The international environment

- *Recovery continues in North America and output in continental Europe has stabilised, but the recession in Japan may have some way to go.*
- *Output in the major six overseas economies is likely to grow by 1% this year and accelerate only gradually in 1994. Concerns about rising unemployment have intensified.*
- *Inflation remains very subdued with sharp falls in producer prices in several countries and falling commodity prices.*
- *The widening of fluctuation margins in the ERM has led to some narrowing of interest rate differentials. Despite further falls in nominal rates in October, real short-term interest rates remain high in continental Europe.*
- *Fiscal and monetary policies have eased further in Japan. The yen remains firm.*

Chart 1
Major six GDP

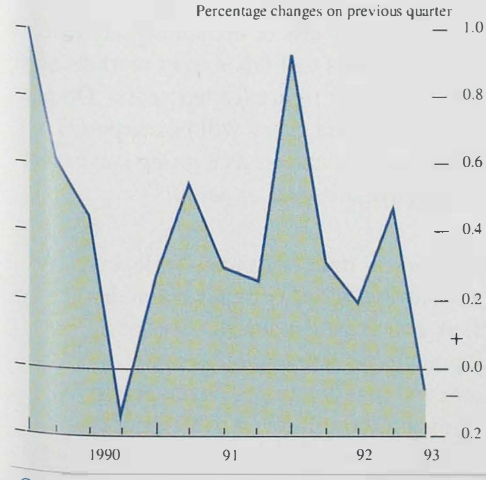
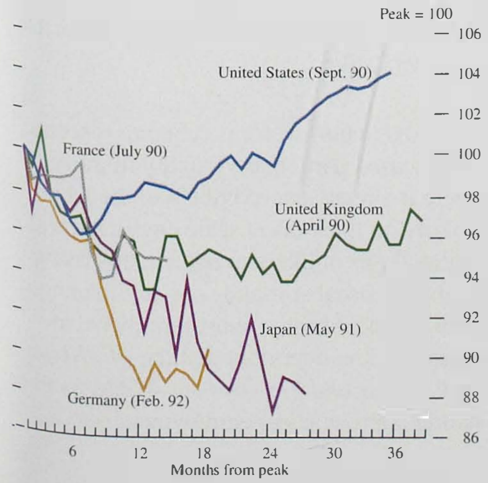


Chart 2
Peak to trough in industrial production



Overview

During the past few months there has been a consolidation of trends among the major economies which have been apparent for some time. It has become increasingly clear that recovery in Japan and continental Europe will be muted and protracted. The Japanese authorities have responded to this prospect with a further easing of policy. In Europe, however, monetary conditions remain tight, despite the room for manoeuvre provided by wider margins in the ERM and the further easing in October. There is some risk that a continuation of tight monetary policies will result in greater pressure for fiscal expansion to address the weakness of demand and rising unemployment. By contrast, modest recovery is well under way in North America and the United Kingdom.

There are no signs of any substantive inflationary pressures in the major economies. Inflation seems set to fall further in Europe and there is no prospect of an upturn in underlying inflation in Japan in the near future. As the recovery continues in the United States, there is a growing likelihood of a pick-up in inflation there. But there are no signs of this at present. Commodity prices, meanwhile, are weak, reflecting depressed demand among the industrial countries as a group.

Activity is still very weak in Europe and Japan

Growth in the major six overseas economies was marginally stronger in the second quarter than in the first; GDP increased by around $^1/_4$%. Japan was the only country in which activity was weaker than in the first quarter; growth picked up in the United States and positive growth was recorded in Germany after four consecutive quarters of falling output. Output was flat in France.

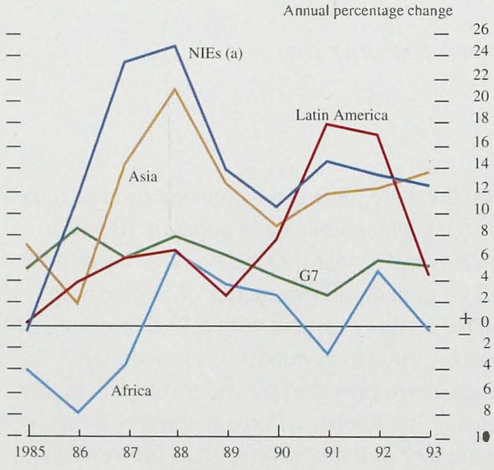
This picture offers little encouragement. Recovery continues, albeit at a modest pace, in North America but it is too early to detect signs

Table A
GDP growth

	1990	1991	1992	1993(a)
United States	1.2	-0.7	2.6	2¾
Japan	4.8	4.1	1.5	-¼
Western Germany	5.9	4.6	1.2	-2½
France	2.5	0.7	1.4	-1
Italy	2.1	1.3	0.9	-½
Canada	-0.2	-1.7	0.7	2¾
Average major 6	**2.6**	**1.1**	**1.8**	**1**
United Kingdom	0.6	-2.3	-0.4	1¾
Average major 7	**2.5**	**0.9**	**1.6**	**1**

(a) Major 6: Bank estimates. United Kingdom: consensus market forecast (October).

Chart 3
Import volume by region



Source: IMF.

(a) Hong Kong, Korea, Singapore and Taiwan.

Table B
Unit labour costs in manufacturing

Percentage changes on previous year

	1990 Year	1991 Year	1992 Year	1993 Q1	Q2
United States	1.2	1.3	-1.0	-2.2	-2.2
Japan	2.9	3.8	8.7	4.8	4.8
Western Germany	2.5	4.3	4.8	7.7	3.6
France	3.6	2.1	1.1	3.9	3.1
Italy	9.0	13.4	5.5	9.0	5.1
Canada	2.2	-2.6	-2.2	-2.1	-3.7
Major 6	**2.6**	**3.0**	**2.2**	**1.9**	**0.9**
United Kingdom	7.6	3.3	0.7	-2.7	-2.9

of an upturn in continental Europe. Growth in Germany in the second quarter was not particularly soundly based; most components of domestic demand, in particular investment, remain weak. Over the year as a whole, GDP in unified Germany may contract by around 2%, with a smaller fall in France and sluggish performances in Italy and Spain. Earlier optimism that Japan was set for an imminent recovery appears to have been premature. Output fell in the second quarter and there is little sign of recovery having taken place in the third.

Most forecasts for growth in the major economies as a group have been revised down throughout the year—largely as a result of the Japanese and continental European economies proving weaker than had been expected. The consensus is now that GDP in the major six overseas economies is likely to grow by only around 1% this year. A modest pick-up is expected in Europe and, perhaps, Japan within the next few months which, combined with continued recovery in North America, may take growth in the major six to between 1½% and 2% in 1994. But even this depends on a degree of further policy easing as well as some restoration of confidence in the most depressed economies.

The uneven pattern of activity extends beyond the major industrial countries. Output growth in the developing world has slowed but should nevertheless be around 5%–6% this year and next, though most of this will be accounted for by the newly industrialised economies of Asia and, to some extent, Latin America. This would sustain a rise in overall world trade of over 5%, but the benefits would be unevenly spread. The weakness of demand—and hence of imports—in Europe and Japan, means that UK export markets may grow by only 2% this year, the lowest figure for ten years. Despite optimism in continental Europe that recovery will be supported by export growth, the major industrial countries as a group can expect no net external stimulus to growth this year or next.

The longer-term outlook for world trade continues to depend heavily on a successful conclusion of the Uruguay round by end-1993. The World Bank and Organisation for Economic Co-operation and Development estimate that the partial liberalisation of agriculture and manufacturing envisaged in the Uruguay round could add over $200 billion (at 1992 prices)—or around 1%—to annual global income. These gains will clearly fail to accrue if the round is not completed. Equally significant, however, is the considerable risk—particularly in circumstances of depressed activity—that the global trading system will, given a failure to secure agreement, take several steps back, at considerable cost to producers and consumers alike.

Unemployment in several of the major overseas economies seems set to rise further, having increased particularly rapidly in the European Community where it already exceeds 11% of the labour force. Recovery—particularly on the modest scale envisaged with output growing below potential—is unlikely to reverse this rising trend. There is neither scope for fiscal stimulus, nor any likelihood that this would provide more than, at best, a short-term boost to employment. For these reasons, it is important that the EC White Paper on *Growth, Competitiveness and Employment* should focus on microeconomic and structural approaches to employment issues.

Chart 4
Inflation

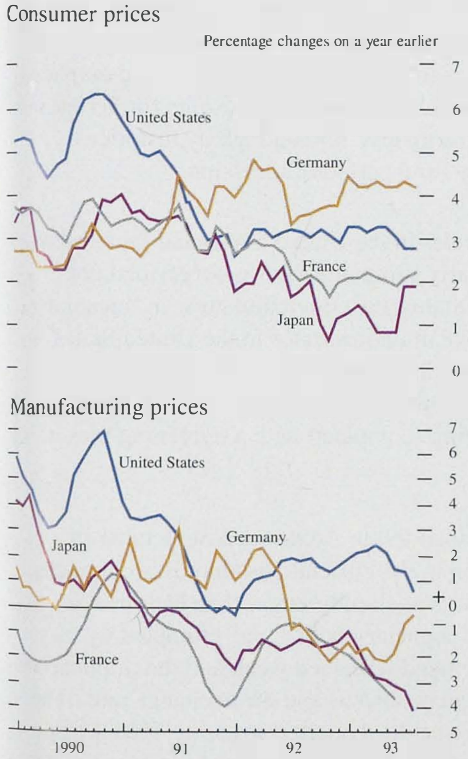
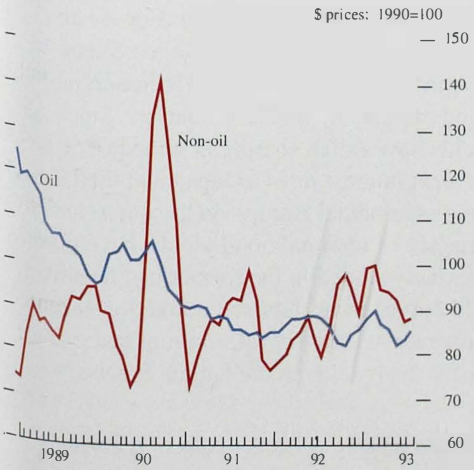


Chart 5
Oil and non-oil commodity prices



Source: The Economist.

Consumer price inflation is low and manufacturing prices are falling in several countries

Consumer price inflation in the United States has continued to retreat from the erratically high rates in the first quarter; while in Japan, a sharp rise in consumer prices over the summer months was largely weather-related. Progress continues to be made with underlying inflation—particularly earnings growth—in continental Europe. In Germany the outturn for consumer price inflation for the year as a whole is likely to be around 4%, although a fall (to around 3%) is expected in 1994.

The relative stability of consumer price inflation in the main overseas economies conceals strikingly different trends in underlying inflationary pressures and, in particular, the behaviour of manufacturing sectors in Japan and continental Europe on the one hand and North America on the other. Producer prices in Japan, Germany and France are falling quite sharply as weak demand and high real exchange rates are exerting powerful disinflationary pressures. Unit labour costs in these economies are still rising relatively quickly (even though earnings growth is moderating) and profit margins in manufacturing are being squeezed—despite some relief from falling import prices. Although it is possible that pressures on manufacturers may be partly unwound (for example as margins are restored during an upturn), the depressed outlook for demand in these economies makes this a distant prospect; inflation pressures are weak and seem set to ease further.

In North America, by contrast, unit labour costs are falling (as the counterpart to exceptionally rapid productivity growth) and producer prices are rising—albeit quite modestly. Although the outlook is for broadly stable inflation in the United States, with consumer prices rising at around 3%, an increase is less remote than elsewhere. As well as being in a modest recovery, recent revisions to GDP figures indicate that the recession in 1991 was slightly shallower than had been thought, and it seems likely that the output gap is by now quite small.

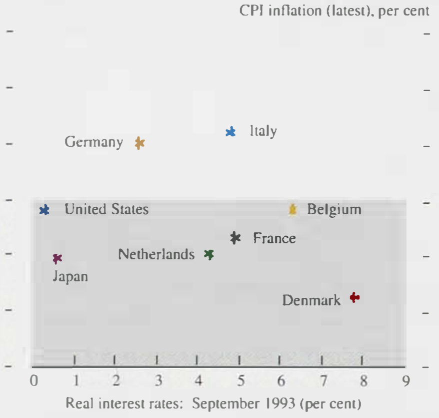
There is little immediate threat to inflation from commodity prices. Non-food prices have been subdued and are likely to remain so. Demand conditions in the industrial countries have resulted in commodity prices overall (in SDR terms) rising by only around ½% in the year to September with a fall in the third quarter. Oil prices (in dollar terms) fell by over 30% in the year to September. Production continues to outpace demand and this has been reflected in a build-up of stocks and falling prices. This trend is likely to continue although prospects for supply—not least from Russia, the third largest producer—are uncertain.

ERM bands have been widened and monetary conditions have generally eased

In response to renewed pressure in the foreign exchange markets at the end of July, intervention margins for the ERM currencies were widened to plus or minus 15% (see the box on pages 456–7). In principle, this allows a much greater differentiation of monetary conditions among the former narrow-band countries. In practice, however, little such differentiation has occurred and the authorities in several countries have made it clear that they see limited scope for rapid easing independently of Germany.

The Deutsche Mark weakened against the US dollar in the turmoil preceding the adoption of wider ERM bands. It regained ground in August and September and stayed broadly stable around DM 1.60 against the dollar, notwithstanding some nervousness at the time of the political upheavals in Russia, until the cut in official interest rates in Germany on 21 October. Real short and long-term interest rates in Europe have eased quite markedly since the beginning of the year as cautious reductions in nominal interest rates have outpaced falls in inflation. The financial markets expect some further easing. Real short-term rates, nevertheless, remain high by historical standards and particularly for a period of recession.

Chart 6
Inflation and real interest rates (September)

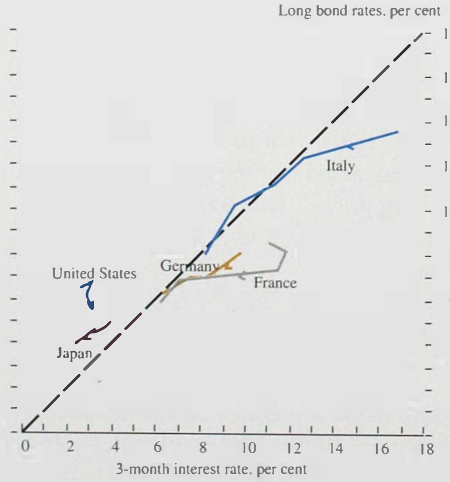


Real short-term interest rates in the United States and Japan were broadly stable over the early summer. After recovery had got under way in the United States, the conviction grew in financial markets that the next move in interest rates in the United States would be upward. But the timing of this remained uncertain. The Federal Open Market Committee reverted to a 'neutral' policy stance at its August meeting (compared with a tightening bias in earlier months).

Money-market rates in Japan fell in August and September in anticipation of a reduction in the Official Discount Rate (though, in the event, the reduction was slightly larger than had been expected). The easing of monetary policy was prompted by growing evidence that demand remained weak and the implications of this for the current account surplus and the exchange rate. The yen continued to rise into the third quarter, reaching ¥101.1 against the dollar in the middle of August, but has since been contained at around ¥105.

Japan has also continued to make use of the room for manoeuvre provided by its strong fiscal position by introducing a further fiscal package in September amounting to ¥6 trillion. This supplements earlier packages introduced in August 1992 and April 1993. Although the headline figures overstate the impact of these packages on demand, they should nevertheless have an effect in underpinning activity.

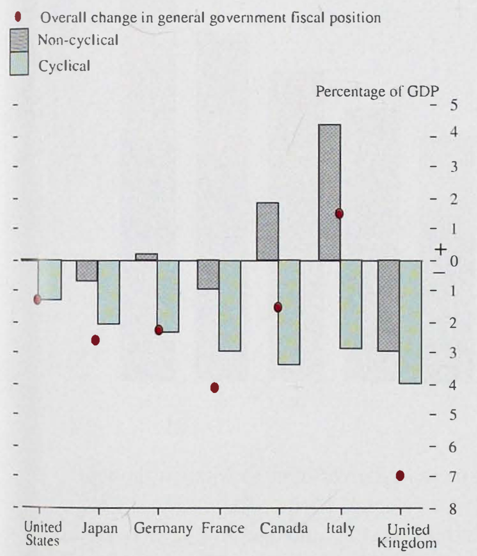
Chart 7
Long bond rates and short interest rates (September 1992–October 1993)



An expectation of falling short-term interest rates in Europe and Japan, and the possibility that a tightening in the United States might occur later than originally thought, has contributed to the continued strength of bond markets in several countries. Since the beginning of the year yields have fallen sharply in all major centres. Disparate levels of short-term interest rates in Japan and the United States on the one hand and continental Europe on the other, and a relatively greater convergence of nominal bond yields, have resulted in yield curves being positively sloped in the former and negatively sloped in the latter. Yield curves have flattened markedly since the beginning of the year, however, with short rates falling faster than yields in Europe and slower than yields in the United States.

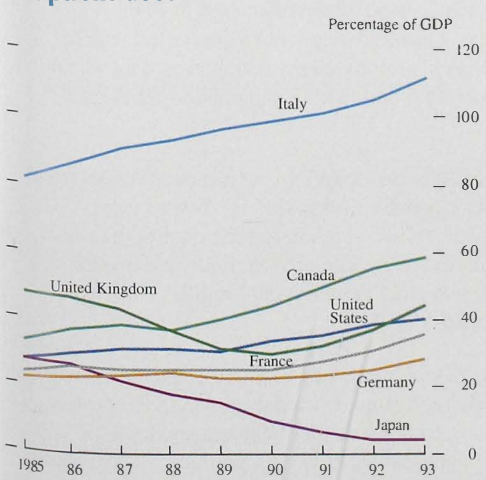
The strength of bond markets largely reflects market participants' expectations concerning the future path of inflation and pattern of short rates. To some extent this is because activity is weak in many countries and perceived as likely to result in further policy easing. It also indicates that markets are generally confident that the anti-inflationary thrust of policies and fiscal consolidation will continue into the recovery.

Chart 8
Changes in fiscal positions 1990–93



Source: OECD.

Chart 9
Net public debt



Source: OECD.

Cyclical pressures are placing strains on fiscal policy

With the downturn in growth, the average general government deficit of the major six overseas economies more than doubled as a share of GDP between 1990 and 1993 to around 4%. The average in the European Community this year is expected to exceed 6%. This is largely a result of the operation of automatic stabilisers. There are various ways of adjusting fiscal positions to take account of cyclical factors—none of them precise. Chart 8 shows OECD estimates of cyclical and non-cyclical contributions to changes in fiscal positions over the past three years. Net public sector debt also increased over this period and its average level is now around one third of GDP.

Any significant re-evaluation of the sustainability of fiscal positions by financial markets would be potentially damaging for the countries concerned. Fiscal consolidation therefore remains a high priority. The budget package agreed in the United States—which is intended to reduce the federal deficit to 2.2% of GDP by 1998—is particularly significant in this connection (even though some uncertainties remain, especially regarding the financing of health care reform). Consolidation of the underlying budgetary position has also taken place in Canada and further deficit-reducing measures have been introduced in Germany to buttress the Solidarity Pact. It is important that depressed conditions elsewhere in Europe do not undermine progress towards lower deficits in the medium term.

North America

The recession in the United States was shallower than had been thought

Growth in the United States increased to 1.9% (seasonally adjusted annual rate) in the second quarter. Although this represented an improvement over the first quarter, growth has perceptibly slowed compared with last year. There nevertheless seems little prospect of the recovery stalling. Domestic demand, led by consumer spending and business investment, is growing faster than GDP (and is stronger than in most of the United States' trading partners) so that net trade made a negative contribution to growth in the first half of the year. The Administration has published a revised forecast showing growth of 2% by the fourth quarter of this year from a year earlier. This is consistent with a pick-up in growth in the second half and a year-on-year growth rate somewhat higher—at around $2\frac{3}{4}$%. However, quite substantial revisions to past GDP were not available in time to be allowed for in this new assessment.

On the basis of the revised GDP figures, growth over the period 1990 to 1992 was about $\frac{1}{2}$% a year stronger than originally thought. The recession therefore appears to have been less severe and the recovery stronger. The revisions are particularly significant because of their effect on assessments of the gap between potential and actual output, and hence the risk of an upturn in inflation as the recovery progresses. The Federal Reserve estimated the output gap to have been between 2% and 4% in the first quarter of this year—suggesting that modest recovery could continue for some time before potential inflationary pressures emerged.

On the face of it, the latest revisions—which place GDP at the beginning of 1993 some $1\frac{1}{2}$% above its previously estimated

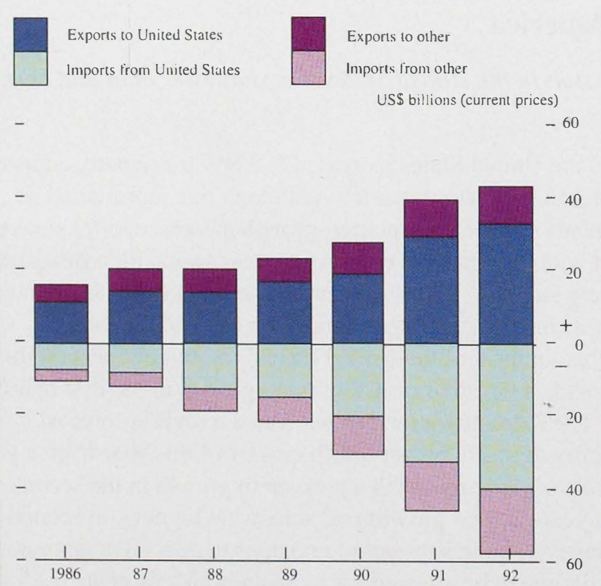
Mexico and NAFTA

The North American Free Trade Agreement (NAFTA), embracing Mexico, the United States and Canada, was signed in December 1992. (Canada and the United States have had a more limited free trade agreement since 1989.) If obstacles to US ratification are overcome, the agreement will be implemented on 1 January 1994 and its provisions phased in over a maximum of 15 years. NAFTA is a comprehensive agreement covering services, textiles, agriculture and investment as well as labour and environmental issues. It will create a market with a GDP of $6,850 billion and a population of 365 million. It is hoped that liberalisation under NAFTA will be extended to other countries through the GATT process.

In common with all trade liberalisation measures, NAFTA should increase the economic welfare of the region, but the participants will not gain equally. US gains relative to GDP will be smaller than those of Mexico. However, the absolute impact on US exports will not be insignificant: in 1992, Mexico was the third most important trading partner of the United States and accounted for 12% of the growth in total US exports between 1986 and 1992.

The United States is Mexico's largest trading partner, accounting for 72% of total trade. Three quarters of trade is in manufactured products and involves the 'maquiladora' industries (border assembly plants) which import components duty free. A surge in investment, increased and more certain access to the US market for Mexican goods and the enhancement of competition, are expected to have a significant, positive net effect on Mexico's growth and employment.

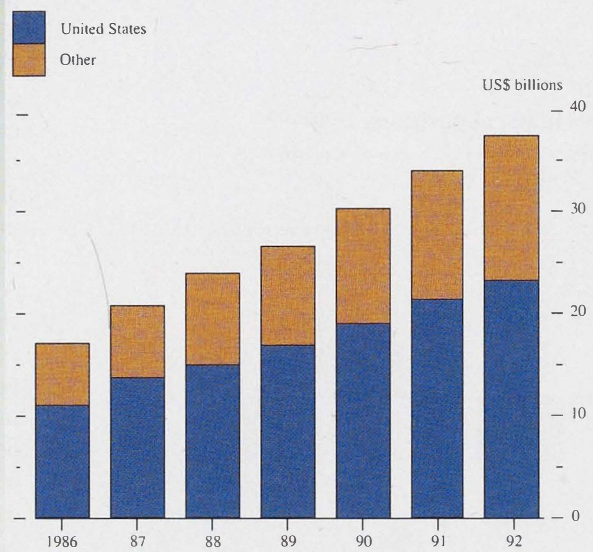
Chart 1
Mexico: trade shares



Source: IMF, Direction of Trade Statistics.

The benefits of freer trade have begun to accrue even before NAFTA is implemented. The average weighted Mexican tariff against the world is now less than 10%, reflecting substantial trade liberalisation since 1985 when the level was 25%. Even so, NAFTA has the scope to increase trade flows further. The dynamic effects of increased investment in Mexico should strengthen exports of US capital goods. The lifting of US quotas on sugar, clothing, textiles and agricultural imports and the diversion from Asia to Mexico of some US car and electronic goods imports will boost Mexican exports.

Chart 2
Mexico: origin of cumulative FDI



Source: Bank of Mexico.

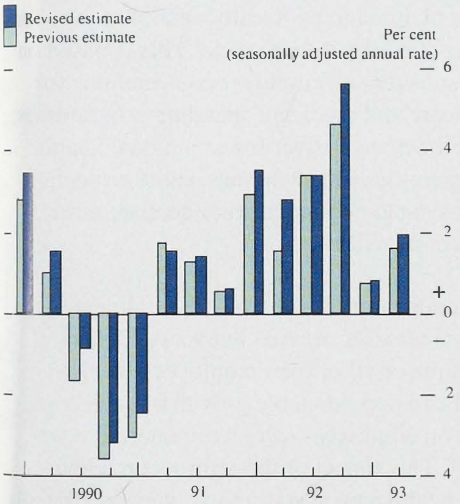
For Mexico, NAFTA may have a greater immediate impact on investment than on trade flows. US direct investment in Mexico has more than doubled since 1985 and now accounts for 65% of total foreign direct investment (FDI): US Department of Commerce surveys show that, between 1977 and 1990, the increase in employment from US investment in Mexico was greater than that in the 13 major Asia/Pacific countries combined. Mexico's proximity to the United States is a major advantage in this respect. Three quarters of FDI is in manufacturing, much spurred by the relaxation of FDI regulations in 1989. Further deregulation is expected which, combined with Mexico's improved economic prospects, should encourage continued FDI both within and outside the NAFTA framework.

Much of the impact of NAFTA on FDI is expected to derive from the greater stability it provides for investors. NAFTA rules afford national treatment to foreign investors, control the use of performance requirements (relating for example to domestic content), protect intellectual property and establish a disputes settlement mechanism.

Research by the US Department of Commerce concludes that US FDI is primarily motivated by output growth in the host country, even in countries where unit labour costs might be expected to be the main factor. If NAFTA produces the expected rise in Mexican output growth, it should lead to a surge in US investment in Mexico. A recent poll reported that 40% of US manufacturers intend to move some manufacturing to Mexico in the next few years. Increased confidence and access to North American markets should also attract more third country investment in Mexico. Significantly, Japan currently accounts for less than 5% of the stock of foreign capital.

level—would seem considerably to reduce estimates of the likely output gap (notwithstanding the possibility that potential output may also be higher than had been thought). Bank estimates suggest that there is still some slack in the US economy and that a pick-up in inflation is unlikely in the remainder of this year. It is, nevertheless, possible that the output gap could be eliminated in the near future. Capacity utilisation has risen by around three percentage points since the trough in early 1991, and is currently close to its average since 1970. The labour market is also tightening—non-farm payrolls have increased at an average rate of 150,000 per month since the beginning of the year—and the sustained fall in long-term interest rates is providing a strong stimulus to demand. As a result, it is possible that an upturn in inflation expectations over the coming months could require some tightening of policy.

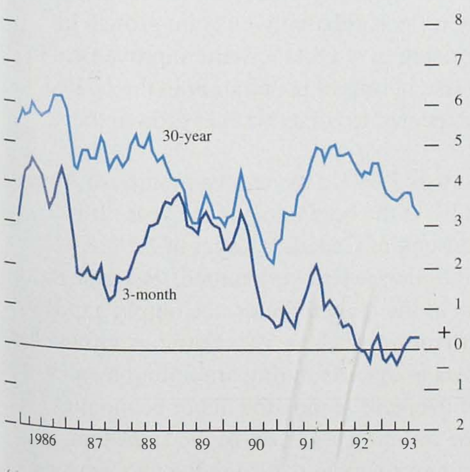
Chart 10
United States: GDP growth



The likely need to tighten the monetary stance at some point during the recovery in the United States has been acknowledged by the authorities. Real short-term interest rates are currently around zero and this is unlikely to remain appropriate as the recovery matures. Financial markets remain sensitive, however, to indications that the recovery may yet prove fragile.

There is, as yet, little sign of any pick-up in inflation. Consumer prices increased by 2.7% in the year to September and the increase in producer prices over the same period was 0.5%. The monetary aggregates, meanwhile, continue to give little indication of inflationary pressures. M2 growth picked up slightly over the summer, to 1.2% (annualised growth on a fourth quarter base), but is still only barely above the bottom of its target range. This slow growth continues to pose problems of interpretation, however. In particular, flows into non-M2 financial assets—particularly mutual funds—have continued at a very rapid pace (and, indeed, have contributed to the strength of bond markets).

Chart 11
United States: real 3-month interest rates and real 30-year bond yields[(a)]



(a) Interest rate and yield less consumer price inflation.

Higher imports may blunt the impact of stronger demand

The deficit on the balance of trade in goods and services in the first half of 1993 widened to $57 billion at an annual rate (compared with just over $30 billion during 1992); as a consequence, the growth of GDP was half that of domestic demand. The wider deficit reflected the relatively strong cyclical position of the United States with recession in several major export markets, notably Japan and continental Europe, and a surge in imports. Import penetration of US markets rose strongly in the second half of 1992, and has remained high in 1993.

A rise in import penetration during a cyclical recovery is not unusual, and a cyclical downswing in overseas markets may exacerbate the process if overseas producers divert output from depressed home markets. But the scale of the recent deterioration in the trade balance appears greater than cyclical factors alone would suggest, and is puzzling in the face of the broad stability in the dollar's real exchange rate. Unit labour costs in manufacturing have fallen since 1990 (compared with a continued rise in Japan and Germany).

The fiscal impact of the proposed health care reforms depends on their effect on costs

The Administration's proposals for health care reform were launched on 22 September. The reforms aim to ensure universal health insurance and to restrain the rate of growth of national health care costs by encouraging greater competition among health care providers. Presently, health care spending accounts for around 14% of GDP, compared with under 10% in most other industrialised economies.

The proposals (which take effect from 1995) involve employers financing 80% of their employees' average health insurance fees, subject to an overall limit. There will be government subsidies to low income individuals and small firms, to enable individuals presently without adequate insurance cover to be brought in. Overall, the proposals are claimed to be fiscally neutral in the short term, and deficit-reducing after about four years. This is based on projected substitution of subsidy and employer contributions for much of the current medicare and medicaid spending programmes; a strong assumption that the plans deliver lower national health costs, reducing remaining entitlement spending; and a projection that as employers' health-related non-wage costs decline, direct wages and income tax receipts will rise.

The medical services component of the CPI has risen almost twice as fast as the overall price index for the past ten years. As many employers already bear some or all of their employees' health insurance costs, the rapid and unpredictable growth of such costs has acted as a brake both on employees' direct remuneration, and labour market flexibility. The impact of the reforms on labour markets and government health care spending will depend crucially on whether they achieve their objective of restraining the growth of health care costs.

Non-inflationary recovery continues in Canada

Canada recorded the lowest growth rate of the major six overseas economies in 1992, but its recovery has to date been the most steady. Stockbuilding contributed around three quarters of the growth in domestic demand in the first half of the year; growth in consumer spending and investment was more modest. As in the United States, fragile employment prospects and slow real wage growth seem to be inhibiting personal sector spending. A widening current account deficit in the first half of the year has also held growth back. This partly reflects relatively buoyant growth in Canada itself, but is surprising given that a sharp improvement in competitiveness and the rise in import penetration in the United States might have been expected to offset weaker growth there.

Consumer price inflation was 1.7% in the twelve months to August, having fallen from over 2% at the beginning of the year. It is therefore well within the Bank of Canada's target of 2.5% by mid-1994. Underlying inflation is still very muted. Because the recovery began later than in the United States, the output gap is considerably wider—perhaps as much as 5%. Earnings growth has fallen and unit labour costs in manufacturing are falling by almost 4%—the sharpest rate of decrease among the major economies. This has largely offset the inflationary effect of the Canadian dollar's depreciation—of approximately 12% in the two years to mid-1993. Although it is possible that margins could widen as recovery progresses, a significant rise in inflation seems unlikely.

Despite the Liberal victory in the Federal election on 25 October, the exact future course of economic policy in Canada remains uncertain. The Liberals emphasised growth and employment issues during the election campaign, but the fiscal deficit will also need to

Chart 12
GDP in the major European economies

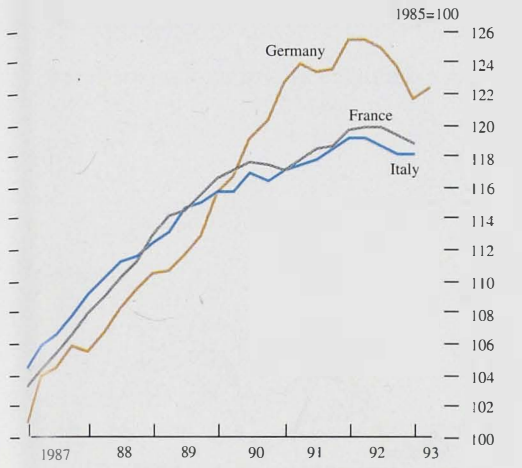


Chart 13
France and Germany: nominal and real interest rates

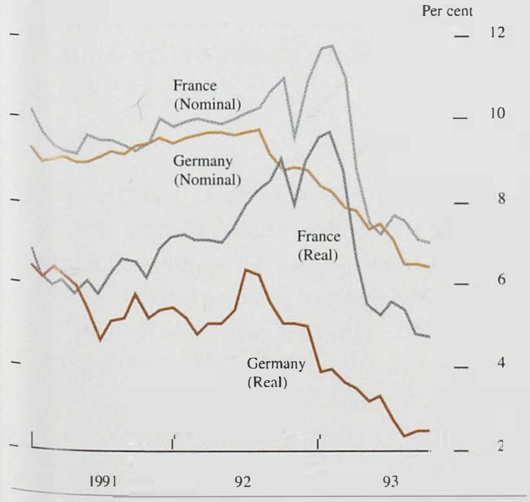
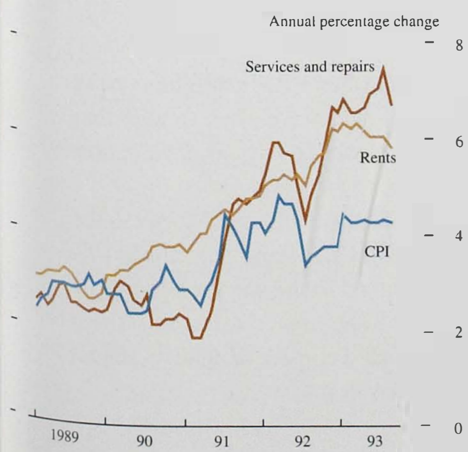


Chart 14
Germany: consumer prices, services prices and rents



be addressed. The Liberals have also pledged to renegotiate NAFTA, raising some uncertainty about its implementation.

Western Europe

Activity in the major continental European economies broadly stabilised in the second quarter. Although a further significant contraction seems unlikely, there are few positive signs of an upturn and the outlook for the coming year is, at best, subdued. Little scope exists for fiscal action to support activity since there is a clear need to address fiscal deficits in several countries, even though the effect of this in the short term may be further to depress demand. The slackness of labour markets, meanwhile, is leading to an erosion of real wages and confidence in several countries which is likely to hold back consumption. These internal factors, together with their corollary—a depressed outlook for European trade—and pressures on competitiveness are likely to result in continued corporate retrenchment.

This places a particular burden on monetary policy which, as measured by real interest rates, remains tight, particularly among the former narrow-band ERM economies notwithstanding the further, German-led round of interest rate reductions in October. Despite the adoption of 15% margins there has been a continued reluctance to ease policy ahead of Germany. This is seen as risking exchange rate depreciation and, despite the weakness of demand, a pick-up in inflationary pressures.

There is little sign of a sustained upturn in Germany

Activity in the western German economy appears to have stabilised, albeit at a relatively low level. GDP grew 0.6% in Q2, after three successive quarters of contraction, but this was more than accounted for by stock-building. All other components of demand fell. Order books and confidence indicators suggest that the industrial sector is past the worst of the slowdown, although production in August was over 5% below its level of a year earlier.

Equally, however, there are few signs of recovery: business and consumer confidence remain subdued; the strong Deutsche Mark and recent rapid increases in unit labour costs have eroded competitiveness; and rises in unemployment and planned increases in social security contributions and taxes are likely to inhibit any recovery in consumption. Consequently, GDP in west Germany is likely to fall by over 2% over the year as a whole and to show little growth in 1994. Even a slow recovery would be predicated on a strong performance of exports and further monetary easing.

Inflation has responded only slowly to weak activity and tight monetary conditions. This is attributable to continuing strong increases in non-tradables prices, notably rents, services and administered prices. Low settlements in this year's wage round may eventually reduce inflationary pressures; manufacturing earnings are currently rising by around 1½% a year in western Germany and this restraint is likely to continue into next year, with real wage cuts in many sectors. Current forecasts project a steady fall in inflation over the next two years, despite residual pressures from rents, so that there is a good prospect of inflation falling below 2% by the end of 1995.

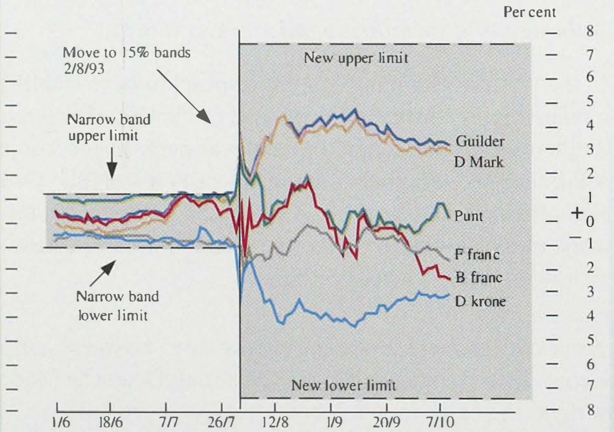
Exchange rate developments in the European monetary system

Changes in the exchange rate mechanism

ERM tensions lead to reforms . . .

On 2 August 1993, after renewed tensions in European foreign-exchange markets, EC finance ministers and central bank governors decided to widen the fluctuation bands in the exchange rate mechanism (ERM) of the European Monetary System. Currencies may now move by up to +/-15% around their central rate against each other ERM member, although Germany and the Netherlands have a bilateral agreement to restrict movements of the Deutsche Mark and guilder to +/- 2.25%. This reform followed a year of turbulence in the ERM after five years of stability. In September 1992, sterling and the lira suspended their ERM membership and the Spanish peseta was devalued. Subsequently, the peseta and Portuguese escudo were devalued twice and the Irish pound once. In addition, three Scandinavian currencies decoupled from their unilateral link to the ECU.

Chart 1
Movements in ERM (June–October 1993)

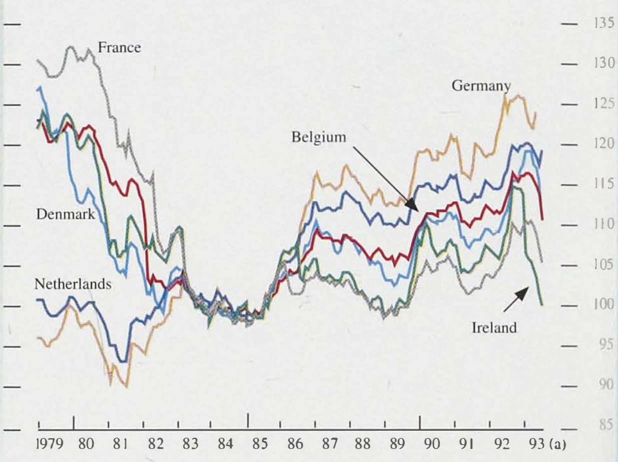


. . . increasing the scope for nominal exchange rate movements.

There is now considerable scope for bilateral exchange rate movements within the ERM. However, there was always some flexibility as a result of the +/- 2.25% and +/- 6% fluctuation bands and the possibility of occasional changes to central parities. From the start of the ERM in 1979, to 1987, there were 11 realignments. This meant that bilateral exchange rates diverged considerably. Their trade-weighted (effective) exchange rates fluctuated even more because movements in third country currencies had a differential effect on ERM members.

Between 1987 and 1992, when central parities were constant (see the box on UK competitiveness on page 429), Chart 2 shows that divergences in effective rates in the old narrow band were much more limited and mainly reflected the different relative importance of the dollar, sterling and the lira.

Chart 2
Nominal effective exchange rates of ex-narrow-band members



(a) End-August data.

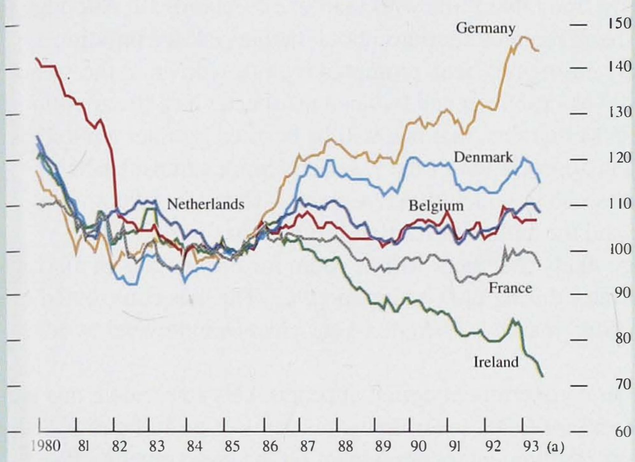
Review of real exchange rates

Some of the movement in nominal rates reflects changes in relative costs and prices. Real exchange rates take account of such movements—they are nominal exchange rates adjusted for relative cost or price movements. The analysis below considers movements in real effective exchange rates, using two possible deflators: relative CPI inflation and relative normalised unit labour costs in manufacturing (RNULC). These measures can serve as indicators of an economy's international competitiveness. An article in the September 1982 *Quarterly Bulletin* discussed alternative measures of competitiveness, and included an explanation for the adjustment of ULC data for cyclical changes in productivity. Cost-based measures are generally more informative than price-based measures, but both have value.

Nominal movements were greater in early years . . .

Between 1979 and 1987, when ERM realignments were frequent, changes in real rates were often smaller than movements in nominal exchange rates as devaluations and revaluations of currencies compensated for cost and price divergences. The absence of any changes to the parity grid between January 1987 and September 1992 (except when the lira moved to the narrow band in 1990) constrained movements in nominal rates against the other ERM members, but allowed considerable divergences in real exchange rates to develop.

Chart 3
Real effective exchange rates (RNULCs) of ex-narrow-band members



(a) End-July data.
An *increase* in the index indicates a *loss* of competitiveness.

... but real divergences developed later.

Chart 3 shows effective exchange rates deflated by relative normalised (ie cycle-adjusted) unit labour costs of former narrow-band countries.

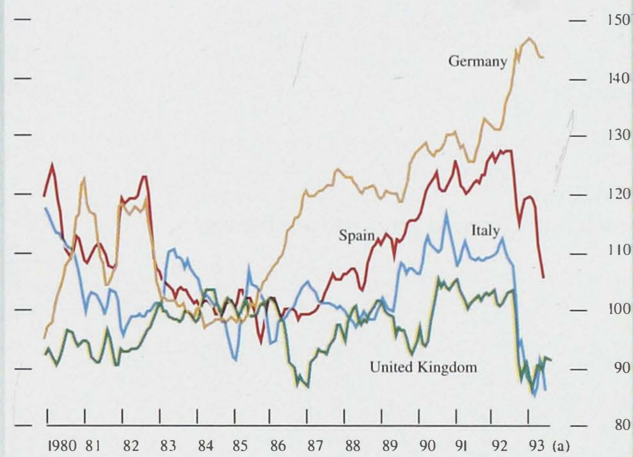
On this basis, the Deutsche Mark has experienced the most marked appreciation over the last decade. This is largely because it is the only ERM currency not to have been devalued against any other member, but is also attributable to a faster rise in normalised unit labour costs in domestic currency terms. Slow productivity growth in Germany in the late 1980s and high relative wage growth in the 1990s have contributed to this. But CPI deflated exchange rates show no aggregate price-competitiveness loss, because of lower price inflation over the 1980s.

Italy, Spain and the United Kingdom experienced considerable changes in real exchange rates.

Of those countries not in the narrow band earlier this year, the Italian lira showed greatest real appreciation in the late 1980s, largely as a result of faster growth in labour costs than its competitors. The consumer-price adjusted exchange rate tells a similar story (Chart 5). Italy was the first ERM country to devalue last autumn (before joining the United Kingdom in suspending membership) and its competitive position has now been restored as a result of the sharp depreciation of 18% in real terms since last summer.

Spain's real exchange rate also rose sharply after it joined the ERM in June 1989, caused by high wage growth and labour market rigidities which inhibited productivity improvements. Three realignments of the peseta since September 1992 have contributed to a net 19% real depreciation of the peseta against the Deutsche Mark, and

Chart 4
Real effective exchange rates (RNULCs)



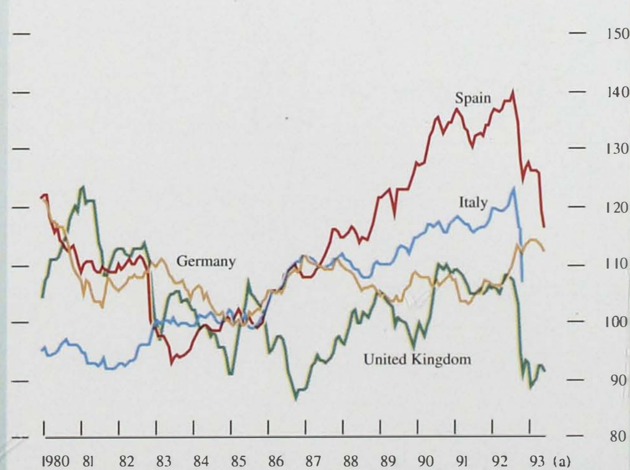
(a) End-August data.
An *increase* in the index indicates a *loss* of competitiveness.

a smaller depreciation of 15% in real effective terms. In the United Kingdom, competitiveness (based on the RNULC measure of real exchange rates) has varied over the last decade. It received a boost from sterling's departure from the ERM and has also benefited from productivity gains; wage moderation has been a factor more recently.

Outlook for costs ...

The short-term outlook for price and cost competitiveness of western European countries against third countries seems favourable, but structural problems in labour markets and social security costs are causing considerable concerns. Price and wage inflation is currently subdued throughout Europe, with continued moderation expected to be underpinned by slack in labour and product markets, weak commodity prices and only a gradual recovery of domestic demand.

Chart 5
Real effective exchange rates (relative CPI inflation)

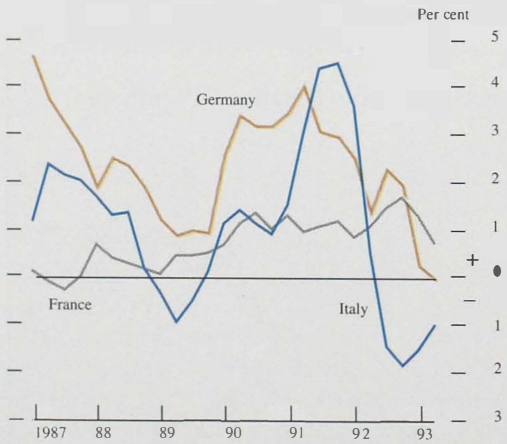


(a) End-June data.
An *increase* in the index indicates a *loss* of competitiveness.

Chart 15
French and German interest rate futures

Implied interest rates on French franc and DM futures, December 1993 contract.

Chart 16
Real wage inflation



Monetary policy has eased further. With October's reductions in interest rates, the discount and Lombard rates have now been reduced by 100 basis points and 150 basis points respectively since early July (broadly in line with market expectations). Although the Bundesbank remains cautious about the outlook for inflation, monetary easing has been prompted by a slowdown in the rate of growth of M3 (and a much reduced prospect, since the adoption of wider ERM margins, that this will be boosted by intervention) as well as an appreciation of the Deutsche Mark against ERM currencies and in wider effective terms. The view of both the market and the authorities is that inflation has peaked. It is therefore likely that there will be room for further cuts in market interest rates during the coming months. This has contributed to a rally in bond markets where ten-year yields are now below 6%.

The general government deficit appears likely to escalate this year to above 5% of GDP under the twin strains of re-unification and recession. Parliamentary agreement on the government's fiscal consolidation programme is expected in December. However, even if that package is implemented in full, next year's deficit is unlikely to fall much below 5% of GDP.

Growth in the eastern German economy, meanwhile, has slowed from over 9% last year to around 6%. This largely reflects the weakness of output in western Germany and elsewhere in Europe which has led to a slowdown in export and investment growth. The relatively rapid convergence of wages toward western German levels risks undermining already weak competitiveness and further impeding the recovery process.

Activity may have stabilised in France and Italy

Activity in France also seems to have reached a trough. GDP was stable in Q2 after a 0.7% fall in the first quarter. There is, consequently, some prospect that the recession may be relatively short-lived compared with the experience of other European countries. Most forecasts now project a fall in GDP of around 1% of GDP this year, with activity broadly flat over the second half. Recovery is likely to be relatively muted in 1994 and, as in Germany, even this is predicated on further cuts in official interest rates over the coming months.

Inflationary pressures are subdued in France and are likely to remain so, given high real interest rates and the flat outlook for activity. Consumer price inflation was 2.3% in the year to September. Tax measures introduced this year might, other things being equal, be expected to add 0.5 percentage points to the index but the weakness in demand should subdue their impact. The depreciation of the franc in the period following the move to 15% margins is unlikely to affect inflation performance noticeably given its modest scale and the likelihood that industry will, in the short term at least, absorb import price pressures in the face of very weak (internal and external) demand.

Cyclical pressures, and in particular those stemming from the rise in unemployment (to 11.7% in August), continue to cloud the fiscal outlook. Recent changes in the stance of fiscal policy could result in a rise in the general government deficit (on Maastricht Treaty definitions) beyond 6% of GDP this year. Although it is intended that the State (central) government deficit will be reduced

Chart 17
Italy: exchange rate and inflation

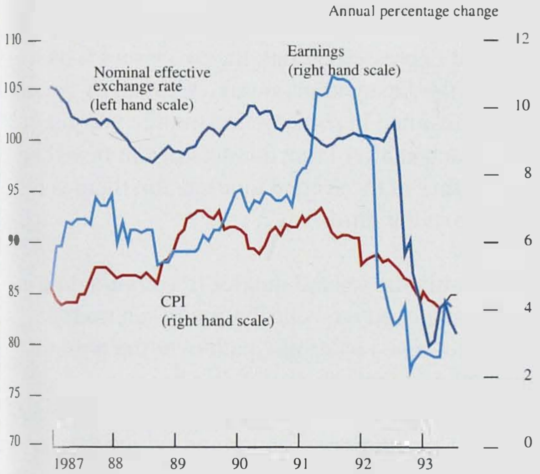
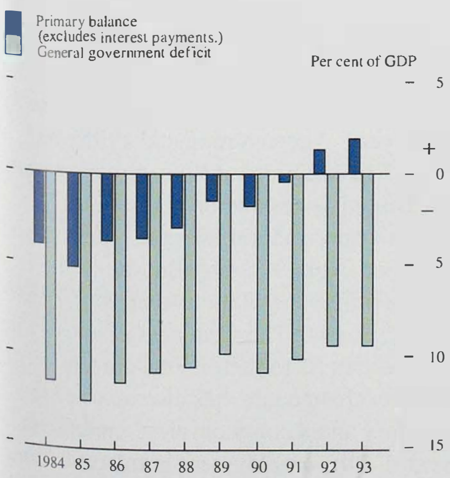


Chart 18
Italy: general government deficits



(to around FFr 300 billion) next year, the general government deficit could rise further. The more than FFr 100 billion raised through the 'Balladur bond' (proceeds of which are convertible into shares of privatised companies) and further privatisation revenues are to be deployed towards a variety of 'off budget' employment and regional development programmes as well as the refinancing of maturing debt.

The Italian economy also appears to be near the bottom of the current recession though here too, the prospect is for a slow recovery. Export growth appears to have been buoyant since the lira left the ERM but the outlook for domestic demand is subdued. Consumer demand is likely to be inhibited by weak real wage growth and rising unemployment, and investment expenditure has shown little response so far to the recent recovery in net exports.

The inflation news is more encouraging. Consumer price inflation has fallen over the past year, despite a depreciation of approximately 20% since the lira left the ERM in September 1992, to reach 4.2% in September. Although most forecasts project a gradual fall in inflation over 1994, there remain risks that the recent squeeze on margins may prove unsustainable and that wage pressures may resurface. These risks are greater than in France or Germany where demand is weaker.

The policy mix in Italy, although reflecting similar tensions to the rest of Europe, does show some encouraging signs. The steady reduction in interest rates over the past year has had a substantial impact on bond yields and, hence, the current and future cost of government borrowing and the overall fiscal outlook. At present there seems to be a good prospect that any overshoot of this year's target (9.7% of GDP) will be modest by past standards, reflecting the tightness of successive budgets over the past eighteen months. However, the target for 1994 is already showing signs of slippage (not all of which is attributable to the weak activity outlook) even if budget proposals are passed in full.

Activity remains weak among the smaller European economies, with a similar tension in several cases between monetary and fiscal policies as real interest rates remain high and fiscal deficits are under pressure. In Belgium, for example, the desire to maintain broad parity with the Deutsche Mark risks exacerbating the effect of high interest rates on activity and the fiscal deficit (which is projected to exceed 7½% of GDP this year). This dilemma led, in mid-October, to a marked weakening of the Belgian franc. Denmark experienced a sharp depreciation—of 4%—following the introduction of wider bands but foreign exchange markets have tended to focus on strong economic fundamentals there. A series of interest rate cuts (against the background of the introduction of an expansionary budget) resulted in the Danish krone firming slightly.

In several other countries monetary policy has been eased somewhat. In Spain, where domestic demand remains weak and unemployment continues to rise, the effective exchange rate depreciated by 14% in the year to September and interest rates fell by four percentage points, albeit from exceptional levels, over the same period. The external sector has performed strongly with a rise in exports of 19% in the year to July, but the tightening of fiscal policy embodied in the budget for 1994 may inhibit a recovery in

Chart 19
Japan: industrial production

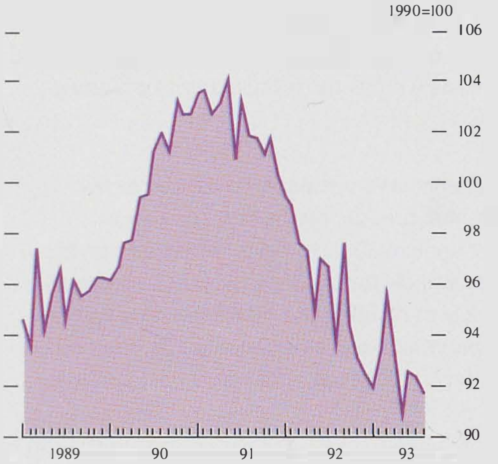


Chart 20
Japan: real and nominal effective exchange rates

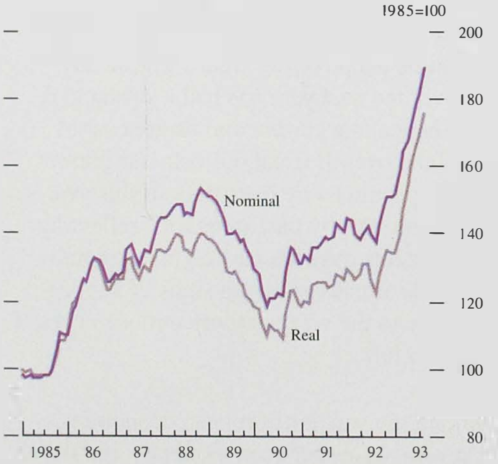
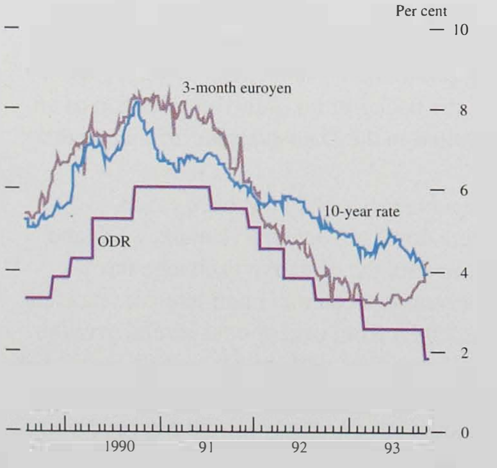


Chart 21
Japan: interest rates



domestic demand. A similar picture exists in Sweden and Finland where the contraction of output between 1991 and 1993 is expected to be 5% and 14% respectively. There has recently been a pick-up in production and orders, though here too rising unemployment and tighter fiscal policy may hold back recovery.

Japan

There is little sign of recovery

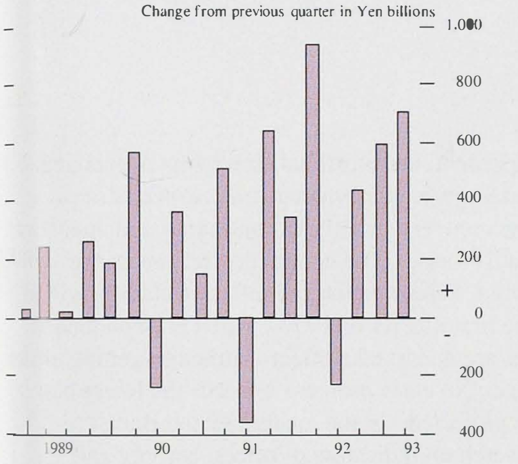
Fiscal and monetary policies in Japan have been eased further in the face of the strong yen and depressed output, the two issues which are currently dominating the Japanese economy. Growth of ½% in Japan in the first quarter resulted in some optimism that a turning point might have been reached after three quarters of flat or falling output. But GNP fell further in the second quarter, and there is little sign so far of any pick-up in the third.

Domestic demand was flat in the second quarter (the contraction in activity overall came from a negative contribution of net trade). Consumer spending has followed an erratic path over the past six quarters and its contribution to growth overall has been approximately zero. There is a marked contrast, however, between the persistent weakness of the corporate sector and an already perceptible stimulus from the public sector.

Business investment has now fallen for seven consecutive quarters and, according to the latest Tankan survey, business confidence is at its lowest ebb since 1976. Industrial production weakened in the second and third quarters. High indebtedness and stock levels have borne heavily on the corporate sector in Japan since the economy first turned down in 1991; adjustment to both has proved a protracted process. Investment may also be inhibited by the 'overhang' from the very rapid accumulation of capital goods in the late 1980s. An additional factor, which has become more acute since the beginning of the year, has undoubtedly been the strength of the yen.

In effective terms, the yen appreciated by 27% between the beginning of the year and mid-August, largely reflecting Japan's burgeoning current account surplus which is likely to exceed the equivalent of 4% of GDP this year. The yen retreated a little on expectations of the cut in the Official Discount Rate and as a result of intervention in which the United States authorities were involved. The scale of the yen's appreciation over the recent period is now comparable with that seen over 1985–86. But the conjunctural circumstances are different and the potential implications for industry more serious. The weakness of activity in Japan, as well as being an important factor behind the current account surplus and hence the exchange rate, has also resulted in a sharp cyclical fall in productivity and a commensurate increase in unit labour costs. In the year to July, employment in manufacturing fell by less than 1% and industrial production fell by over 2% in the year to August. Partly as a consequence, the increase in unit labour costs in the year to the second quarter was around 15%, whereas output prices fell by over 3%. Strains on the manufacturing sector are therefore particularly acute. A number of companies have indicated that staff numbers are to be reduced to contain costs, although little labour shedding seems yet to have taken place; reductions in labour input have so far taken the form mainly of a fall in working hours.

Chart 22
Japan: nominal government spending



Set against the weakness of the corporate sector is the positive contribution to activity from the relatively expansionary fiscal stance adopted over the past eighteen months. A third fiscal package was announced in September amounting to a headline total of ¥6 trillion. This was in addition to the packages introduced in August 1992 and April this year which nominally totalled ¥23 trillion. Although these headline totals overstate their effective sizes, these packages are having a perceptible effect on demand and this seems set to continue for some time. In the nine months to June, government spending in Japan contributed a stimulus equivalent to GNP growth of 1¼%—approximately half of which can be attributed to the first package. The impact of the subsequent two will be seen towards the end of this year and into 1994 and may support a tentative pick-up in growth.

Despite a weather-induced upturn in consumer price inflation over the summer, there are no signs of underlying inflationary pressures in Japan. Producer prices are falling by over 3% at an annual rate and earnings growth is stable at less than 2%. The growth of the main monetary aggregate (M2 plus CDs) has picked up a little from the exceptionally low rates seen around the turn of the year but the rise in the twelve months to September was, nevertheless, only 2%. Inflows into (non-monetary) postal savings have levelled off and the fiscal packages have resulted in increased lending to public agencies. Although the cut in the Official Discount Rate took interest rates to a new low in nominal terms, real short-term market rates are still above 1%.