributions to western German GDP growth (a)

Percentage points

	1991	1992			1993
	Year	Year	Q3	Q4	Q1
Consumption	2.1	0.5	-0.1	0.8	-0.6
Investment	1.4	-0.2	-0.3	-0.4	-0.5
Government expenditure	0.3	0.5	-0.2	0.1	-0.1
Stockbuilding	-0.5	0.5	-0.8	0.4	-0.8
Domestic demand	3.3	1.2	-1.4	0.9	-1.9
Net trade	0.5	—	1.0	-1.7	0.5
GDP	**3.7**	**1.2**	**-0.4**	**-0.8**	**-1.4**

(a) Quarterly contributions are relative to the previous quarter.

inflation is also easing, largely because of weak demand. In some countries, lower inflation has permitted a substantial and sustained easing of interest rates during the last two years. In the United States and Japan, for example, official interest rates are 3% and 2.5% respectively.

Monetary policy has been eased in several countries against a background of low wage growth and productivity improvements which are putting downward pressure on unit labour costs, particularly in Canada, the United States and the United Kingdom. Table E shows the diversity of manufacturing unit labour cost growth in the G7. Low wage growth has mostly been a cyclical phenomenon, but it may also reflect a downward adjustment of inflation expectations after a period of sustained policy tightening. In Italy, the abolition of wage indexation has reduced wage pressures and perhaps inflation expectations.

Fragile consumer demand and a desire to maintain market share have so far prevented firms from fully passing on higher raw materials costs and/or higher import prices in Canada, Italy and the United Kingdom; consequently, despite the weakness of labour costs, firms' domestic profit margins may sometimes have narrowed. A key factor in the outlook for inflation is whether firms widen margins as confidence recovers.

Western Europe

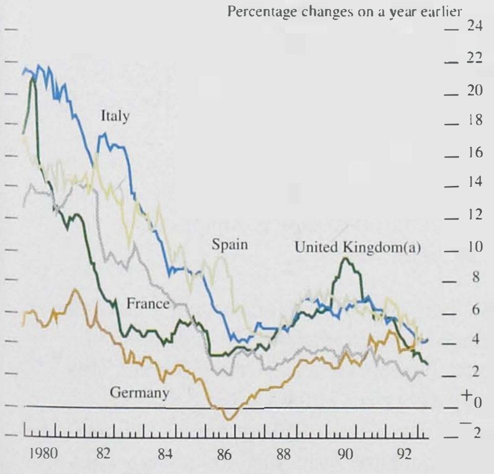
In Germany, output fell sharply early in the year. The discount rate was cut in early July

Output in western Germany fell sharply in the first quarter; the drop of 1.4% was the fourth consecutive quarter-on-quarter fall. Since 1991, the major contributions to the slowdown have been negligible consumption growth and falls in machinery and equipment investment of 14% in the past year. Only the growth of building investment has remained strong. In the first quarter, net exports made a positive contribution to GDP (see Table F), primarily reflecting weak domestic demand relative to Germany's main European export markets. Industrial production stopped falling in the second quarter, indicating that the industrial sector may be bottoming out, but there is little evidence that consumer demand is recovering.

German inflation has been slow to respond to weak activity. The twelve-month increase in consumer prices in June—at 4.2%—was only marginally below its January peak. But cost pressures are easing: wage settlements have averaged below 3.5% in the first half year and producer prices fell by 2.1% in the year to May. Import prices are 3.6% below a year ago. Nevertheless, service and rental sector prices have so far appeared largely impervious to tight monetary policy.

German official interest rates were cut in July, the first major change since April. The Bundesbank's reluctance to ease policy quickly has reflected stubborn inflation (among the highest in the G7), high M3 growth and the widening fiscal deficit. Concern that a more rapid easing in interest rates might undermine the deutschmark and bond prices contributed to this cautious approach (the currency depreciated by 4% in the second quarter as shown in Table D). Interpreting M3 growth has remained difficult; it was

Chart 6
Consumer price inflation in the EC



(a) RPI excluding mortgage interest payments.

Chart 7
Industrial production in the EC [(a)]

(a) Three-month moving average.

subdued in the first two months of the year, increased rapidly in March and April and was above its target 4.5%–6.5% range in May and June. Recent M3 growth reflects large increases in public sector borrowing and continued (but lower) growth in private sector borrowing.

The general government fiscal deficit has continued to widen and may exceed 5½% of GDP this year. In July, the Cabinet approved a substantial package of medium-term expenditure cuts with its 1994 budget. If approved by Parliament, these measures will help to prevent a further escalation of the Federal deficit, but Laender and municipality finances remain a concern.

The eastern German economy, after contracting substantially in 1990 and 1991, is expected to continue the growth which began in 1992. Growth is likely to exceed 5% this year, although largely because of fiscal transfers of DM 120–130 billion (net) which are stimulating construction investment and consumption. Inflation is moderating in the east, and fell to 8.5% in the year to May; nevertheless, rent increases and non-tradable goods inflation remain high as prices continue to adjust to western German levels. Although most industrial sectors have agreed to nominal wage increases in line with inflation, industrial action in the steel, metal and electrical engineering sectors has secured substantial real wage increases. The weak competitive position and already high unit labour costs (wages are now some 70% of western levels) pose a threat to growth and potential inflation.

French interest rates have fallen; the economy is still weak

Through most of the second quarter, the French franc was stable within the ERM, prompting cuts in short-term interest rates. French official short-term interest rates had fallen more than two percentage points since early April (more than the easing in German rates); but the franc later came under pressure in the ERM and short-term market rates were pushed back above German rates.

The maintenance of the ERM parity has had other consequences. In particular, a loss in competitiveness as the exchange rate has appreciated against some of its main competitors. Partly as a result of this, and the generally tight policy stance, industrial production fell 0.9% between the first and final quarters of 1992, and GDP fell by 0.5% in the first quarter of 1993. Unemployment rose further to 11.5% in May.

Reflecting the weakness of demand and the authorities' long-standing commitment to price stability, French inflation remains subdued, with consumer prices rising by 2% in the year to May. During the preceding six months, French inflation was some two percentage points below Germany's. The French fiscal deficit remains large: the general government deficit is projected to be over FFr400 billion in 1993 (around 6% of GDP).

Weak domestic demand in Italy more than offset the recovery in exports in early 1993

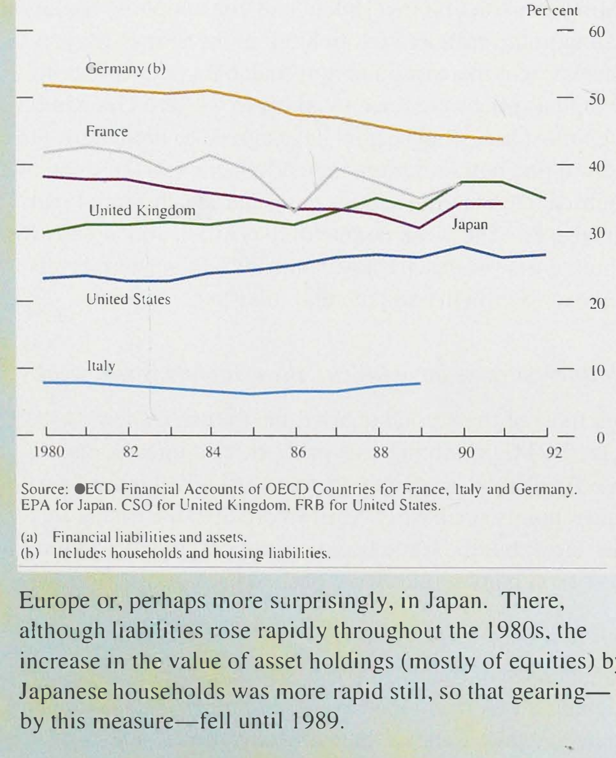
Despite a strong rise in exports in recent months, continued weakness in most components of domestic demand in Italy has resulted in an overall contraction in activity. GDP fell by over 1% in the second half of last year, with a rapid slowdown in

Personal sector gearing in the major economies

Capital gearing

Capital gearing, the most commonly used measure of indebtedness, expresses financial liabilities as a proportion of financial assets. Chart A presents this measure of gearing for the personal sector[1] in six major economies,[2] and shows that there was a rise in net indebtedness over the 1980s in the United States and United Kingdom, but not in continental Europe or, perhaps more surprisingly, in Japan. There, although liabilities rose rapidly throughout the 1980s, the increase in the value of asset holdings (mostly of equities) by Japanese households was more rapid still, so that gearing—by this measure—fell until 1989.

Chart A
Personal sector liabilities as a percentage of assets[a]



Source: OECD Financial Accounts of OECD Countries for France, Italy and Germany. EPA for Japan. CSO for United Kingdom. FRB for United States.

(a) Financial liabilities and assets.
(b) Includes households and housing liabilities.

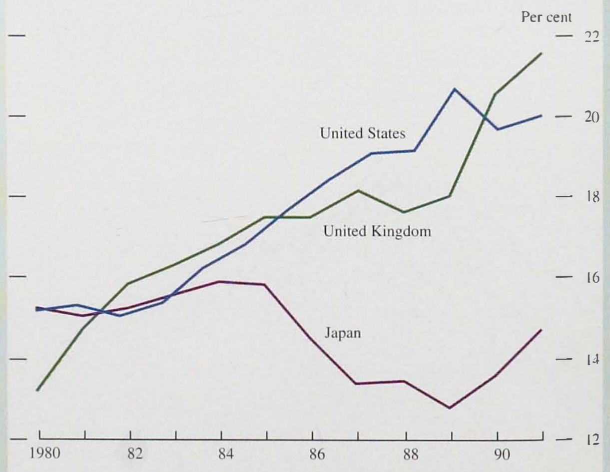
The much weaker activity in all of the major economies since 1990 might be expected to have reduced preferred indebtedness levels. But Chart A shows that, with the exception of the United Kingdom, capital gearing has not yet fallen significantly in the 1990s (on available data).

Much of the reason why gearing levels have remained high may be because of difficulties faced by debtors in effecting a reduction. Many liabilities, particularly those for house purchase, are large and have long maturities: in 1990, mortgages accounted for approximately three quarters of household liabilities in the United States, two thirds in the United Kingdom and just over 40% in Japan. Because few people are likely to be able to prepay a significant proportion of such large liabilities out of income or financial asset holdings, liabilities of this size are only likely to be reduced significantly in nominal terms if the underlying asset is sold. Falls in interest rates on floating-rate liabilities (or renegotiated fixed-rate liabilities) will reduce the share of income devoted to servicing such debt; but whether the income liberated in this way is used to prepay debt will depend, at least partly, on expectations regarding the future path of factors such as income, asset prices and interest rates.

Although the capital gearing data shown in Chart A are consistent across countries, they are incomplete in that they do not include housing in the measure of assets (whereas housing finance is included in liabilities). Chart B shows capital gearing for three countries on a basis which takes account of housing wealth. The measure of gearing used is financial liabilities as a proportion of *net* assets including housing.[3] Gearing on this basis rose quite sharply during the 1980s in the United Kingdom and the United States. In Japan, however, as with the narrower measure of gearing, a rise from the late 1980s only partly reversed a sharp fall in gearing between 1984 and 1986. Once again, this reflects the fact that asset values in Japan rose more rapidly than borrowing for much of the 1980s.

As Chart B shows, personal sector capital gearing including housing has continued to rise quite sharply in the United Kingdom and Japan, but less so in the United States. This reflects the falls in asset prices in the United Kingdom (largely housing) and Japan (land and equities). Unless borrowing is being repaid at a faster rate than asset values are falling, personal sector capital gearing on this measure[4] will not fall.

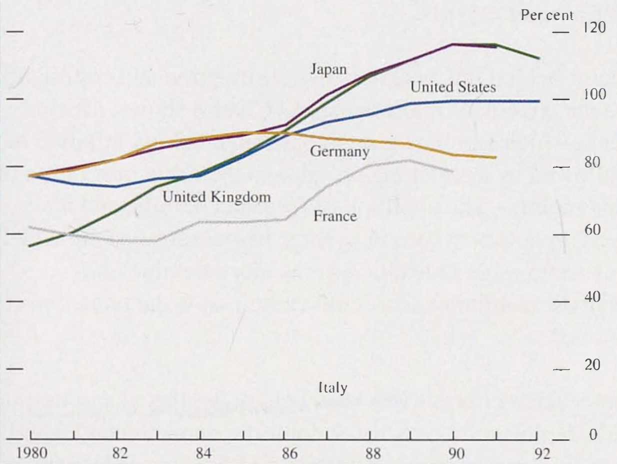
Chart B
Personal sector capital gearing[a]



(a) Financial liabilities as a percentage of net wealth (including tangible assets).

(1) The technical definitions of personal and household sectors are not consistent across countries. As far as is possible, the data presented are the best available to represent the equivalent of the UK personal sector.
(2) Here shown excluding household assets.
(3) ie liabilities relative to assets less liabilities.
(4) The timing of reductions in gearing on this measure will also depend on whether liabilities are repaid directly or savings are accumulated in order to repay them later (for example when moving house). To the extent that households are doing the latter, measured gearing will fall more slowly and this may account for the persistence of high gearing levels.

Chart C
Personal sector liabilities as a percentage of personal disposable income



The above measures of capital gearing show only liabilities in relation to assets—that is, households' net asset positions. As such, they give no indication of whether liabilities are large or small in relation to other variables such as income. Chart C shows gross liabilities as a proportion of personal sector income. The importance of measuring indebtedness in this way is immediately apparent. The personal sector in France, for example, has a higher ratio of liabilities to assets than those in the other major economies, but the *level* of these liabilities is relatively modest—around three quarters of personal sector income as opposed to over 100% of income in Japan and the United Kingdom. Liabilities represent a still smaller proportion of income in Italy where there is much less of a tradition of credit-financed consumption.

Income gearing

The measure of gearing which is perhaps most relevant to households' financial behaviour in the short term is their *income gearing*. This measures gross interest payments as a proportion of disposable income rather than the stock of liabilities in relation to assets or income.

The net interest obligations of households reflect the balance of their interest-bearing assets and liabilities. In the United Kingdom, for example, a significant proportion of assets is in the form of life assurance and pension funds which do not pay interest income. In Japan, equities have at times accounted for around a quarter of households' financial assets. The household sector in Japan is, nevertheless, a substantial creditor and hence a net recipient of interest.

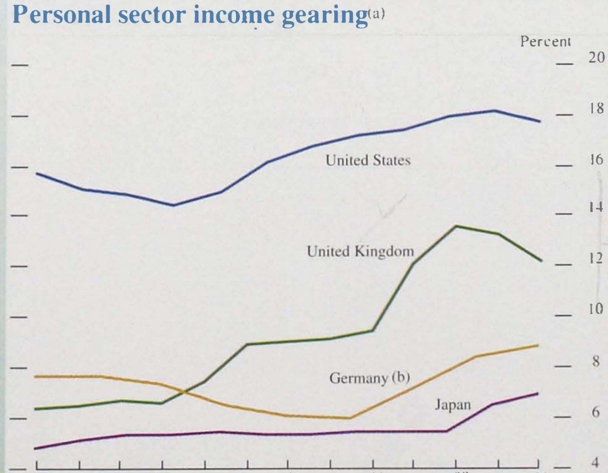
The effect of changes in interest rates on household behaviour will depend not only on the ratio of interest-bearing assets to liabilities but also on the proportion of these which have floating rates of interest. This has a significant effect on the speed of adjustment of income flows to official interest rate changes. In the United Kingdom, where the bulk of mortgage borrowing is at variable rates, households' floating-rate liabilities exceed their assets so that the household sector is a net floating-rate debtor—and hence benefits from lower interest rates. This is also true of households in France.

In some countries, including the United States and parts of continental Europe, fixed interest rate liabilities are more prevalent. Many mortgages, however, are open to renegotiation, so that the interest rates on these operate (asymmetrically) like floating rates. Around 80% of new mortgages in the United States are currently taken out on fixed rates, and a large proportion of existing fixed-rate mortgages has been renegotiated as interest rates have fallen. Overall, the household sector in the United States is a net floating-rate creditor and, on balance, loses from lower interest rates.

Consistent data on shares of assets and liabilities which are interest-bearing and the proportions of these which are at floating rates are not available for many countries. So detailed quantification of these effects is not possible. Chart D, however, shows estimates of income gearing (gross interest payments as a share of personal disposable income) for four major economies.[1] Income gearing in the United States and the United Kingdom rose throughout much of the 1980s. The rate of increase in the United States was slower, although the level was consistently higher. In 1990 interest payments were around 13% of disposable income in the United Kingdom compared with over 17% in the United States. In both cases, income gearing has fallen back since 1990—mainly as a result of falling interest rates on floating-rate obligations. The impact of servicing a larger stock of indebtedness is apparent from the fact that interest payments accounted for 17% of personal disposable income in the United States in 1991 compared with less than 15% in 1982—even though interest rates were significantly lower in 1991 than in 1982. Three-month money-market rates in the United States, for example, averaged 13% in 1982 compared with less than 4% in 1991.

Perhaps the most surprising development in income gearing arises, once again, in Japan where the share of personal incomes accounted for by gross interest payments rose after 1989. Interest rates rose from 1989–91 before falling to historically low levels. Households increased their borrowing sharply over this period and, using the gearing measure in Chart D, the rise in borrowing more than offset the effect of the subsequent interest rate reductions.

Chart D
Personal sector income gearing[a]



(a) Gross interest payments as a percentage of personal disposable income.
(b) Includes estimate of interest payments on household debt.

(1) These data are National Accounts estimates of interest flows.

Chart 8
Italian earnings and consumer prices

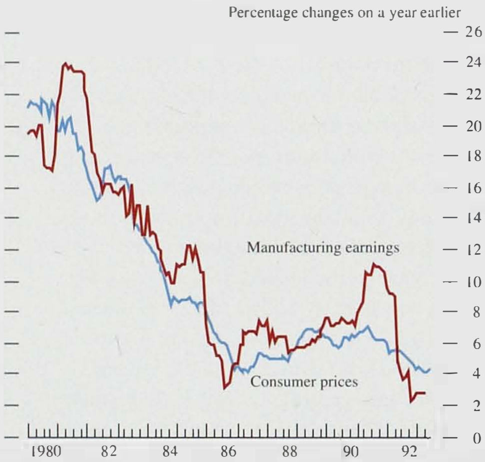
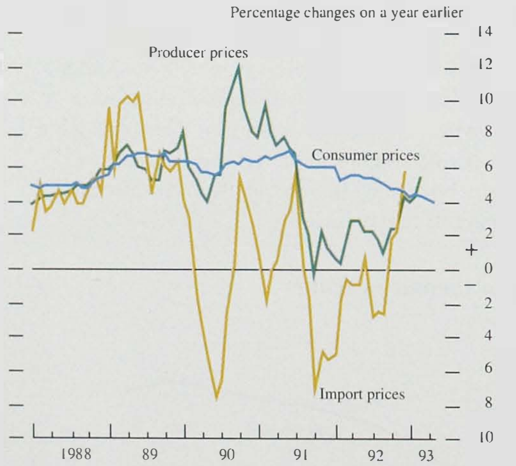


Chart 9
Italian consumer, producer and import prices



consumption and a sharp fall in investment. Recent indicators suggest that there was little recovery in the first quarter. Industrial production fell by a further ½% despite a depreciation-induced strengthening of exports.

One factor behind the weakness of consumption and confidence may be the erosion of real wages. As Chart 8 shows, previous periods in which earnings growth has fallen behind inflation have been followed by a 'catching up', due to the wage indexation of the scala mobile. The abolition of the scala mobile, and its proposed replacement by a new wage bargaining system, which contains some wage indexation but is more flexible and potentially less inflationary, could cause real wage reductions to be sustained.

Consumer price inflation has been held down this year—despite the lira's depreciation—by weak domestic demand and lower than usual tariff increases. One counterpart to this low inflation is that Italian importers' margins have probably been temporarily squeezed by the currency's depreciation. As Chart 9 shows, the rate of increase of both producer and import prices has risen recently, and this may lead to some acceleration in consumer prices over coming months.

The weak economy has contributed to a worsening of the fiscal outlook this year. The 1993 target is around 9½% of GDP, but lower than projected revenue from tax measures and privatisation may imply some overshooting is possible.

Weak activity in Spain has not entirely offset the effect of devaluation on inflation

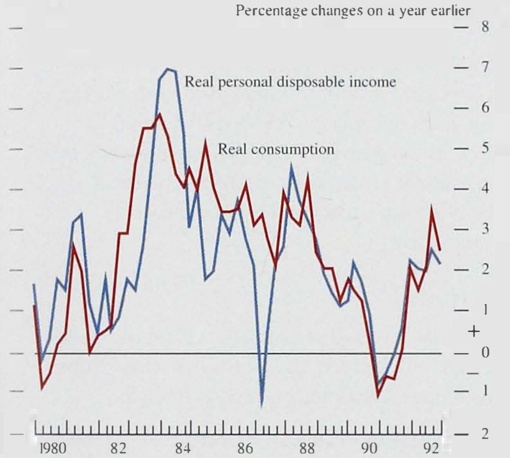
In Spain too, growth is weak: first quarter GDP was 1% lower than a year earlier and unemployment has risen to almost 22%, depressing consumer confidence and household expenditure growth. Although successive devaluations have benefited export prospects, interest rates have not been cut by as much as in most other EC countries because of the unsettling effects of the election and potential downward pressure on the peseta. Inflation has increased over recent months to 4.9% in the year to June, reflecting the effects of devaluation. Real interest rates of around 9% may help contain further upward pressure on consumer price inflation but are also likely to prevent a significant economic recovery for the rest of the year.

In much of the rest of Western Europe, activity has been affected by the slowdown in Germany

The recession in Germany has contributed to a sharp slowdown in its smaller neighbours. Although the Netherlands (and, for a while, Belgium) were able to reduce short-term interest rates below German levels, these are still high in real terms. Consequently, output in Belgium and the Netherlands is expected to be flat or to fall this year; industrial production has fallen in both countries in recent months. Slow growth in Belgium and the Netherlands may have a disproportionate effect on UK exports: around 13% of the United Kingdom's visible goods were destined for the two countries last year.

Prospects in Denmark are better because its strong fiscal position and low inflation rate (1%) have allowed some stimulatory measures. But Denmark's growth is expected to be subdued this year and, early in the third quarter, the currency came under pressure in the ERM. Sweden and Finland are still struggling to emerge from their deep recessions. Both still face rising unemployment and fiscal deficits but prospects for 1994 will be improved by lower interest rates and more competitive exchange rates.

Chart 10
US disposable income and consumption growth



North America

The United States looks set for moderate growth and low inflation

Preliminary GDP figures for the United States showed a small rise in growth to 1.6% in the second quarter. Personal sector spending recovered in the second quarter and retail sales were 3.2% higher than a year earlier. Growth in retail sales was strong in the final months of 1992 because of the post-election rise in confidence and because of the boost to income by companies paying bonuses early to avoid potential tax increases in 1993. The lower growth of retail spending in the first half of this year can therefore be seen as a correction from earlier high growth rates. The growth of consumers' expenditure was correspondingly subdued in the first half of 1993 by comparison with the second half of 1992. The prospects for a large rise in consumer spending, also, seem limited as subdued earnings growth and proposed tax increases will dampen growth of real disposable income. Chart 10 illustrates the growth of disposable income and consumer spending.

Table G
Contributions to US GDP growth(a)

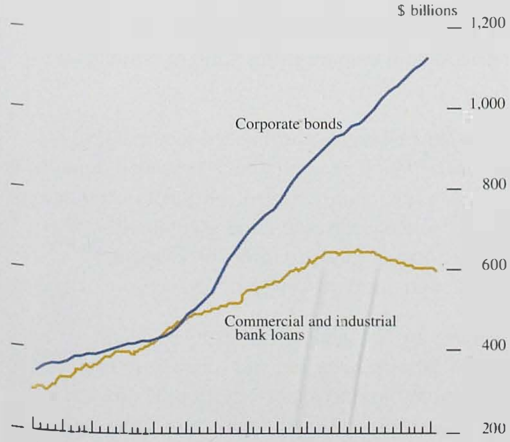
Percentage points

	1991	1992			1993	
	Year	Year	Q3	Q4	Q1	Q2
Consumption	-0.4	1.5	0.6	0.8	0.1	0.6
Business investment	-0.7	0.1	—	0.3	0.3	0.4
Residential investment	-0.5	0.5	—	0.2	—	-0.1
Government expenditure	0.2	-0.1	0.2	-0.1	-0.3	—
Stockbuilding	-0.3	0.5	0.2	-0.1	0.5	-0.5
Domestic demand	-1.8	2.5	1.0	1.1	0.6	0.4
Net trade	0.6	-0.4	-0.2	0.1	-0.4	—
GDP	**-1.2**	**2.1**	**0.8**	**1.2**	**0.2**	**0.4**

(a) Quarterly contributions are relative to the previous quarter.

Business investment has risen in recent quarters, after falling between 1990 and 1991, and there is growing evidence that the financial position of the industrial sector is improving. For more than a year, companies have been able to obtain cheap funds, whether for investment, working capital or to refinance existing debt. The yield on the 30-year long bond reached an historic low of 6.67% at the end of the second quarter (and fell further in early July). As well as issuing record amounts of new fixed-rate bonds, companies have raised large quantities of new equity, some of which has replaced existing debt, thereby reducing gearing. Lower interest payments and reduced gearing should enhance companies' ability to respond to further increases in demand although absolute gearing levels are still high. Chart 11 shows that, although companies' borrowing from banks remains lower than a year ago, the stock of domestic corporate bonds has continued to rise throughout the recession. (A box on pages 336–7 examines personal sector gearing.)

Chart 11
US companies' bond and bank borrowing (a)



(a) Amounts outstanding.

US productivity growth has risen and earnings growth is still subdued

Although employment is rising, demand pressures in the labour market remain weak. Non-farm employment rose 160,000 in the second quarter, twice the average in 1992. As shown in Chart 12, employment in manufacturing continued to fall in the second quarter but in other industries, mainly services, employment continued to rise. Different sectoral experiences reflect a number of factors. Most importantly, high capital gearing, which has been particularly prevalent among manufacturers, is restraining companies' ability or willingness to increase the workforce. Some firms may also have been reluctant to increase employment

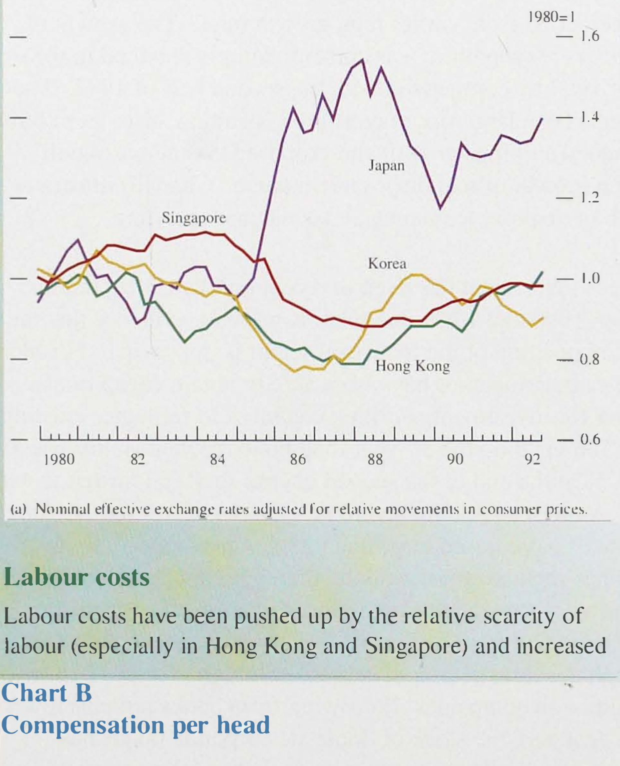
Asian competitiveness

Over the past decade, the newly industrialised economies (Hong Kong, Singapore, Korea and Taiwan—the NIEs) have doubled their share of world exports (see page 57 of the February *Bulletin*), and increased the real value of their bilateral trade surpluses with Europe and North America. This box looks at possible explanations for this performance.

Exchange rates

Although the NIEs have sometimes been accused of holding down their exchange rates to gain competitive advantage, Chart A shows they have experienced real exchange rate appreciation since 1986. The nominal US dollar exchange rates of Hong Kong and Korea are currently at their 1983 levels but both have experienced real appreciation because of high inflation. The real exchange rates of Singapore and Taiwan have also appreciated over the last ten years, though more because of nominal exchange rate changes than to relative prices.

Chart A
Real effective exchange rates (a)

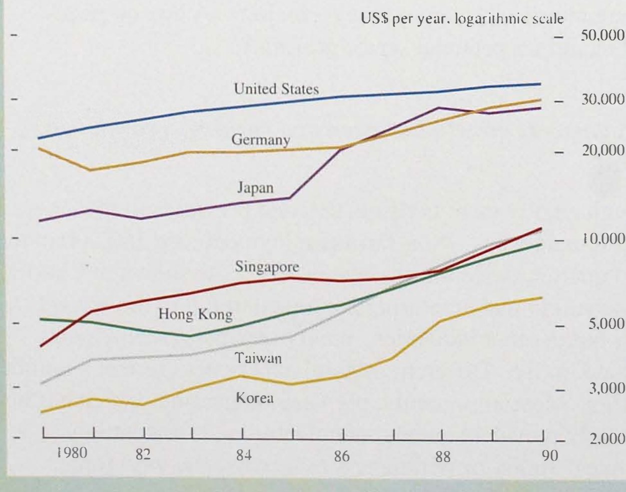


(a) Nominal effective exchange rates adjusted for relative movements in consumer prices.

Labour costs

Labour costs have been pushed up by the relative scarcity of labour (especially in Hong Kong and Singapore) and increased trade union activity (especially in Korea). In US dollars, compensation per employee in the NIEs' manufacturing sectors increased by an average of 12% per annum during the 1980s—three times the rate of increase in the United States.

Chart B
Compensation per head



Despite a rapid increase in labour costs, Chart B shows that the *level* of compensation per employee is still far lower than in the major industrialised countries. Labour costs are, nevertheless, higher than in neighbouring developing countries with more abundant labour: anecdotal evidence suggests manufacturing sector annual wage rates of around US$500 in Vietnam and US$1,000 in China. But the level of compensation is only one determinant of unit labour costs; improvements in labour productivity in the NIEs have also kept unit labour costs internationally competitive.

Range of goods traded

Exchange rates and cost levels alone cannot explain the trade surpluses of the NIEs with Europe and North America. Some other explanations focus on the range of goods traded:

- The NIEs export goods to European countries which the latter have largely stopped producing (such as inexpensive consumer electronics, toys and textiles)—although the NIEs' industries are increasingly moving into higher value-added, more technology-based industries.
- The demand for European consumer goods in the NIEs is modest but growing rapidly, in line with disposable incomes. Over time, this should help increase European exports to the NIEs, although the larger NIEs currently still constrain such imports with tariff and non-tariff barriers.
- Demand for consumer goods in the NIEs, however, is frequently satisfied by locally produced less expensive goods. Intellectual property right violations in some Asian countries remain a source of trade tension.

Foreign investment

Another source of continued competitiveness for the NIEs is the successful internationalisation of production processes in the Far East. The NIEs are the source of a growing share of foreign direct investment (FDI) in other countries in the region. This has been facilitated by favourable investment climates in other Asian countries, resulting from political stability and outward-looking economic policies promoting investment and exports.

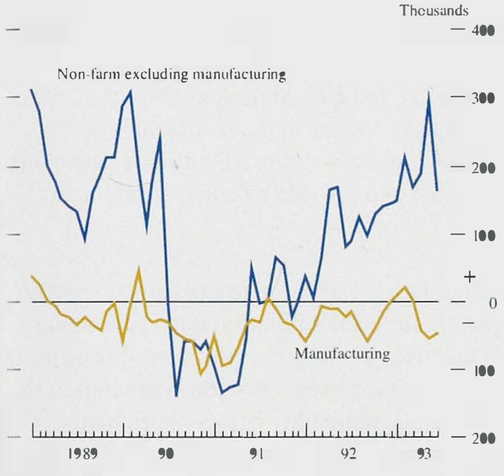
The growth in outward FDI has been financed by the NIEs' high domestic savings rates, which generally have exceeded domestic investment rates. This savings-investment surplus has resulted in sizable current account surpluses and the accumulation of foreign assets, in the form of outward direct investment, portfolio investment, and large official reserves.

The NIEs are overcoming rising labour costs by relocating (through FDI, joint ventures, licensing and subcontracting) their land and labour-intensive production processes to China and other developing countries in the region, where factor costs remain low, and by concentrating internally on more capital and skill-intensive production processes and services. This regional specialisation according to factor endowments and comparative advantage has produced efficiency gains and allowed the NIEs to maintain highly competitive export prices.

because of high non-wage labour costs and the fear that social security taxes may increase.

Manufacturers' reluctance to increase employment has meant that, as demand has risen, existing employees have worked longer. Increased overtime is typical in the early stages of recovery but has been particularly prevalent this time: the average working week in manufacturing, some 41½ hours in the second quarter, is the highest since the 1960s. Relatively slow and uncertain prospects for economic growth may also have inhibited firms from taking on permanent staff; anecdotal evidence suggests that firms have been recruiting more temporary staff through employment agencies (employment via staff agencies is registered to the service sector, even if manufacturing is the ultimate sector of employment).

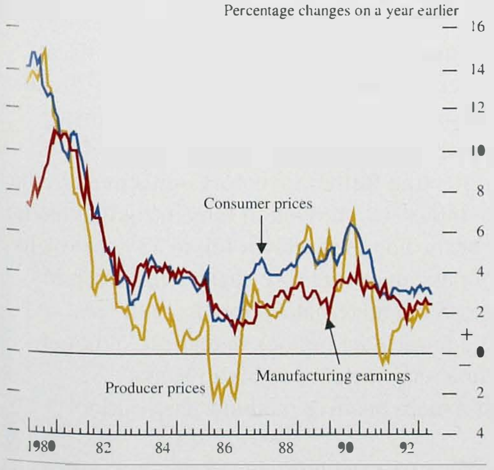
Chart 12
Changes in US employment [(a)]



(a) Two-month moving average.

As output has increased and employment growth has continued to lag, many US firms have achieved substantial productivity improvements. Strong productivity growth and low earnings growth have kept downward pressure on labour costs. Manufacturing unit labour costs fell 2.1% between the second quarters of 1992 and 1993. Favourable trends in unit labour cost growth relative to its main trading competitors will provide an important fillip to US exporters. Chart 3 shows that the US real exchange rate—the trade-weighted effective rate, adjusted for differences in relative unit labour costs—has been stable this year, while the Japanese real exchange rate has risen (ie become less competitive) as have those of several European countries. In the long run, such changes in the real relative costs of production are likely to have a significant effect on trade flows. Non-price competitiveness and the openness of overseas markets will then determine whether exporters are able to capitalise on any sustained improvements in cost competitiveness.

Chart 13
US prices and earnings



Low growth in unit labour costs and consumer spending means that inflationary pressures have so far been subdued in the United States. The rise in recorded wholesale prices in the first few months of the year, (reflecting possible inadequate seasonal adjustment and higher commodity prices which have since fallen), seems to have abated and had little permanent effect on consumer prices.

A key issue is the outlook for inflation as the economy picks up. The Federal Reserve estimates that US output may be up to 4% below its potential, leaving scope for non-inflationary growth. During the second quarter—after the rise in inflation earlier in the year—the financial markets became increasingly preoccupied with the timing of any future tightening of monetary policy. As the markets began to focus on *when*, rather than *if*, the Fed would tighten, both short and long-term dollar interest rates edged up. The yield on the 30-year long bond, which had fallen to an historic low in the first quarter, rose back toward 7% but, as inflation data turned out more benign than some had feared, yields fell back to a new low. Overall, because short rates rose and long rates fell, the US yield curve flattened during the quarter.

Canada's growth has been export-led; weak domestic demand has so far restrained inflation pressures

Canadian growth is now firmly established, based partly on stronger net trade. Domestic demand remains subdued: retail sales

Table H
Contributions to Canadian GDP growth(a)

Percentage points

	1991 Year	1992 Year	Q3	Q4	1993 Q1
Consumption	-1.2	0.7	0.3	—	0.4
Business investment	-0.2	-0.8	0.1	-0.1	0.2
Residential investment	-0.7	0.4	0.1	—	-0.3
Government expenditure	0.5	0.4	0.2	0.1	0.2
Stockbuilding	0.4	-0.5	-0.6	-0.3	0.9
Domestic demand	-0.8	0.2	0.1	-0.4	1.3
Net trade	-0.9	0.5	—	1.0	-0.3
GDP	**-1.7**	**0.7**	**0.1**	**0.7**	**0.9**

(a) Quarterly contributions are relative to the previous quarter.

Chart 14
Canadian consumer and producer prices

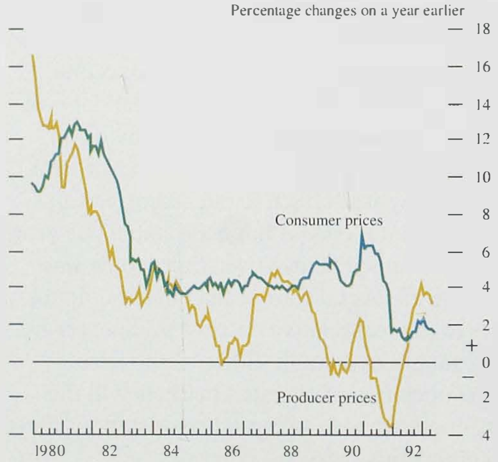
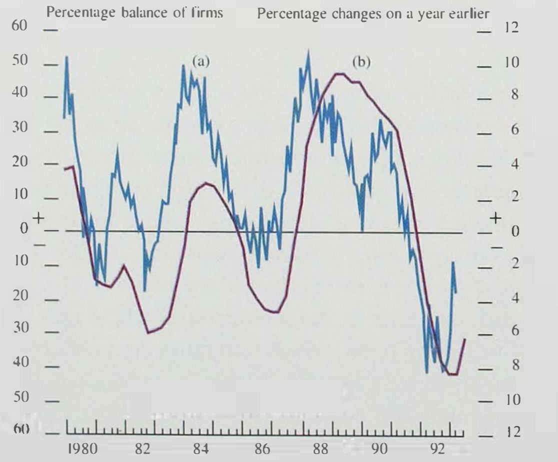


Chart 15
Japan: manufacturing confidence and industrial production



(a) Industrial production, right hand scale.
(b) Major manufacturers' view of business conditions: favourable minus unfavourable, third quarter of 1993 is forecast, left hand scale. Source: Tankan Survey.

growth has been on a gentle upwards trend for more than a year, but consumer confidence remains fragile because of job insecurity and low earnings growth. Unemployment, which edged down in recent months, is still high at over 11%. Manufacturing and construction firms remain particularly reluctant to increase employment.

The fall in the Canadian trade deficit has reflected the weakening of the exchange rate last year and increased demand from Canada's main export market, the United States. Growth in the United States is expected to be higher in the second half of this year than in the first which should result in a continued narrowing of the Canadian trade deficit and provide a further stimulus to GDP.

Annual consumer price inflation was 1.7% in the second quarter, lower than the first quarter and well within the Bank of Canada's inflation target. High unemployment is keeping wage pressures in check. Material input prices have risen since the beginning of the year, reflecting a rise in some commodity prices (particularly timber, though prices have now fallen) and the fall in the exchange rate which has increased import prices. So far, the rise in wholesale price inflation since the beginning of last year has not been passed on to consumers (see Chart 14). But, if consumer demand increases markedly, firms might attempt to re-establish their profit margins by marking up finished goods prices.

Japan

The economy may be bottoming out and the financial sector looks more robust

The Japanese economy grew by 0.6% in the first quarter of 1993. The public sector was an important source of growth, reflecting the fiscal package announced in August last year (further fiscal measures were announced in April and described on page 201 of the May *Bulletin*). Consumer spending also grew in the first quarter, although retail sales fell. Stockbuilding depressed first-quarter growth, reflecting further inventory adjustment in the manufacturing sector. Industrial production remains quite volatile on a month-to-month basis though in May it fell to 13% below its peak. Registrations of passenger cars rose sharply in March to 3½% above a year ago. Such mixed indicators from the real economy imply that the immediate outlook is unclear, although improvements in the financial sector (notably in banks' capitalisation) suggest a more positive medium-term outlook.

May's Tankan survey of short-term business conditions showed no change in business confidence from February—the first time confidence had not deteriorated since 1989. Chart 15 shows that the index of manufacturing confidence has risen from its trough. But large manufacturers expect profits and capital spending to fall in the current fiscal year; for many this would be the fourth consecutive year of falling profits. Despite this, the Nikkei was trading at the end of June at a price/earnings ratio of around 70, its highest since 1989. The rise in the Nikkei this year probably owes more to expectations of policy stimulus and a continued strengthening of the yen (encouraging foreign investors), possibly some buying by public sector funds, and the rally in bond prices around the turn of the year. The latter may have encouraged some

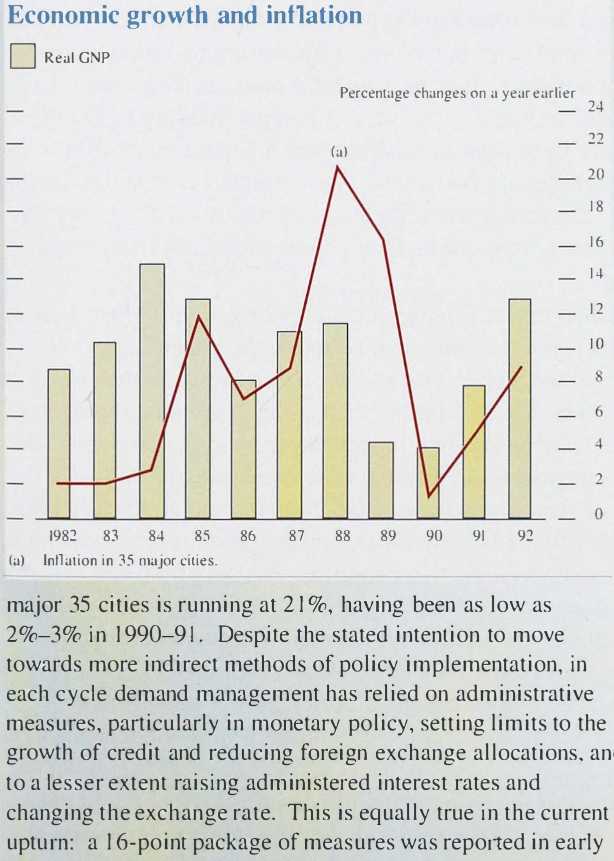
China's reform process and economic performance

Economic development

By any standards, China has experienced rapid economic development and growth since the start of its reform process in the late 1970s, averaging around 10% a year real GNP growth over the period 1982–92.

This economic development path has been punctuated by pronounced economic cycles. It is likely that the peak of the latest cycle has now been reached; at present, real GNP is growing at an annual rate of around 14% and inflation in the

Chart A
Economic growth and inflation



(a) Inflation in 35 major cities.

major 35 cities is running at 21%, having been as low as 2%–3% in 1990–91. Despite the stated intention to move towards more indirect methods of policy implementation, in each cycle demand management has relied on administrative measures, particularly in monetary policy, setting limits to the growth of credit and reducing foreign exchange allocations, and to a lesser extent raising administered interest rates and changing the exchange rate. This is equally true in the current upturn: a 16-point package of measures was reported in early July aimed particularly at reducing speculative investment. In addition, interest rates have been increased by three to four percentage points since May, mainly with the aim of repatriating foreign exchange and retaining deposits in the banking system.

The reform process

China's economic reforms have touched all aspects of economic life. Planning and controls in agriculture have been lifted. The liberalisation of the prices of commodities, products and services has been far-reaching. The subsequent rises in prices have added to inflation though it remains largely demand-led. Private enterprise has been encouraged such that it now accounts for around a half of industrial production. Foreign direct investment has been attracted to the Special Economic Zones and to the coastal cities and provinces; and rural and township enterprises have been established on a wide scale. The state-owned enterprises—many still loss-making—are being reformed with a view to increasing private sector involvement.

In the financial sector, a monobank structure was replaced in 1984 by a system comprising the People's Bank of China as the central bank, and four specialised commercial banks. New investment and credit institutions were permitted at the same time and these have grown markedly at the local level. Stock markets have also been introduced recently, in Shanghai and Shenzhen, and Chinese state-owned companies are beginning to be listed on the Hong Kong Stock Exchange; this is encouraging the adoption of international financial and accounting standards. China's financial infrastructure is also being strengthened with a bankruptcy law, tighter prudential supervision, improvements to the payments system and new banking legislation.

The emphasis on administrative measures in the recent package aimed at cooling China's economy has overshadowed two other steps which will increase the role of market mechanisms in setting the exchange rate and interest rates.

In May the authorities withdrew an administratively set floor to the exchange rate in the foreign exchange swap markets, where transactions not covered by official state planning are permitted. As a result, the yuan initially depreciated sharply, converging with the prevailing parallel market exchange rate of yuan 11 per US dollar. Since then, however, the yuan has recovered to around yuan 8.5 per dollar because of intervention by the People's Bank and the recent economic package. China's state-owned companies are still required to transact at the official exchange rate which is now about yuan 5.7 per dollar although the authorities have announced their intention to move to a unified exchange rate and full convertibility in due course.

The People's Bank has also announced a plan to issue securities in its own name. The intention is to encourage the development of a money market in which the People's Bank can intervene to influence liquidity and hence interest rates. Although no date has been set to begin this programme, it can be seen as official recognition of the importance of allowing interest rates to reflect market pressures fully and of developing market-based monetary policy techniques.

Chart B
Current account and exchange rate

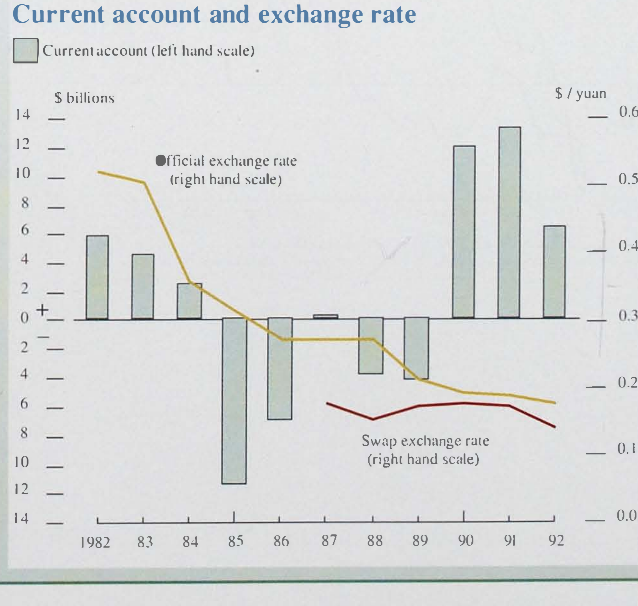


Table J
Contributions to Japanese GNP growth(a)

Percentage points

	1991 Year	1992 Year	Q3	Q4	1993 Q1
Consumption	1.3	1.0	0.4	-0.3	0.7
Business investment	1.2	-0.9	-0.4	-0.7	—
Residential investment	-0.5	-0.3	—	-0.2	-0.1
Government expenditure	0.4	1.0	-0.2	0.3	0.5
Stockbuilding	0.3	-0.2	-0.4	0.4	-0.3
Domestic demand	2.7	0.6	-0.6	-0.6	0.7
Net trade	1.4	0.9	—	0.6	-0.1
GNP	**4.1**	**1.5**	**-0.6**	**—**	**0.6**

(a) Quarterly contributions are relative to the previous quarter.

Chart 16
Yen/US dollar exchange rate

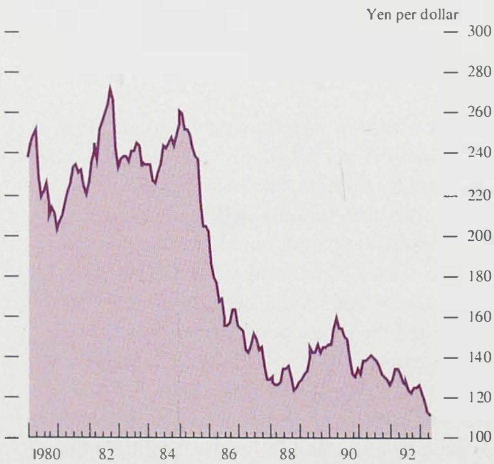
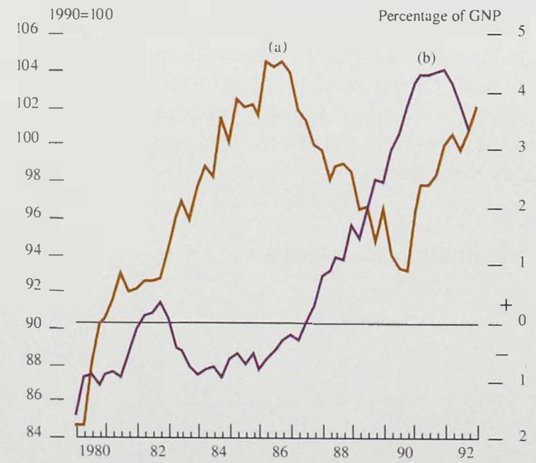


Chart 17
Japanese relative demand and current account



(a) Current account as a percentage of GNP, right hand scale.
(b) Japanese domestic demand relative to the other G7 countries, left hand scale.

investors to switch from bonds into equities. The price of 10-year Japanese government bonds fell in the second quarter, though the apparent shift in investors' preferences and the consequent steepening of the yield curve does not necessarily reflect an increase in inflation expectations.

Japanese money and credit conditions may have eased

Growth of the most widely used measure of money supply, M2 plus CDs, was around ½% in the first half of the year following no growth in the second half of last year. Bank lending growth has not yet increased and has been rising at around 1%–2% per year since early last year, half the rate of 1991. Large companies, however, have been borrowing heavily in domestic and international capital markets, though much of this has been to refinance debt issued in the buoyant 1987–89 period. The Tankan survey found firms perceiving a further improvement in banks' lending attitudes. But the Tankan is concentrated among large firms and, as banks' asset quality and profitability have fallen, they have been keen to establish and maintain relationships with large high-quality customers. Some smaller companies, unable to obtain securities market funding, and whose credit quality has deteriorated, may still be facing tight conditions from banks.

The yen appreciated in the second quarter. During late June and early July, political uncertainty before the general election weakened the yen, but its trade-weighted value at the end of the quarter was still 20% higher than at the beginning of the year. This underlying strength reflects three main factors. First, the rising Japanese trade surplus, which reached $57 billion in the first half year, around 3% of GNP. In particular, the $22 billion surplus with the United States, and the potential for growing trade tensions between the two countries, was seen by some as a signal for pushing the yen higher against the dollar. Second, the gap between US and Japanese bond yields narrowed during the quarter. And third, the deutschmark came under pressure as the German economy weakened further. All of these factors increased the attractiveness of holding yen-denominated assets.

The effect of the rising yen on trade imbalances has not yet become clear. In the short run, because trade volumes are slow to react to relative price changes, the value of Japan's surplus has probably been boosted (the 'J-curve' effect). But relative demand was the most important determinant of the Japanese trade surplus in 1992 and is likely to remain so (see Chart 17). If the United States continues to grow more quickly than Japan, the surplus may continue to rise. Nevertheless, much will also depend on whether the yen's rise is sustained. As shown in Chart 3, Japan's real exchange rate rose by a similar amount in 1986, helping contribute (with rising relative demand) to a fall in the surplus in the following four years. Japanese manufacturers may respond to the higher exchange rate by improving their productivity growth and non-price competitiveness.