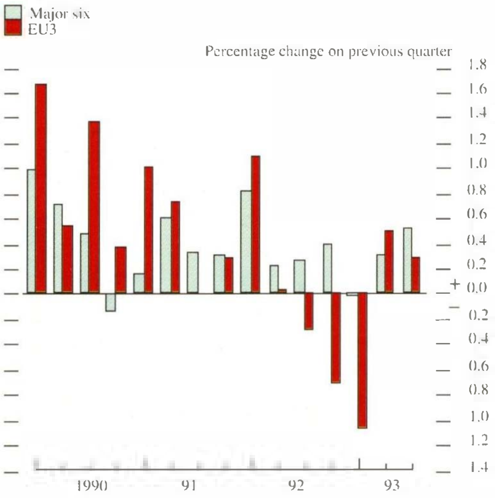
The international environment

- *Activity has strengthened in the major overseas industrial economies: growth has quickened in the United States, but only a slow and hesitant recovery seems to be under way in Europe.*
- *Output in the major six economies is projected to have grown by 1¼% last year, and to grow by 1½%–2% in 1994. Recovery in Europe is likely to be dampened by a lack of confidence and continued labour shedding. In Japan, corporate debt remains high and likely to inhibit recovery.*
- *High and rising unemployment has prompted debate in the European Union about a number of policy prescriptions, including labour market deregulation.*
- *The successful conclusion to the GATT Uruguay Round will raise world output and reduce world inflation in the long term as well as strengthen the multilateral trading system (see the box on the Uruguay Round and financial services).*
- *Inflationary pressures remain weak in the major countries; producer prices are particularly subdued. Despite recent rises in non-oil commodity prices, there is no sign of a change in longer-term trends, while oil prices have weakened further (see the box on recent trends in commodity prices).*
- *The easing of short-term interest rates in Germany, France and other European economies has mostly been accompanied by further falls in long rates.*

Chart 1
Quarterly percentage change in major six and EU3(a) GDP



(a) Weighted average of France, Germany and Italy.

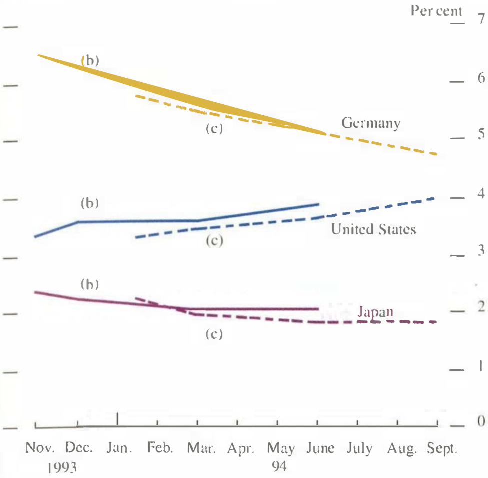
Overview

Over the past year, economic activity in the major six industrial countries has strengthened. The US recovery continues robustly, with ten quarters of growth—the last seven at an average annualised rate of nearly 3%. For the major European countries as a whole, there are signs that a trough in activity was passed in the first quarter of 1993, and output is around 1% above its low-point (see Chart 1). In Japan, GDP has risen slightly, suggesting that it too has passed its trough. But recovery is likely to be only gradual.

Stronger output has led to upward revisions in our projections for growth in the major economies; but business and consumer confidence remain at a low ebb in most countries and the profile continues to be one of gradual recovery. GDP in the major six economies is likely to have grown by 1¼% last year, and is set to rise by 1½%–2% this year—still less than the growth in productive potential.

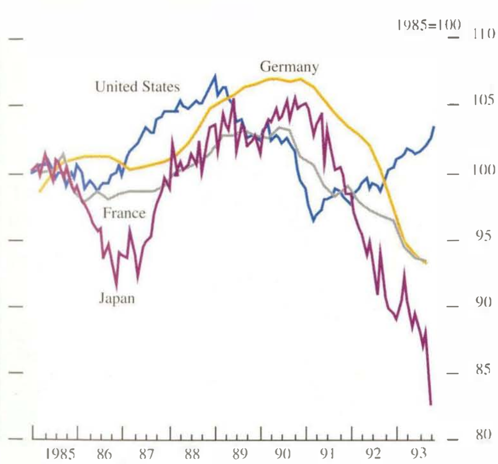
There are no signs of resurgent inflationary pressures in the major economies. Inflation is likely to fall further in Europe this year, and in Japan there is no sign of any increase from an already low level. There is some danger that US inflation may pick up slightly as the recovery proceeds, but so far price pressures are subdued. Indeed, the possibility of price deflation may be greater overall—as producer prices continue to fall significantly in Germany, Japan and France. Changes in commodity prices have largely offset each other, with rises in non-oil prices offset by weak oil prices (see the box on page 14).

Chart 2
Futures rates and 3-month interest rates(a)



(a) Implied path of three-month eurocurrency rates from futures contracts.
(b) As at 2 November 1993.
(c) As at 20 January 1994.

Chart 3
Capacity utilisation in industry



National sources.

The successful conclusion of the Uruguay Round of the GATT will, in the long term, raise world activity and reduce inflationary pressures. Estimates by the OECD and the World Bank suggest that within the next ten years the further liberalisation of the trade in goods is likely to raise world income by \$100–\$270 billion (0.4%–1.2% of GDP), and to reduce annual consumer price inflation by around 0.2 percentage points (principally through the cut in OECD tariffs on industrial goods). These estimates do not take account of the whole Uruguay Round package and may be an underestimate. The conclusion of the Round has defused some potentially damaging trade disputes and strengthened the arrangements underpinning the whole trading system. In the short term, the agreement will strengthen business confidence.

Both short and long-term interest rates have fallen in Europe and Japan

Germany, France and the other continental European countries made small reductions in their official interest rates during the fourth quarter of 1993. Short-term market rates in Germany and the United States have fallen by slightly more than markets expected at the time of the last *Bulletin* (see Chart 2), and markets now expect slightly larger falls in the coming quarters. Long rates have for the most part continued to decline alongside short rates in Germany; 10-year government bond yields dropped towards $5^1/_2$% in mid-January. A similar, albeit smaller, fall in short and long rates occurred in Japan over the last quarter. There too, short rates have declined by more than the markets had expected and further falls are still envisaged by the market. In the United States, short rates have remained broadly flat, but the yield curve has steepened marginally, as long rates edged upwards reflecting market concerns about potential inflation.

The improving outlook for activity and the prospect of continued monetary easing in Europe led to significant increases in equity prices, notably in France and Germany. The US market also rose as market expectations regarding the timing of the tightening of monetary policy were pushed back. The Japanese market has risen to the 18,500–19,000 level, but remains below its highs of last year (see Financial market developments, pages 23-33).

Output remains below potential across the industrialised world

Output remains below capacity in Japan, Germany and elsewhere in continental Europe. According to surveys (see Chart 3) and other measures, the output gap is widening in these countries. Industrial production fell in Japan in the fourth quarter, and seems likely to have done so in Germany and France (see Table A). In the United States, output is closing on capacity although estimates of the proximity of output to potential—and hence of incipient inflationary pressure—vary considerably (see section on United States below).

Table A
Growth of industrial production

	1993 Q1	Q2	Q3	Q4
United States	1.4	0.5	0.6	1.8
Canada	1.8	0.8	0.9	. .
Japan	0.4	-1.5	0.1	-3.5 *
Germany	-2.9	—	0.7	-1.0 *
France	-1.3	-0.6	0.6	-0.7 *
Italy	-0.5	-0.9	0.2	. .
Memo:				
United Kingdom	0.1	1.0	1.0	1.3 *

. . not available.

Note: change on previous quarter; *based on 2 months' data.

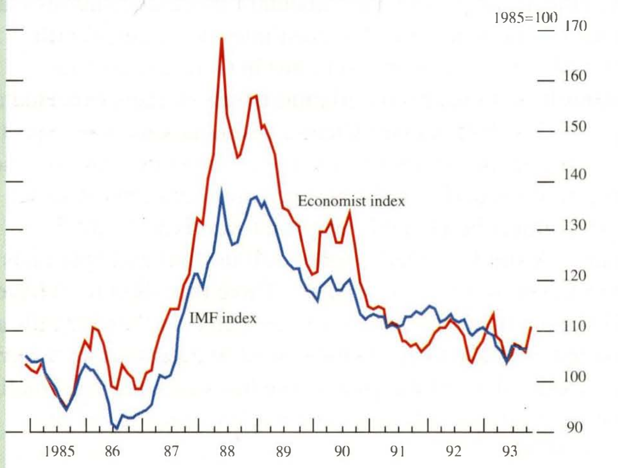
The US recovery has taken time to become well-established. Its strengthening has reflected the steady rise in employment growth and the effects of lower interest rates on corporate and personal sector income gearing, both of which have improved consumer confidence. Income gearing has been reduced in the United States despite the relatively small downward adjustment of debt levels. In Europe, the recovery is likely to be inhibited by the lack of confidence and the rise in unemployment. Debt levels have not risen significantly, but real interest rates remain high for this stage

Trends in commodity prices

Turning points have become more difficult to detect

Chart A shows two different measures of non-oil primary commodity prices: the Economist index and the IMF index. The two indices have generally moved closely together over the past decade, but this relationship has recently become slightly less stable: although the series have continued to follow the same trend, there have been significant short-run divergences, so making it more difficult to spot turning points in non-oil commodity price trends. Part of the reason for the recent, greater volatility of the Economist index relative to the IMF's is its use of a different timber price series.

Chart A
Non-oil commodity price indices[(a)]

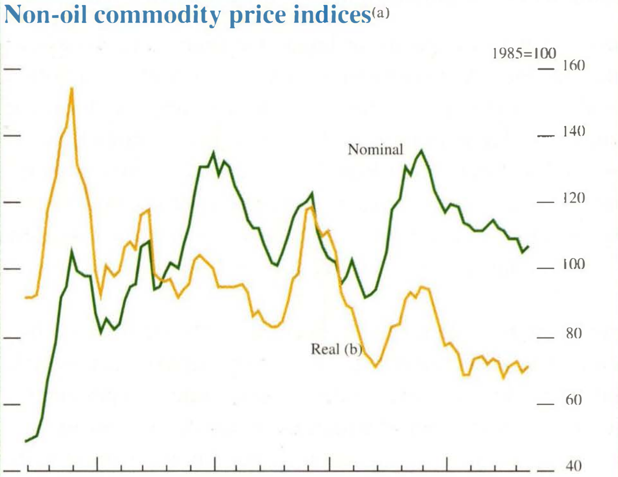


(a) In US dollars.

The long-term trend in prices has been down

Chart B shows that commodity prices were broadly flat over the past two decades and have fallen in real terms by, on average, around 2% a year since the early 1970s. The trend rate of decrease also appears to have been roughly constant throughout both the 1970s and 1980s. This

Chart B
Non-oil commodity price indices[(a)]



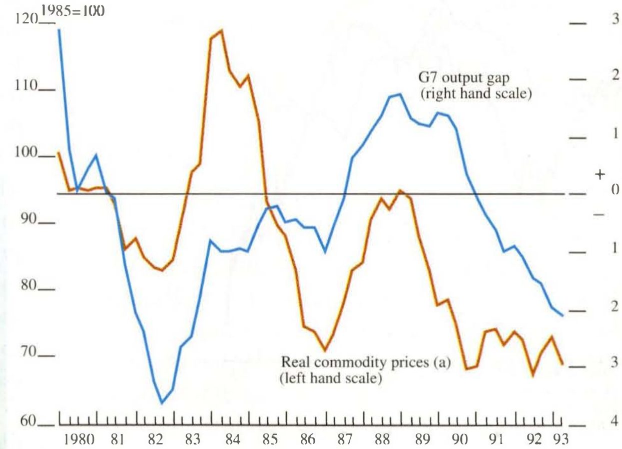
(a) IMF index.
(b) Deflated by world manufacturers' export prices.

decline in real non-oil commodity prices probably reflects several long-term demand influences. New technology, and a wider spread of existing production processes to newly industrialising countries, has meant that many manufactured products are less energy and commodity intensive than they once were. And increasing levels of GDP per capita alter the composition of GDP which, in turn, induces relative price changes between commodities. For example, the demand for basic foodstuffs by industrialised economies is unlikely to rise in line with income.

The recent weakness of commodity prices partly reflects recession in the industrial economies

Chart C, which shows the real non-oil primary commodity price together with a measure of activity (the output gap in the G7 economies), suggests that changes in commodity prices are correlated with changes in demand. Given that the output gap in the G7 continued to widen through the first half of 1993, there has been further downward pressure on commodity prices. Econometric work suggests that the elasticity of commodity prices with

Chart C
Real non-oil commodity prices and excess demand



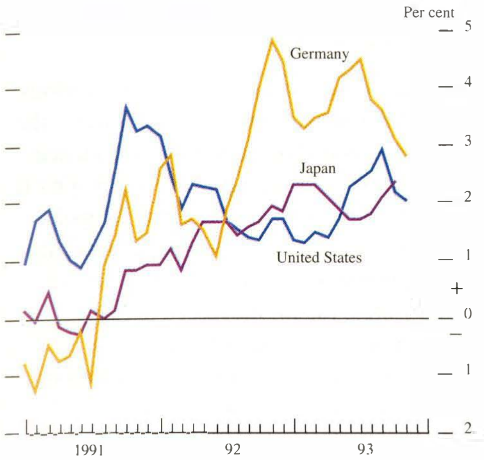
(a) Deflated by world manufacturers' export prices.

respect to this measure of activity may be as high as three in the long run. There is also evidence to suggest that commodity prices overshoot in the short run following a change in demand. For example, a one percentage point rise in output relative to potential could result in a 5%–10% rise in commodity prices in the short run, and a 2%–3% rise in the medium term.

The outlook for commodity prices

Given these long-term demand influences, and with activity likely to be weak in the major industrial economies for some time, the outlook for commodity prices is muted. But this outlook will also depend on supply-side developments for the individual commodities, which are difficult to predict at an aggregate level.

Chart 4
Inflation differentials(a)



(a) Service price inflation minus goods price inflation.

Table B
Commodity price changes in the fourth quarter

US dollars

	On previous quarter	On a year ago
Economist all (non-oil) items index	3.5	3.7
Metals	*-6.2*	*-18.4*
Agricultural non-foods	*12.3*	*17.2*
Food	*4.1*	*13.3*
UK weighted non-oil commodity prices (£)	7.0	16.7
Brent oil price	-7.6	-20.1

Table C
Major exchange rates

	1993 H1	Q3	Q4	1994 20 Jan.
Dollar effective	65.30	65.40	66.40	67.30
DM effective	124.80	123.90	124.70	122.40
Yen effective	165.30	183.90	180.20	176.30
DM:$	1.63	1.68	1.68	1.74
¥:$	115.50	105.60	108.20	111.70

of the cycle. In Japan, the corporate sector has yet to adjust its debt position perceptibly. Confidence has also been dampened by weakness in the labour market, though this takes less visible forms than a rise in unemployment.

Consumer price inflation remains low, and producer prices are falling

Consumer price inflation in the major six overseas economies fell to around 2½% in November—the lowest for six years—while producer prices continue to fall, most notably in Japan and France. Goods price inflation in the G3 economies remains significantly below that of services prices (see Chart 4). The differential has widened by over two percentage points in these countries since 1990, as goods prices have been subject to stronger pressures from the fall in demand during the recession and from international competition. But although there is a risk of more generalised price deflation in some countries, the rate of fall in price inflation is not out of line with past experience, given the depth of the slowdown.

Non-oil commodity prices have risen in recent months, but remain well below their levels of the late 1980s. The most significant increases have been in non-food agricultural products, particularly timber, reflecting specific developments in the United States (see Table B). Overall demand and supply conditions suggest that prices should remain weak in underlying terms (see the box on page 14). Oil prices—now $14 a barrel of close-dated Brent—have fallen by around one quarter from their highs in spring 1993, as demand has weakened and the likelihood of an increase in supply in the medium term has increased.

The dollar has strengthened in line with market expectations of relative interest rates

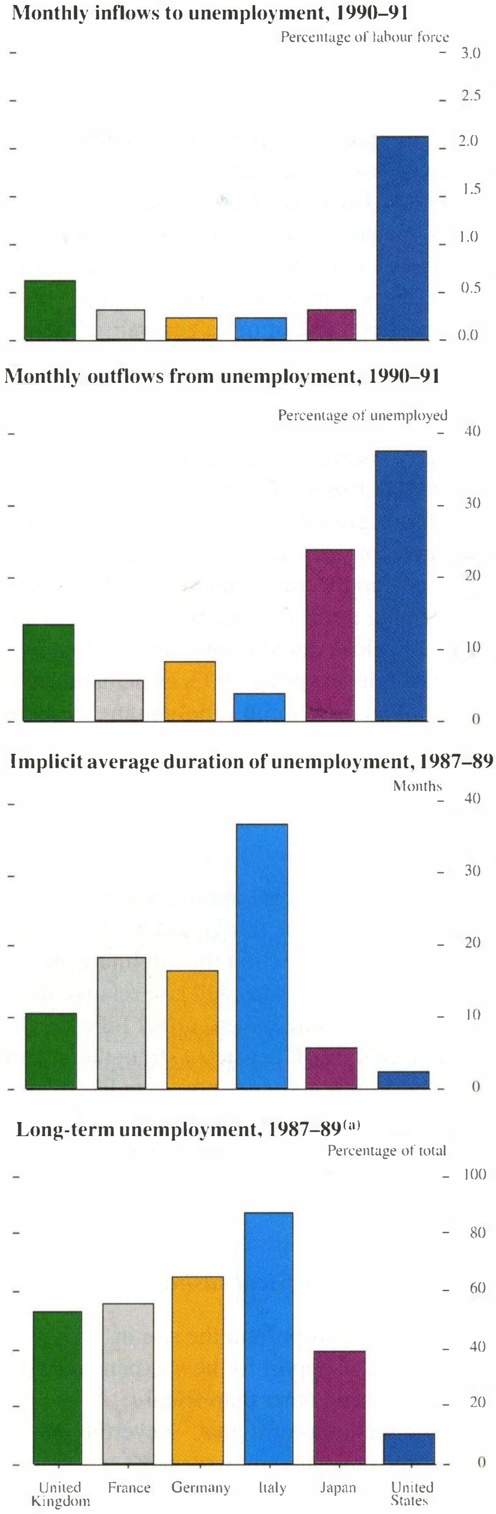
The dollar has strengthened by three per cent in effective (trade-weighted) terms since the end of the third quarter. This has reflected two influences: a growing conviction that, in line with relative cyclical positions, dollar interest rates will rise relative to Deutsche Mark and yen rates; and a 'safe haven' effect following the election results in Russia (see Table C). Such a strengthening of the dollar is in line with fundamentals and does not seem likely to be damaging to global economic balance. Within the ERM, the French, Belgian and Danish currencies have strengthened relative to the Deutsche Mark and the Dutch guilder, while the Irish pound has risen appreciably.

Only Japan has scope for discretionary fiscal easing

Despite the low level of activity in Europe, and the rise in unemployment, there has been little support for new expansionary fiscal measures or belief that anything other than fiscal consolidation is an appropriate medium-term goal. Nevertheless, fiscal deficits in much of Europe have already widened substantially; the EU countries' combined fiscal deficit is now larger as a percentage of GNP than the peak in the US fiscal deficit during the 1980s, even on a cyclically adjusted basis.

There are various ways of calculating cyclically adjusted deficits, but the OECD's figures show that little structural reduction was achieved during the 1980s. In Japan, however, where some fiscal stimulus has already been put in place—although its contribution

Chart 5
Indicators of labour market turnover



(a) Unemployed for six months or longer.

has been rather less than the headline figures would suggest—there remains scope for further relaxation.

European unemployment will rise further

Unemployment remains a major policy concern. Even in countries where recovery is now established—such as the United States—the fall in employment during the recession has held back confidence. Elsewhere, unemployment continues to rise. Over the whole OECD area, it is now over 30 million (around 10%) and in the European Union around 17 million. Concern about this continuing upward trend prompted the European Commission's White Paper on *Growth, Competitiveness and Employment,* discussed at last December's EU Council. The paper identifies imbalances in macroeconomic policy as part of the problem, but also focuses on the structural reforms necessary to encourage labour market flexibility and employment growth. Over the last twenty years, increasing wage and non-wage labour costs and labour market inflexibilities have held back employment growth. Together with an increase in the EU labour force, this has contributed to a trend rise in unemployment in the European Union. In the United States, unemployment has followed a more cyclical path.

There are a number of striking differences between European and North American labour markets. Labour market turnover is significantly higher in North America, as measured by the rates of inflow to, and outflow from, unemployment (see Chart 5). Regional and occupational mobility are also higher in the United States; and the average duration of measured unemployment is significantly lower. Long-term unemployment (of a duration of six months or more) accounts for around two thirds of measured unemployment in the European Union, compared with only 11% in the United States.

Relative differences in countries' cyclical positions explain some of these differences in turnover and duration. But they are also likely to reflect the relative flexibility of the US labour market. For the employee, this means the nature of the benefit system: how this affects the willingness of workers to search for jobs and the wage which they are prepared to accept. For the employer, flexibility is a function of the relative ease and cost of hiring and firing.

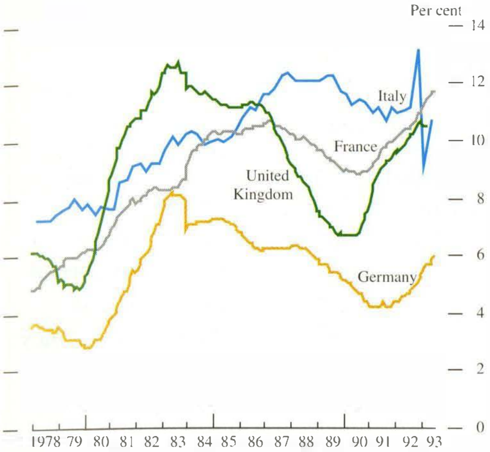
Non-wage costs to the employer are a further factor. These are significantly higher in continental Europe than elsewhere (despite the steady rise in the United States over the last twenty years, which largely reflects health-care costs). The White Paper endorses the efforts of governments (such as France, Belgium and Spain) to reduce such costs, particularly in low-wage jobs where minimum wage legislation can also impede the employment of lower productivity workers.

Western Europe

Activity has stabilised and inflation is falling . . .

Output in the major continental European economies stabilised in the first half of last year. Despite some further rises in GDP in Germany and France in the third quarter, sustained recovery remains elusive. Although there is no significant debt overhang to act as a brake on recovery (in contrast to Japan and the United States), any upturn is, nevertheless, likely to prove gradual and fragile: growth in Germany, France and Italy combined is unlikely to exceed 1% this year. The pace of recovery in the near term will not be

Chart 6
Unemployment rates (a)



(a) OECD standardised rates.

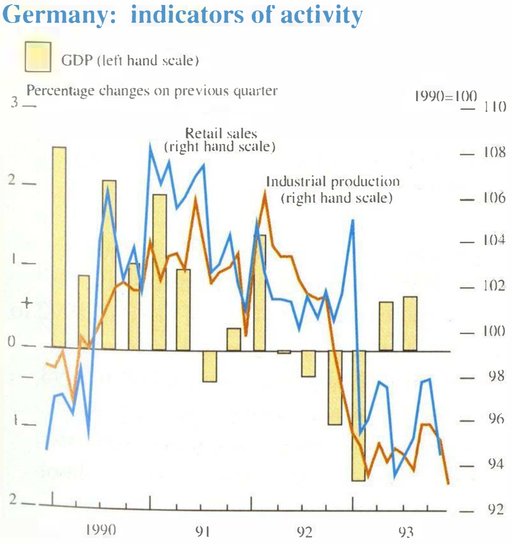
Table D
Contributions to European GDP growth

	1993 Q1	Q2	Q3
Germany			
Domestic demand	-2.0	0.7	-0.2
Net trade	0.3	-0.1	0.8
GDP	-1.6	0.6	0.6
France			
Domestic demand	-1.2	0.7	0.1
Net trade	0.5	-0.5	0.1
GDP	-0.7	0.2	0.2
Italy			
Domestic demand	-3.4	0.6	. .
Net trade	3.3	0.2	. .
GDP	-0.1	0.8	-0.5
United Kingdom			
Domestic demand	0.1	0.8	0.3
Net trade	0.5	-0.1	0.4
GDP	0.6	0.7	0.7

. . not available.

Note: GDP at market prices.

Chart 7
Germany: indicators of activity



sufficient to prevent further rises in unemployment, which stands at over 12% in France and 9% in Germany. The effect of this on incomes and confidence is likely to dampen activity further. Real interest rates also remain high.

GDP grew in Germany and France in the third quarter of last year, by 0.6% and 0.2% respectively; in both cases, this was the second successive quarter of growth. The main stimulus to domestic demand in Germany was consumer spending. But it remains unclear how robust this will prove in 1994 in the face of weak consumer confidence and higher indirect taxes and pension contributions. The corporate sector in Germany is still depressed; investment picked up fractionally in the third quarter but was still 20% lower than its peak in 1991. Industrial production, which had shown a small rise in the third quarter, fell towards the end of the year, though foreign orders picked up.

The downturn in France was less severe than in Germany, but followed two years of weak activity and already high unemployment. The recovery has been correspondingly weak, with growth of 0.2% in each of the second and third quarters. As in Germany, the main driving force behind domestic demand has been consumer spending. Other components remain depressed; investment fell throughout the first three quarters of the year. Industrial production has fallen back after showing signs of recovery. Italy showed little sign of recovery in the second half of last year; a slowdown in destocking accounted for most of the 0.6% rise in domestic demand in the second quarter, and GDP fell by 0.5% in the third. The indications are that weak personal income growth is still inhibiting consumer spending and that investment has contracted further.

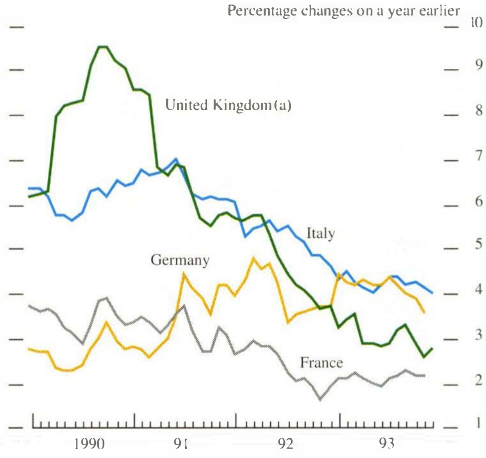
Net trade made a significant contribution to European growth in the first three quarters of last year taken as a whole, more than offsetting an overall fall in domestic demand in Italy and cushioning activity in Germany. Although the figures may not be wholly reliable, movements in relative demand are likely to have contributed to this, with expanding markets in North America and Asia contrasting with weak demand at home. Competitiveness (measured on the basis of producer prices) has also improved.

Inflation in Europe has continued to fall. This reflects quite a severe compression of margins in some sectors, and low wage settlements. Given the weakness of demand and subdued inflation expectations, these are unlikely to rebound in the near term.

Consumer prices in Germany increased by 3.7% in the year to December, down from around 4¼% in the summer. Inflation in the most recalcitrant sectors—services and rented property—is at last retreating—to around 5½% at end-year. The rate of increase of goods prices has also fallen, and early indications from the wage round suggest that increases in average earnings in 1994 may fall to below 2%.

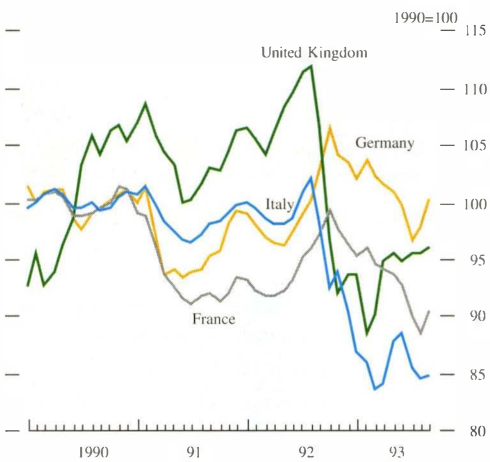
After reaching almost 4½% in February and over the summer months, consumer price inflation in Italy had fallen to just over 4% by the end of last year. By contrast, producer price inflation has picked up gradually since the devaluation of the lira in 1992; inflation on this measure was 4.3% at the end of the third quarter, compared with 2.5% at the end of the previous year. This is,

Chart 8
European consumer prices



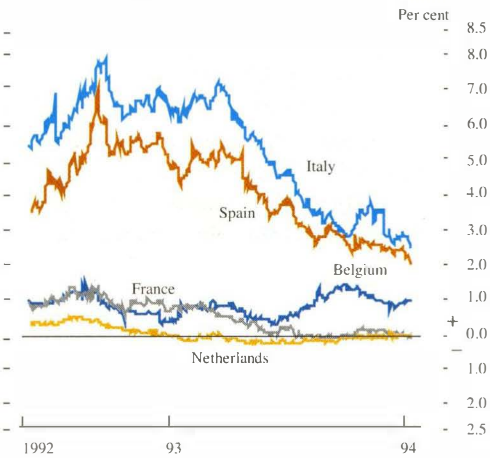
(a) RPI excluding mortgage interest payments.

Chart 9
Relative producer prices[(a)]



(a) Calculated on a common currency basis.

Chart 10
Long-term yield differential with Germany[(a)]



(a) 10-year government bond yields.

nevertheless, a very muted response to a devaluation of over 20% in effective terms, reflecting the weakness of domestic demand and the subdued behaviour of earnings. Inflation in France was just above 2% during the second half of last year despite a rise in indirect taxes.

. . . and cautious easing of monetary policy continues

Against this background, stability returned to the ERM with all former narrow band currencies (except the strong Irish pound) returning to within 2¼% of their central rates. Although there remains little enthusiasm for the reintroduction of narrower formal fluctuation constraints, several countries have emphasised that existing central rates are consistent with fundamentals and that they are not anxious to see significant deviations from these.

The improved stability of their currencies has allowed those European countries with an interest premium over Germany to continue reducing interest rates significantly. Danish rates, for example, have fallen by around three percentage points since August. In general, interest rates throughout Europe have tracked the falls in German market rates. German market rates fell 50 basis points in the fourth quarter (although neither discount nor Lombard rate has been changed since October). Further movements in European rates are likely to be governed by the policy stance in Germany.

The Bundesbank is continuing to adopt a cautious approach to monetary easing, despite the fall in inflation. In part, this reflects continued concern about the pace of broad money growth which, in the year to the fourth quarter, overshot its target range by some ½%. The target range has been lowered to 4%–6% for the coming year, in part reflecting a reduced estimate of potential growth. The Bundesbank does not wish to accommodate the monetary overshoot and is anxious to avoid any adverse market reaction, in the form of excessive exchange rate depreciation or a rise in bond yields, to a more rapid easing.

Financial markets continue to expect a further monetary easing in Europe, led by a fall of 1–1½ percentage points in German market rates in the first three quarters of 1994. This would leave real German short-term interest rates at around 2%. Bond yields have also continued to fall throughout Europe. In Germany, France and the Netherlands, they approached 5½% in mid-January. There is no sign that the (actual or anticipated) easing of monetary policy has increased inflationary expectations or caused currency instability. Although the Deutsche Mark has generally been trading lower against the dollar, this seems in part to have reflected uncertainty over the Russian elections and the anticipation of some policy tightening in the United States.

Weak activity has worsened the fiscal positions of the major European economies. The French general government deficit is officially estimated to have increased from 4.5% of GDP in 1992 to around 5.5% last year, and in Germany, the general government deficit is likely to have reached 5% of pan-German GDP in 1993 (compared with a budget forecast of around 4%). In Italy, the public sector borrowing requirement remains at around 10% of GDP, despite substantial fiscal tightening. The largest overshoot was in Spain, where the general government deficit probably reached 8.5% of GDP in 1993—nearly double the budget forecast.

Uruguay Round—financial services

The Uruguay Round world trade agreement reached in December 1993 broke new ground by bringing trade in services, including financial services (banking, securities and insurance), within the framework of multilateral trade rules for the first time. Over 100 countries took part in the negotiations, including all the major market economies, with scope for others to accede at a later stage.

The new rules for trade in services are set out in the General Agreement on Trade in Services (GATS), a parallel agreement to the General Agreement on Tariffs and Trade (GATT). Signature of the Final Act of the Round, which includes the GATS, is planned for April this year, with ratification by participants and subsequent implementation involving the establishment of a new World Trade Organisation (WTO) to follow, probably in 1995.

Basic principles

The agreement is built on certain basic principles which will apply to all service sectors. A central principle is the most favoured-nation principle (MFN), which prevents countries from discriminating between the service suppliers of other member countries of the WTO. (However, the GATS contains provisions for exemptions from MFN treatment, enabling WTO members to maintain measures which provide for different treatment to be accorded to the service suppliers of different countries.)

Given the highly regulated nature of many service sectors in a number of countries, the GATS promotes transparency by obliging each member to: publish promptly all relevant measures of general application; inform the Council for Trade in Services of new measures; and respond promptly to all requests for specific information by any other member on any of its measures of general application.

The Agreement provides for any GATS member which considers that another member has failed to carry out its obligations or specific commitments under the Agreement to have recourse to a body for settling disputes. If this body considers the circumstances to be sufficiently serious, it may authorise the suspension of obligations and commitments by a member or members in respect of the member. The dispute settlement procedures and the administration of the Agreement have been tailored to meet the particular features of the financial services sector, in particular through the involvement of financial experts.

In an agreement which lays down deregulatory principles, it is important to maintain sufficient flexibility for financial regulators to protect depositors and investors and to ensure the integrity and stability of the financial system. The Agreement provides a clear statement of the right of regulators to take reasonable prudential measures for these purposes, notwithstanding any other provisions of the Agreement.

In addition to accepting these principles, countries which sign up to the GATS must deposit schedules of specific commitments regarding the openness of their markets to foreign service providers. Virtually all the larger countries have included commitments on financial services in their schedules. In most cases, these are no more than standstill provisions, guaranteeing existing levels of access. Some important measures of genuine liberalisation have, however, also been adopted. For example, Canada has committed itself to extend the treatment available to Mexican and US financial institutions under the North American Free Trade Agreement (NAFTA) to financial institutions from other GATS signatories. A number of the more important developing countries, however, made offers which do not amount to full standstill.

In addition to accepting the general GATS principles, a number of developed countries, and one or two developing countries, made their specific commitments in accordance with an Understanding on Commitments in Financial Services. This includes the following principles:

- granting to foreign financial institutions[1] the right to establish or expand a commercial presence in a member's territory;
- removing or limiting any significant adverse effects of measures that constrain the ability of foreign financial institutions to enter, operate or compete in a member's territory;
- providing for foreign financial institutions to offer certain financial services on a cross-border basis; and
- providing for foreign financial institutions established in a member's territory to introduce new financial services into that market.

Further negotiations

The GATS commits signatories to the principle of progressive liberalisation. Countries will seek to build on commitments made in the Uruguay Round with further liberalisation in subsequent rounds. Some countries with financial markets which are generally open to foreign firms were concerned that, if they gave an unconditional MFN commitment, the requirement to keep their financial markets open to firms from all GATS members under the same terms and conditions might make it more difficult in future to negotiate improvements in access to foreign financial markets which are at present relatively closed.

Partly as a result of these concerns, it was agreed at the end of the Uruguay Round that there should be provision for a further period of negotiations, at the end of which countries would decide on their commitments and MFN exemptions. Commitments made in current offers will not take effect until the WTO is established. There will then be a six-month period during which these commitments will apply and MFN exemptions will be suspended. At the end of the six-month period, those countries that have already tabled MFN exemptions (including the United States) must decide whether or not to maintain them; others (including the European Union) which have not done so will be free to take exemptions at that stage. All countries will also be able to revise the level of their liberalisation commitments made during the Round. The degree of liberalisation adopted by individual countries in financial services, and the degree to which commitments will be made on an MFN basis, therefore remain uncertain. The UK Government wishes countries to build on the commitments already made in the Round and to ensure that these are firmly established on an MFN basis.

(1) Strictly speaking, rights are only extended under the GATS to countries which are GATS members.

Chart 11
United States: GDP and domestic demand

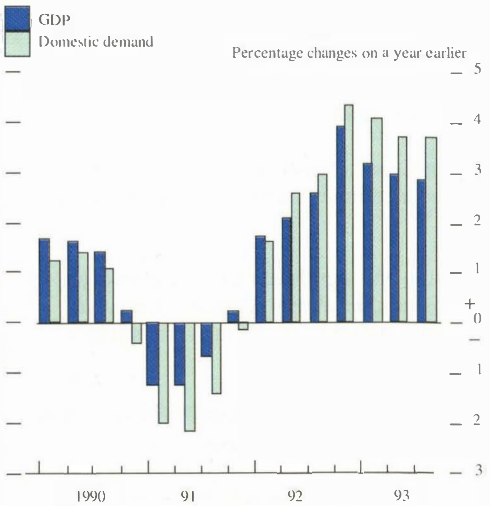
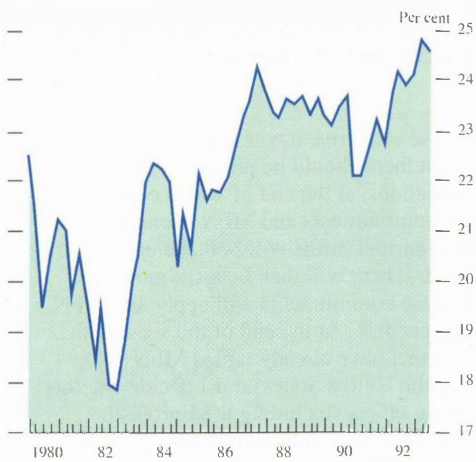


Chart 12
US merchandise import penetration(a)



(a) Merchandise imports as a percentage of final sales of goods.

North America

Recovery is well established

After slowing at the beginning of 1993, growth in the United States picked up strongly, reaching 0.7% (an annual rate of 2.9%) in the third quarter. It would have been stronger still but for flooding in the Midwest, which resulted initially in a run-down of agricultural stocks. The main contribution to growth came from consumer spending, which increased at an average rate of 0.8% over the year to the third quarter and by over 1% in the third quarter itself. Consumer spending rose faster than disposable income over the first three quarters of the year, resulting in a fall in the saving ratio. This suggests that the personal sector is relatively unencumbered by current debt levels—partly because low interest rates have provided the opportunity to refinance long-term indebtedness. Expenditure on interest-sensitive durable goods has also been buoyant.

Business fixed investment increased by 1.8% in the third quarter and the rise over 1993 as a whole may well exceed 10%. The climate for investment remains very favourable, with falling corporate bond yields and rising equity prices reducing the cost of finance against a background of rising capacity utilisation (which is now above the average for the past 25 years), balance sheet restructuring and rising profitability.

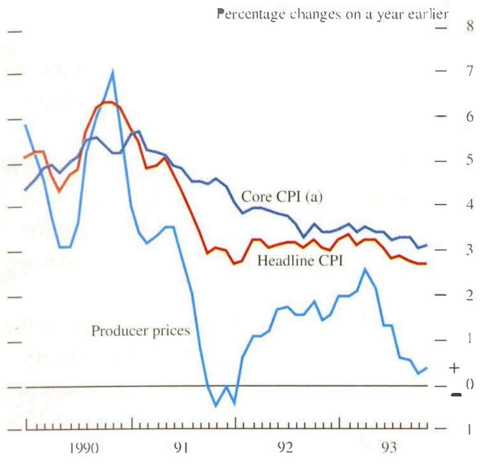
Growth in the fourth quarter is likely to have exceeded that in the third. Industrial production and retail sales both grew strongly, by 1.8% and 2.9% respectively. Some rebound from the effects of the autumn flooding is likely, with a slowdown of destocking and, possibly, rebuilding and delayed starts to investment projects. Growth for 1993 as a whole may be around $2^3/_4$%–3%. Monetary growth remains depressed by the low relative rates of return on monetary assets and the trend to disintermediation. M2 grew by less than 2% in the 12 months to December.

The robust growth performance of the United States is having perceptible effects on employment and the current account, but its implications for future inflation are still unclear. Employment has risen throughout most of the past two years. Non-farm payrolls rose by 1.8% in 1993, with particularly strong growth in the final quarter (when manufacturing employment increased by almost 40,000). The average working week reached a record high at the end of the year and it is this, rather than any increase in earnings growth (which remains stable at between 2% and $2^1/_2$%), which has accounted for a modest rise in personal income growth.

The growth in domestic demand in the first three quarters of last year exceeded that of GDP by almost $1^1/_2$%. There was an associated rise in the current account deficit to $1^3/_4$% of GDP. Import penetration (merchandise imports as a share of final sales) has risen sharply over the past two years (though comparable increases have been seen in the past) and has tended to blunt the impact of demand growth on output.

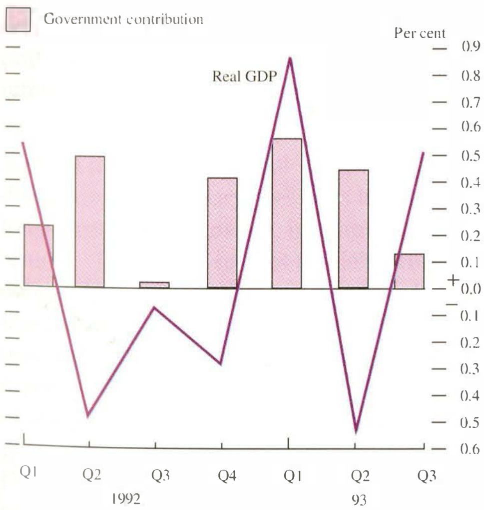
The implications of a solid and prolonged recovery for US inflation in the near term remain uncertain. Consumer price inflation over the second half of last year was stable at around $2^3/_4$%, while the rate of increase of producer prices fell quite sharply. The fall in oil prices and the strength of the dollar were partly responsible for this, but underlying inflationary pressures remain very muted: unit

Chart 13
US inflation



(a) Excluding food and energy.

Chart 14
Government contribution to Japanese GDP growth(a)



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

labour costs in manufacturing, for example, were still falling by around 2% in the third quarter.

The near-term outlook for inflation depends largely on the relation between current output and potential, and the growth of these over time. Estimates of these magnitudes vary, depending to a large extent on judgments concerning the recent behaviour of the capital stock. The Administration estimates that output is still some way below potential, so that even output growth of around 3% in 1994 (in excess of most measures of potential) may be sustainable for some time without a rise in inflation. If output is currently close to potential, however, a period of above-trend growth will risk raising inflation sooner rather than later.

Faced with this uncertainty, financial markets remain sensitive to the prospect of a rise in inflation. Some tightening of policy is expected, beginning in the first quarter and continuing through the remainder of the year, largely as a pre-emptive response to an incipient rise in inflationary pressure. It is partly this expectation (held with varying degrees of certainty as actual inflation has remained unexpectedly low) which has caused some volatility in bond yields. These have nevertheless firmed overall in the past three months.

Canada's growth rate slowed a little in the third quarter but is still likely to have reached 2½% for the year as a whole. Domestic demand (and, in particular, consumer spending) are subdued, but trade is making a growing contribution. This reflects strong demand in the United States (which accounts for 80% of Canadian exports) and a sustained improvement in competitiveness.

The Canadian dollar depreciated by almost 4% in effective terms in 1993 (taking the total depreciation since late 1991 to almost 15%). So far, however, this has not resulted in any significant rise in inflation: consumer price inflation at the end of the year was just below, and core inflation just above, 2%. The inflation target range of 1%–3% is to be extended to 1998. Unit labour costs, meanwhile, fell throughout last year. In common with experience in the United Kingdom and Italy, the inflationary consequences of depreciation have been largely contained.

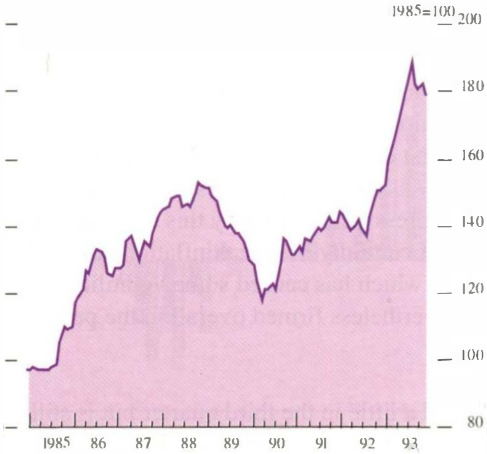
Japan

The economy remains depressed

Most indications suggest that the Japanese economy remains fundamentally weak. Industrial production remained on a downward trend overall throughout 1993 and the corporate sector is still in particular difficulty. The run-down of excess stocks seems to have stalled and business investment fell in the third quarter (it is expected to decline by around 8% over the current fiscal year). November's Tankan survey indicated that business confidence was at the lowest level since 1976, with exporters particularly apprehensive about the strength of the yen.

Against this background, and a consistent fall in retail sales throughout the year, the recorded rise—of 0.5%—in GDP in the third quarter was unexpected. The increase was concentrated mainly in housing investment and housing-related consumer spending. This is surprising given the weak state of the labour market and the associated effects on consumer confidence.

Chart 15
Japan: effective exchange rate



As in Europe, pressures on the corporate sector (compounded in Japan's case by a substantial debt overhang) are being felt in the labour market. So far, this has not been reflected in unemployment (which has risen, but only to 2.8% of the labour force) but less visibly in recruitment, overtime, bonuses and early retirements. It has been estimated that there are now close to three quarters of a million 'excess' workers in manufacturing and a considerably larger number in the economy as a whole. In view of this, it is unlikely that the pick-up in consumption presages a sustained strengthening of personal sector demand.

The persistent weakness of the Japanese economy, together with consumer price inflation below 1% and continuing producer price deflation (currently around 3%), mean that further stimulatory measures remain likely. The three fiscal packages announced since August 1992 have had some impact on demand, though much less than the headline total of almost ¥30 trillion would suggest. In the year to the third quarter, public spending contributed 1.6 percentage points to a total rise in GDP of 0.6% and part of this can be attributed to the packages. A sizable and transparent stimulus in the form of a substantial cut in direct taxation would underpin activity without undermining the Japanese authorities' prudent approach to the fiscal deficit, which in 1993 is likely to have been around 0.25% of GDP.

The timing of any further stimulus, however, is bound up with wider political issues in Japan and the associated uncertainty has unsettled financial markets. The yen has weakened in recent weeks, falling to around ¥110 against the dollar in mid-January, some 12% below its August peak (but still 10% above its level at the beginning of 1993). This is a consequence of the growing expectation of interest rate cuts (markets see monetary easing as more likely if a fiscal stimulus cannot be agreed). The yen's weakness has also been a reaction to the continuing fall in the current account surplus—to below 3% of GDP in the third quarter.