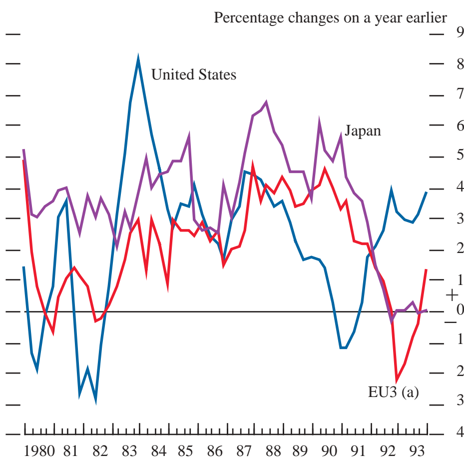
The international environment

- *Economic activity has strengthened in France, Germany and Japan, but recovery is likely initially to be modest and large output gaps will remain.*

- *Inflation has continued to fall in most major countries. But a number of forward-looking indicators such as commodity prices and, in the United States, high capacity utilisation point to some upward pressure on future inflation.*

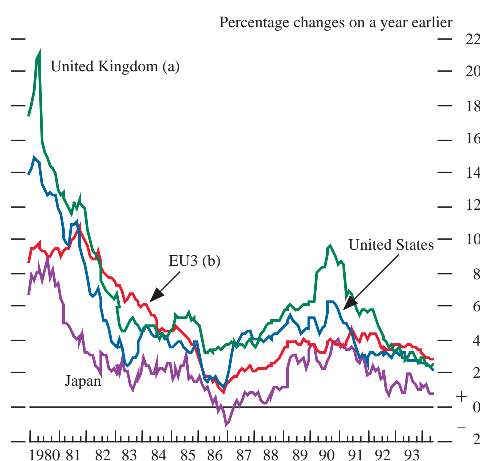
- *Despite higher activity and lower inflation, financial markets have continued to be volatile in recent months. Bond yields have risen further and the dollar has weakened.*

Chart 1
GDP growth



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

Chart 2
Consumer price inflation



(a) RPI excluding mortgage interest payments.
(b) GDP-weighted average of France, Germany and Italy.

Overview

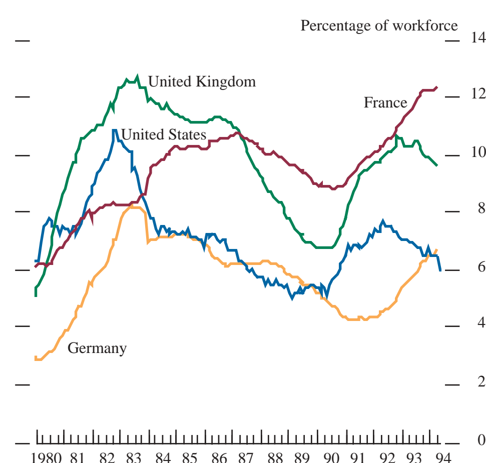
A feature of the recent period of slow growth in the industrialised world—which began in 1990 with the US recession—has been the diverse growth paths of the major countries: the timing, duration and depth of recession have varied widely. As a result of this variation, the overall effect of recession has probably been less severe than in the 1981–82 downturn (when countries' growth paths were more synchronised) but the slowdown has lasted much longer. In the last three months, however, there has been clearer evidence that all of the Group of Seven (G7) countries—including those which entered the recession last—are recovering.

In the first quarter of this year, aggregate G7 GDP rose by around 0.8%—its highest rate for four years. Chart 1 shows the path of GDP growth in the major international economies; in the first quarter, GDP rose by 0.5% in France and Germany and by 1% in Japan, while growth in the United States slowed to 0.8% from its very high fourth-quarter rate.

Although economic recovery in Europe and Japan seems to be more firmly established than three months ago, growth is likely to be modest this year and may be uneven, at least initially. The government sectors have provided large contributions to growth in France and Japan, but these effects may fade later this year. Increasing unease in bond markets over budget deficits and rising government debt may limit the scope for future fiscal stimulus. Consumer confidence and spending in France and Germany are still weak and business investment is not yet recovering. First-quarter growth in Germany and Japan may also have been overstated because of seasonal factors.

Chart 2 shows that most of the major countries have continued to make progress in reducing consumer price inflation in recent months. Despite lower inflation in the G7 countries since the beginning of the year, however, uncertainty and volatility have continued to affect financial markets. The weakness of the dollar, and falls in bond and equity prices worldwide, have illustrated the concerns of financial markets over potential upward pressure on US inflation from high capacity utilisation and rising commodity prices.

Chart 3
Unemployment(a)



(a) OECD standardised rate except for the United States, which is on the basis of a national definition.

Chart 4
European industrial production

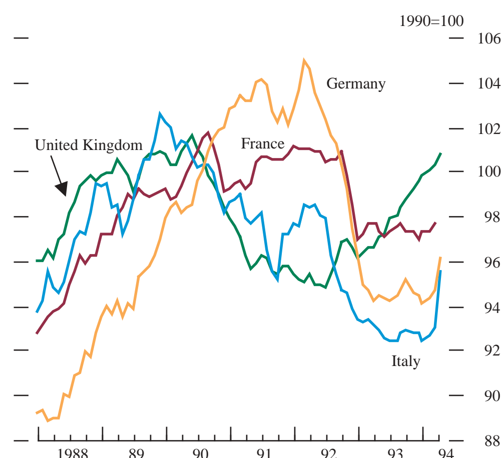


Table A
Contributions to western German and Japanese GDP growth

Percentage points (a)

	1992 Year	1993 Year	1993 Q4	1994 Q1
Western Germany				
Consumption	0.9	—	—	—
Investment	0.2	-1.4	-0.5	0.8
Government expenditure	0.6	-0.2	0.1	-0.2
Stockbuilding	-0.3	-0.6	-0.9	0.2
Domestic demand	**1.1**	**-2.4**	**-1.2**	**0.7**
Net trade	0.1	0.6	0.8	-0.2
GDP	**1.2**	**-1.9**	**-0.4**	**0.5**
Japan				
Consumption	1.0	0.6	0.4	0.8
Investment	-1.2	-1.6	-0.6	-0.5
Government expenditure	1.1	1.4	0.1	0.6
Stockbuilding	-0.5	-0.1	—	-0.2
Domestic demand	**0.4**	**0.3**	**-0.1**	**0.7**
Net trade	0.8	-0.3	-0.6	0.2
GDP	**1.2**	**0.1**	**-0.7**	**1.0**

(a) Figures for quarters give the change compared with the previous quarter.

The significance of rising commodity prices for the near-term outlook for inflation is debatable. Commodities are a small input into OECD production; manufacturing unit wage costs are a much larger element in manufacturers' costs and, in the first quarter, were lower than a year earlier in Canada, Germany, Italy and the United States. And, with the exception of the United States, the level of output is still well below potential.

Economic recovery is under way in continental Europe and Japan but is unlikely to be rapid

The 0.5% rise in GDP in France and Germany in the first quarter was narrowly based. Private consumption made no contribution to growth in either country.[1] Retail sales volumes were still falling in Germany in April (though they rose in May) and were not yet on a firm upward trend in France. High unemployment in continental Europe is probably a key factor holding back a more rapid consumer-led recovery (see Chart 3). The inflexibility of European labour markets relative to the United States may mean that unemployment will respond slowly to a rise in activity.[2] Chart 3 shows that unemployment in France and Germany has continued to rise in recent months, though the rate of increase has slowed this year; in the United Kingdom and the United States, which are further advanced in the economic cycle, it is falling. Although personal sector activity is weak, European consumer confidence has risen in recent months. But if continental Europe follows the precedent of the United Kingdom and United States, confidence may remain low despite the strengthening of activity. Chart 4 shows that, in spite of the weakness of consumer spending, industrial production in the major EU countries seems to have passed its low-point.

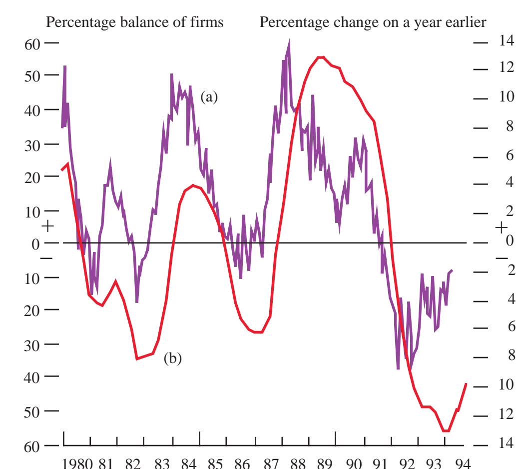
Table A summarises recent contributions to western German and Japanese GDP growth. The rise in west German GDP in the first quarter was largely accounted for by a rise in construction output. Net exports made a negative contribution to first-quarter GDP growth, despite reports of buoyant foreign orders towards the end of 1993; over the previous year, they had made a positive contribution to growth. In the last two years, Germany's competitiveness has deteriorated as the real effective exchange rate—the nominal rate adjusted for changes in relative unit labour costs—has risen by around 8%. Since 1985, Germany's real effective exchange rate has risen by 30%.

In France, the 0.5% increase in output in the first quarter was based primarily on stockbuilding, with net exports—as in Germany—making a negative contribution to growth after several quarters of positive contribution. French unemployment—which averaged 11½% in 1993—had risen to more than 12% by May this year. The government has announced a variety of measures to stimulate the economy and reduce unemployment: these include providing subsidies for employing youth workers and exemptions from social security contributions. But although the government sector made a small positive contribution to growth in the first quarter, unemployment has continued to rise.

As Table A shows, the 1% rise in Japanese output in the first quarter was led by private consumption and government spending, as the effect of earlier government fiscal packages continued to feed

(1) A box on pages 118–19 of the May 1994 *Quarterly Bulletin* described recent developments in the household sector in more detail.
(2) Indicators of labour market turnover were presented on page 16 of the February 1994 *Quarterly Bulletin*.

Chart 5
Japan: industrial production and manufacturing confidence



(a) Industrial production, right-hand scale.
(b) Diffusion index of major manufacturers' view of business conditions, left-hand scale. The figure for the third quarter of 1994 is a forecast.

Table B
Unit wage costs in manufacturing

Percentage changes on a year earlier

	1991 Year	1992 Year	1993 Year	1994 Q1
Canada	-2.6	-2.4	-2.7	-1.3
France	2.1	0.5	1.5	. .
Germany	4.3	4.9	1.5	-5.0
Italy	13.4	5.5	4.3	-1.8
Japan	4.4	8.7	4.5	5.2
United States	1.3	-0.7	-1.2	-1.6
Major six	**3.1**	**1.8**	**0.3**	. .
Memo:				
United Kingdom	7.0	2.1	0.2	2.1

. . not available.

through. The latest Tankan survey of business conditions showed the first rise in confidence for five years, but from a low base (see Chart 5). Last year, industrial production and GDP rose in the first quarter but then fell. Recovery this year is likely to be modest; the OECD projects a 0.8% rise in GDP. Consumer confidence is weak and the outlook for the corporate sector has been adversely affected by the sharp appreciation of the yen and the rise in long-term interest rates.

In the United States, economic growth has fallen from its high (and probably unsustainable) fourth-quarter rate. Output rose by 0.8% in the first quarter, compared with 1.7% in 1993 Q4. Nevertheless, retail sales and industrial production in April were 4%–5% higher than a year earlier. The labour market has also continued to tighten: non-farm employment rose by 3½% in the year to June, compared with 2% last year. But so far, there has been little discernible effect on wage costs: the annual rise in manufacturing earnings was around 2¾% in the second quarter, similar to the rise in the second half of 1993.

Inflation has continued to fall in the major countries

Consumer price inflation in the G7 countries fell from 2½% in the year to December to around 2% in the year to May. In the past year, producer prices have fallen in France, Japan and the United States. And, as Table B shows, in the first quarter of this year, manufacturing unit wage costs were lower than a year earlier in four of the G7 countries. Despite this favourable inflation news, financial markets—particularly in the United States—have concentrated on forward-looking inflation indicators, such as commodity prices, and the implications for earnings growth and output prices of a tightening US labour market and high US capacity utilisation.

Measured by the Economist's dollar-denominated index, non-oil commodity prices rose by 30% in the year to June, while Brent crude oil prices fell by 5%. Non-oil commodity prices have been rising because of a series of unconnected supply shocks and some producer agreements to limit supply. There have also been reports of speculative inflows into some commodity markets, which may presage a rise in final demand. In the past, *supply-driven* non-oil commodity price shocks have often been temporary. And Bank research also suggests that even *demand-driven* changes in non-oil commodity prices have sometimes been partly transitory: non-oil commodity prices have tended to overshoot in response to changes in G7 demand.[1]

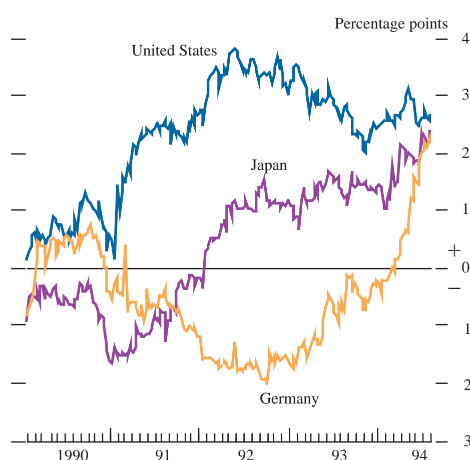
Until March, weak oil prices had largely offset price rises in other commodity markets. Since then, however, the Brent crude oil price has risen from around $13.50 a barrel to $17 a barrel in June, pushed up by higher oil demand in the United States and, reportedly, by the threat of conflict in Korea. But, at $17 a barrel, the oil price is at around last year's average. The surprise, perhaps, is not that oil prices have risen, but that they should have fallen so low in March and April. The implications for inflation of rising commodity prices are discussed in more detail in the August *Inflation Report*.

Financial market volatility poses a threat to nascent recovery

Despite the continuing favourable news of falling inflation and evidence that economic growth was becoming more widespread throughout the G7, there was further financial market volatility in

(1) A box on page 14 of the February 1994 *Quarterly Bulletin* described this process in more detail.

Chart 6
Yield spreads(a)



(a) Ten-year government bond yield minus three-month domestic money-market rate.

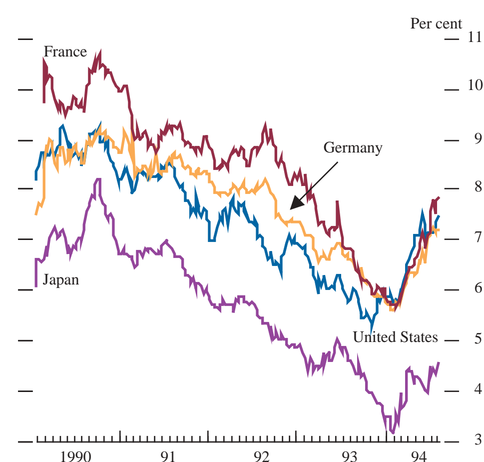
Table C
General government financial balances

Percentage of GDP

	1990	1993	1994
Canada	-4.1	-6.8	-5.5
France	-1.6	-5.8	-5.9
Germany	-2.1	-3.3	-2.9
Italy	-10.9	-9.5	-9.7
Japan	2.9	0.3	-1.9
United States	-2.5	-3.5	-2.6
Memo:			
OECD Europe	-3.7	-6.3	-6.1
G7	-2.0	-3.9	-3.7

Source: OECD; the figures for 1994 are OECD projections.

Chart 7
Government bond yields(a)



(a) Ten-year bonds.

the second quarter. Changed perceptions over the outlook for economic growth and the direction of short-term interest rates in Germany, Japan and the United States, together with a weakening of the US dollar, have contributed to bond and equity-market falls this year.

Earlier in the year, the trigger for falling bond and equity prices was the Federal Reserve's first increase in short-term interest rates for five years. In June, falling US bond prices followed renewed US dollar weakness and a growing view that short rates in Germany and Japan might not need to fall further, given the rise in activity. European bond yields followed US yields up—though eventually yields in some European countries rose by more than US yields. Chart 6 shows that in Germany the gap between long and short-term interest rates widened sharply between March and June. European and Japanese bond yields rose because of changed perceptions of future short rates, but perhaps also because European markets have focused once again on high government borrowing. The latest Economic Outlook produced by the OECD, for example, projects that general government deficits in European OECD countries will be 6.1% of GDP this year, compared with 6.3% last year (see Table C). In most European economies, deficits are projected to fall this year but gross government debt is set to continue rising as a proportion of GDP.

In continental Europe, most personal sector mortgages are priced relative to long-term interest rates and the corporate sector is also more reliant on borrowing at long-term interest rates than, for example, in the United Kingdom.[1] There have therefore been some concerns that rising long rates in Europe (and Japan) could damage recovery—particularly of business investment, which fell sharply during the recession and has not yet begun to rise.

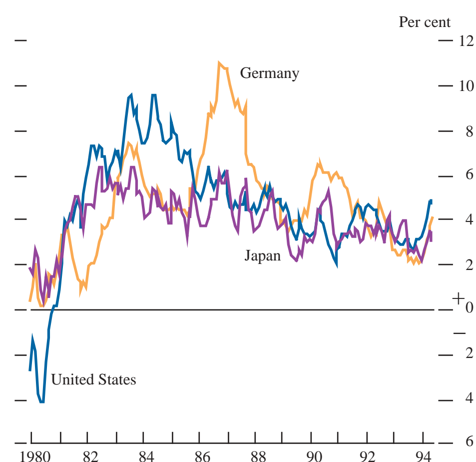
It should be recalled, however, that the increase in long-term yields this year followed three years of steady falls in nominal bond yields (see Chart 7). With hindsight, the rally in bond prices in the second half of last year may have pushed prices too high, and this year's rise in yields may therefore be in part a correction from that overbuoyant period. In June, ten-year government bond yields in France and Germany were 150 to 200 basis points higher than at the end of 1993, but less than 50 basis points higher than a year earlier; Japanese yields were still lower than in June 1993. So it seems unlikely that the rises seen in French and German long-term rates in the year to the end of June will seriously damage the recovery (interest rates have, however, risen more sharply in other European countries, such as Italy and Spain). In the United States, long-term interest rates rose by more than 100 basis points in the year to June, but recovery is firmly established there and the tightening of monetary conditions at the short and long ends of the yield curve may be consistent with maintaining growth on a broadly steady path. One concern, however, is that, adjusted for current inflation, US and German nominal bond yields rose sharply between January and June (see Chart 8).

Monetary growth has been weak in France and Japan but high in Germany

There is little evidence yet that the rise in long-term interest rates has reduced money and credit growth in the major economies

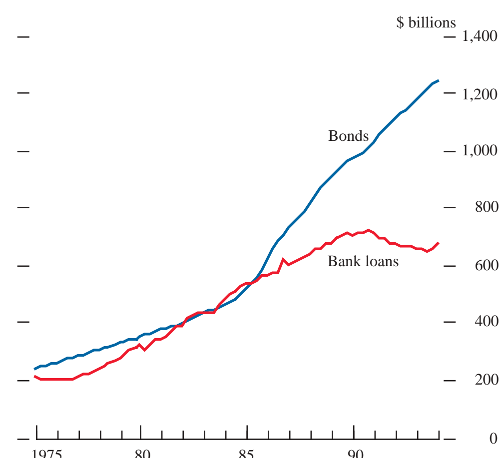
(1) See the article on fixed and floating-rate finance in the United Kingdom and abroad on pages 34–45 of the February 1994 *Quarterly Bulletin*.

Chart 8
Bond yields adjusted for current inflation(a)



(a) Ten-year government bond yield minus current CPI inflation.

Chart 9
US companies' bond and bank borrowing(a)



(a) Amounts outstanding.

Table D
Current account balances

Percentage of GDP

	1992 Year	1993 Year	Q3	Q4	1994 Q1
Canada	-3.8	-4.3	-4.1	-4.5	. .
France	0.3	0.8	1.6	1.3	. .
Germany	-1.2	-1.3	-1.6	-1.6	-1.6
Italy	-2.3	1.1	1.5	2.6	0.5
Japan	3.2	3.1	2.9	2.8	3.2
United States	-1.1	-1.6	-1.7	-1.9	-1.9
Memo:					
United Kingdom	-1.7	-1.7	-1.3	-1.3	-0.5

. . not available.

(though effects would be expected to feed through with some lag). In the United States, where short-term interest rates have also increased, outstanding corporate bond issues have continued to rise and, in the fourth quarter of last year and the first quarter of this, the level of bank loans outstanding rose, after falling between 1991 and 1993 (see Chart 9).

In Germany, where an intermediate money supply target is used, M3 growth has continued to be high in the second quarter. Although its annualised growth rate (compared with the fourth quarter of last year) has fallen in recent months, it was still above 10% in May, compared with a target of 4%–6%. In the first five months of the year, monthly M3 growth averaged 1%. The high growth rate can be explained partly by high government borrowing and increased competition for savings deposits following a relaxation of rules governing savings banks. And earlier this year, M3 growth was distorted upward by taxation effects. So, despite M3 growth in excess of the target range, the Bundesbank has focused on the falling rate of inflation and has continued to guide money-market rates down by cutting its repurchase ('repo') rate and, in May, making a larger-than-expected, 50 basis-point cut in the discount and Lombard rates.

In France, by contrast, the annual rate of M3 growth was negative between October 1993 and May this year. There were a number of special factors, such as taxation changes and high sales of the 'Balladur bond' (a large government issue last year which raised funds to finance measures to reduce unemployment), but underlying M3 growth has been weak. Between May 1993 and February this year, outstanding bank credit was also lower than a year earlier.

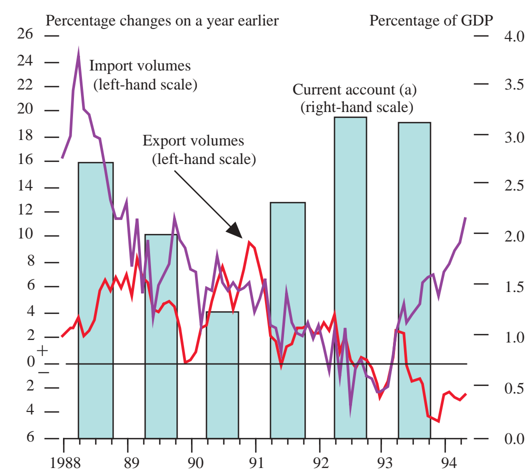
In Japan, annual growth of the most widely watched money supply measure, M2+CDs, has continued at around 1½%–2% for more than a year. The Bank of Japan's foreign exchange intervention to support the dollar—which might otherwise have boosted the money supply—seems largely to have been sterilised by sales of Japanese government bonds to the non-banking sector. In the first four months of the year, the stock of bank loans to non-financial enterprises was unchanged from the same period of 1993 and, with long-term interest rates rising, the cost of bank loans has risen since April. The firms surveyed in the latest Tankan survey confirmed that loan rates had increased in the three months to May, although the overall lending attitude of financial institutions had eased.

By the second quarter, the dollar had been depreciating against the yen for more than a year; by contrast, it strengthened against the Deutsche Mark for most of last year, though it depreciated in the first half of this year. In the year to June, the dollar fell by 6% against the yen and, despite central bank intervention and supporting policy statements, fell below ¥100 for the first time since 1945. The weakness of the dollar, despite the fact that the United States was further ahead in the economic cycle than Germany or Japan, probably resulted primarily from underlying concerns over the bilateral current account imbalance between the United States and Japan.

Current account imbalances have been slow to adjust

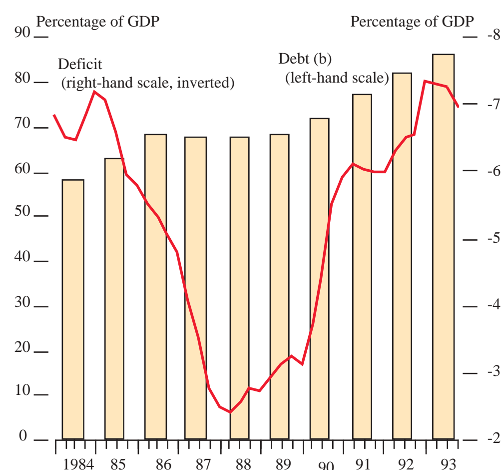
Table D shows current account balances in the G7 countries. The Canadian deficit is the largest relative to GDP (it rose to 4.3% of GDP in 1993), but Japan's surplus is the largest absolute imbalance

Chart 10
Japanese current account balance and trade volumes



(a) Year average.

Chart 11
Canadian government debt and deficit(a)



(a) General government.
(b) End-year.

and it has attracted most interest. The rise in Japan's surplus in the first quarter reflected its weak relative demand—domestic Japanese demand rose by less than 1% over the fourth and first quarters, compared with nearly 3% in the United States. In the first five months of this year, Japan's visible trade surplus with the United States was $20 billion, 9% higher than in the same period last year. Aggregate trade volumes have, however, responded to the high yen—Chart 10 shows that a clear gap has opened up between import and export volume growth. Because a rising yen causes the terms of trade to move in Japan's favour, the surplus has been slow to respond to these volume trends, but it might be expected to narrow if they persist and as Japanese relative demand recovers.

Canada's real effective exchange rate has fallen by 20% over the two years to June, because of a depreciating nominal exchange rate and falling manufacturing unit wage costs. Despite this improvement in competitiveness, the current account deficit has risen, because of strong demand relative to its non-US export markets and—more importantly— a widening invisibles deficit because of rising interest payments to foreign holders of Canadian government debt. Chart 11 shows that Canada's general government debt (domestic and foreign currency) has risen to more than 80% of GDP. Recent rises in long-term interest rates will make it more difficult to reduce the deficit despite a strengthening economy and gradually-falling unemployment (now below 11%).

The mobility of capital, boosted over the last 15 years by deregulation and a trend toward risk diversification via cross-border investment, means that it is easier to finance the current account deficits shown in Table D. But the weakness of the dollar in recent months shows that markets are focusing on these imbalances and the means by which they are financed.

In 1993, the main counterparts to Japan's $130 billion current account surplus were a $78 billion outflow of long-term capital, a $26 billion outflow of short-term capital and a $26 billion rise in foreign exchange reserves, largely the result of intervention to support the dollar. By contrast, in the first quarter of this year, Japan's $34 billion current account surplus was accompanied by a $47 billion *inflow* of long-term capital. This net inflow of long-term capital mainly comprised foreigners' net purchases of Japanese equities (which helped to support the stock market) and a reduction in Japanese holdings of overseas bonds—some investors were reportedly selling overseas bonds because of capital losses following the yen's appreciation. The first-quarter surplus on the current and long-term capital accounts was matched by a $6 billion rise in foreign exchange reserves and an $84 billion outflow of short-term capital.