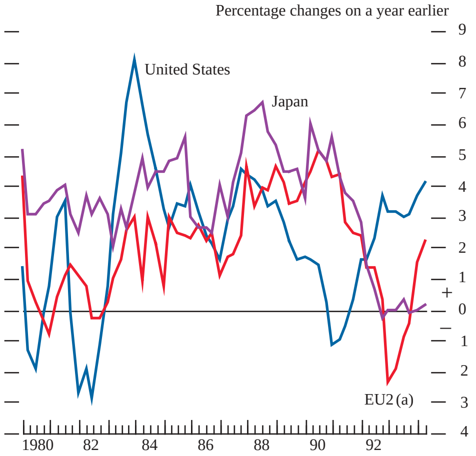
The international environment

- *Economic growth continued to be strong in the second and third quarters in the United States. In Western Europe, activity strengthened in the second quarter; Japan's output fell.*
- *In the United States, inflation has risen from its low in the second quarter. In Japan, western Germany and France, the outlook is for low inflation.*
- *Official interest rates increased further in the United States in the third quarter. And for the first time in this cycle, official rates rose in a number of other OECD countries.*
- *Current account imbalances have begun to fall in some of the major economies. Budget deficits are still high, but higher growth may reduce the cyclical parts of deficits and some countries have tightened fiscal policy.*

Chart 1
GDP in the major economies



(a) A GDP-weighted average of France and western Germany.

Table A
Capacity utilisation

Per cent

	Capacity utilisation 1994 Q2	1970–94
France	81.7	83.9
Japan	82.7	94.2
United States	83.3	80.5
Western Germany	80.5 (a)	83.3

(a) First quarter 1994.

Overview

In most of the Group of Seven (G7) countries, economic recovery continued in the second and third quarters. In Western Europe, activity strengthened but it may not yet be broadly based. In the United States, growth remained above its long-run trend rate. In Japan, which is still affected by high borrowing and investment undertaken in the late 1980s, recovery continued to be unsteady.

In the G7 countries as a whole, GDP rose by 0.8% in the second quarter—as in the first. As Chart 1 shows, the growth rates in the United States and western Europe have begun to converge. In the second quarter, US GDP rose by 1% and Canadian output by 1.6%. In France and western Germany, GDP rose by 1%; but Japan's GDP fell by 0.4%.

Although growth rates are converging, the cyclical positions of the major economies still differ. In the second quarter, output in the United States was 8% above its pre-recession peak, while output in France was $^{1}/_{2}$% above and in Japan $^{1}/_{2}$% below their pre-recession peaks. Table A shows that industrial capacity utilisation rates in France and Japan were below their long-run averages in the second quarter; by contrast, a utilisation rate of 83% in the United States was above its long-run average and close to its peak in the late 1980s. An alternative measure of spare capacity is the gap between actual and potential output (the 'output gap'). The IMF's latest *World Economic Outlook* estimated that the output gap in Japan was around 5% this year, whereas in the United States the gap had probably closed. Spare capacity is, however, hard to estimate on any measure—output gaps or utilisation rates—and comparisons between countries are difficult.

Inflation in the G7 countries was 2.2% in the year to August, compared with 2.5% at the end of last year. Although there is no mechanical relationship between the output gap and inflation, the extent of spare capacity and unemployment in parts of western Europe and Japan suggest that supply constraints are unlikely to push inflation up next year. By contrast, inflation has been slowly

Chart 2
United States: consumer prices and residential investment deflator

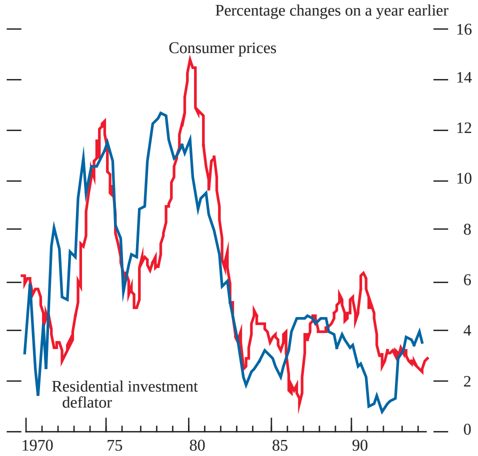


Chart 3
Japan: consumer prices and residential investment deflator

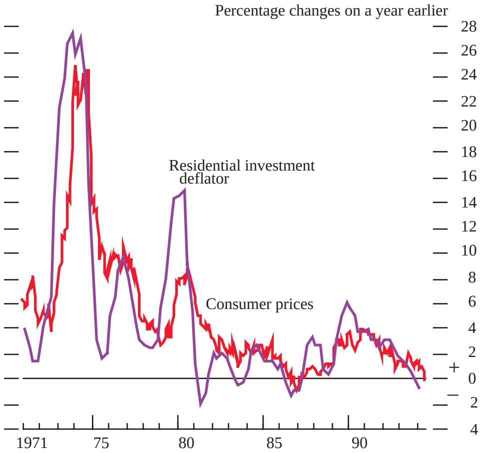


Table B
Contributions to US GDP growth

Percentage points (a)

	1993	1994	
	Year	Q1	Q2
Consumption	2.2	0.8	0.2
Investment	1.6	0.4	0.4
Government expenditure	-0.1	-0.2	-0.1
Stockbuilding	0.3	0.3	0.6
Domestic demand	**4.0**	**1.2**	**1.2**
Net trade	-0.8	-0.4	-0.1
GDP	**3.1**	**0.8**	**1.0**

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

rising in the United States since May. Charts 2 and 3 show that, in the United States and Japan, changes in residential investment deflators (which in the past have moved broadly in line with residential house prices) often precede changes in consumer prices. Based on past relationships, the recent movements for the G3 countries suggest upward pressure on US inflation and continued downward pressure in Japan and western Germany.

It is unclear, however, how far the rise in US inflation will go, since there has been little increase in wage inflation and monetary policy has been tightened this year. The Federal Reserve increased the federal funds and discount rates by a further 50 basis points in August, taking the federal funds rate 175 basis points above its February low.

Australia, Italy, Sweden and the United Kingdom also increased their official interest rates in the third quarter, for the first time during this recovery. By the end of September, futures markets appeared to be discounting the possibility of higher short-term rates before the end of the year in the United States, and also in Germany and Japan (which have not yet increased rates in this cycle).

In the United States, despite fears that consumption had weakened, activity has remained strong

US GDP rose by 1% in the second quarter, compared with 0.8% in the first. Table B shows the contributions to this growth in the first two quarters. In the second quarter, investment continued to grow strongly and contributed 0.4 percentage points to growth. Consumption grew more slowly, however, rising by 0.3% compared with an average growth rate of 0.9% in the preceding four quarters. Stockbuilding made the largest contribution to growth during the quarter.

The weakness of consumption and the strength of stockbuilding suggested that the rise in US interest rates earlier this year was already slowing the economy significantly. Consumption growth, however, was always likely to slow from the high rates of the fourth and first quarters—and consumption was still 3.4% higher in the second quarter than in the same period of 1993. But there has been some evidence of a slowing in housing market activity (an interest-sensitive sector of the economy). In 1992 and 1993, housing starts rose sharply, encouraged by low and falling long-term interest rates. Research published by the Bank for International Settlements earlier this year suggested that a one percentage point rise in US official interest rates would have little discernible effect on activity until at least nine months after the change and the full effect might take around two to three years to register. If so, the rise in official interest rates since February is unlikely yet to have had much effect on activity. But long-term interest rates began rising in October 1993 and it seems, partly as a consequence, that the upward trend in housing starts has become shallower.

Although part of the growth in stocks in the second quarter was probably involuntary (because consumption proved to be weaker than firms had expected), it is likely that some of it was deliberate. Chart 4 shows the inventory to sales ratio for manufacturing industry. During the 1990–91 recession, the ratio rose much less than it had done in the 1974–75 and 1981–82 recessions, partly

Chart 4
US business inventories/sales

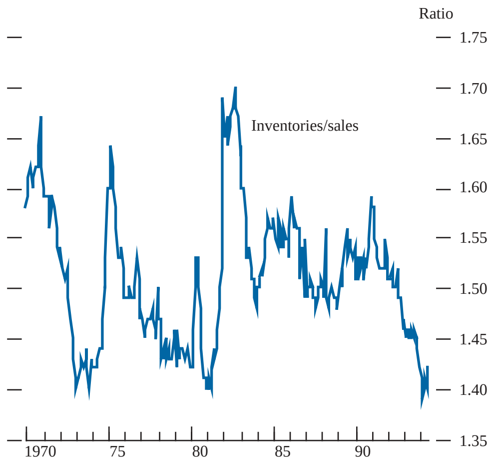


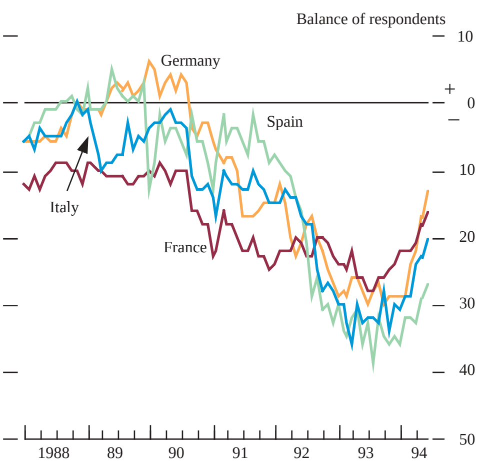
Table C
Contributions to western German GDP growth

Percentage points (a)

	1993	1994	
	Year	Q1	Q2
Consumption	0.1	0.2	-0.6
Investment	-1.7	0.8	-0.2
Government expenditure	-0.2	0.2	-0.6
Stockbuilding	-0.3	-0.4	2.1
Domestic demand	**-2.1**	**0.8**	**0.8**
Net trade	0.4	-0.2	0.2
GDP	**-1.7**	**0.5**	**1.0**

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

Chart 5
European consumer confidence



Source: European Economy.

because of the introduction of 'just-in-time' stock controls. As the recovery has gathered pace, the ratio has fallen and may now have reached a level at which firms wish to rebuild stocks. The Federal Reserve's *Beige Book*, published in September, reported that some retailers were building up stocks ahead of the holiday period; some companies may previously have over-economised, and then lost sales opportunities in the face of faster-than-expected demand.

Growth has strengthened in Europe . . .

Economic activity in the large west European economies has been stronger in recent months than most commentators expected at the beginning of the year. In both France and western Germany, GDP rose by 1% in the second quarter, following rises of 0.7% and 0.5% respectively in the first.

Table C shows the contributions to western German GDP growth in the first two quarters. Stockbuilding more than accounted for the rise in GDP in the second quarter; consumption, which fell by 1%, made a negative contribution of 0.6 percentage points. Chart 5 shows that European consumer confidence has been rising since the second half of last year. But it is probably being held back in Germany by the prospect of tax rises early next year equivalent to around $1\frac{1}{2}$% of this year's real personal disposable income; business confidence has recovered more quickly this year, partly because of the strength of industrial export orders.

In France, consumption and investment each rose by around 1% in the second quarter, in contrast to the first quarter when growth was led by stockbuilding. Household consumption of manufactured goods rose by 1.5%, but without government stimulus to the car market would perhaps have increased by about 0.2%. The consumer sector seems likely to remain fragile; despite a government subsidy scheme, unemployment was unchanged between June and August at 12.6%. Chart 6 shows that business investment in France, Japan and western Germany has yet to recover to pre-recession levels, whereas US investment has grown strongly since the beginning of 1992.

One feature of the recoveries in Western Europe has been the growth of net exports—which, until the first quarter, made a proportionately larger contribution to growth in the major European economies than in the two previous recoveries. A box on page 310 looks at European export performance in more detail.

. . . but in Japan activity was weak in the second quarter

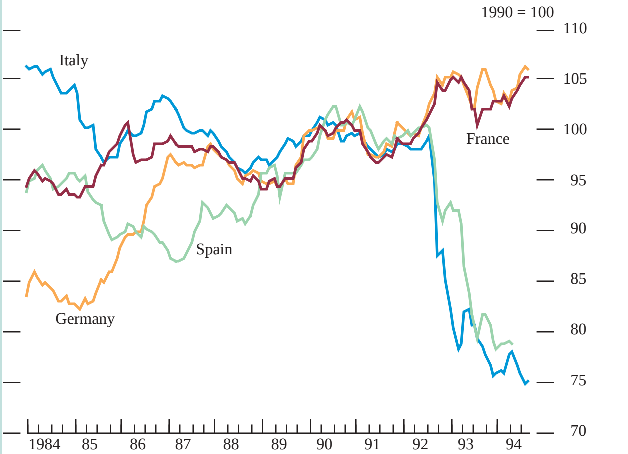
In Japan—where the economy is still recovering from a period of high borrowing and investment in the late 1980s—economic activity has passed its low point, but business and consumer confidence are low and fragile. This year, the high yen, rising real interest rates and political uncertainty have prevented a steadier recovery. Corporate and personal sector indebtedness are probably higher than in parts of continental Europe, and this may be one reason why Japan has not recovered as quickly. Because consumer and producer prices are falling in Japan, the real value of debt is rising.

Japan's GDP rose by 1% in the first quarter, but fell by 0.4% in the second, when both consumption and investment fell. (Housing investment rose by 11%, but this partly reflected government stimulus through subsidised housing loans.) Consumption and

Trends in European trade

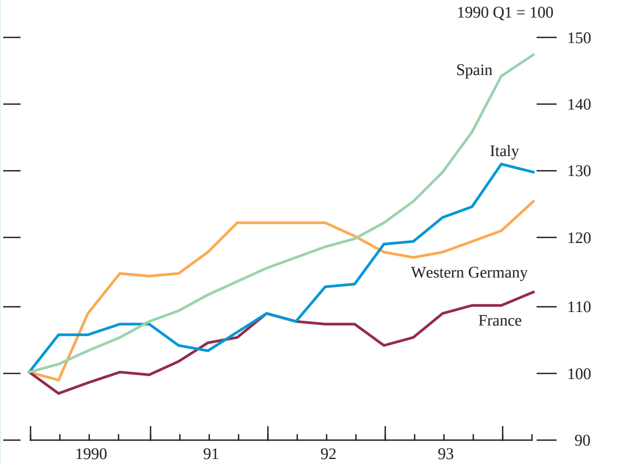
One feature of the recent recovery in western European economies has been the external sector's contribution to growth. This box looks at the recent trade performance of France, Italy, Spain and western Germany. As Chart A shows, these countries provide an interesting contrast: nominal exchange rates in Italy and Spain depreciated sharply in 1992 and 1993; French and German exchange rates did not.

Chart A
Nominal effective exchange rates



The nominal trade-weighted exchange rates of Italy and Spain each fell by around 20% in the 12 months after September 1992. This improvement in competitiveness fed quickly through to trade volumes; Chart B, for instance, shows the path of export volumes. Goods and services exported by Italy and Spain rose by 9%–10% last year, while French and western German export volumes fell by ½% and 3% respectively. In the first half of this year, however, export volume growth in France and western Germany was positive. The weakness of European domestic demand last year meant that import

Chart B
Export volumes(a)



(a) Goods and services.

volumes fell in all four countries. As a consequence of these changes, the current account deficit to GDP ratios fell by 2–3 percentage points in Italy and Spain between 1992 and 1993; current account balances in France and Germany changed by less.

The table shows that the contribution of the external sector to GDP growth has so far been much larger in Italy and Spain than in France or western Germany. In Spain, for example, GDP rose by 0.5% between the end of 1992 and the first quarter of 1994; net exports contributed around 4 percentage points to growth. Up to the first quarter, net exports had contributed proportionately more to GDP growth in the main continental European countries in this recovery than in the previous two.

Net trade contributions to GDP 1992 Q4–94 Q1

Percentage points

	GDP growth	*of which:* Net trade
France	0.2	0.8
Western Germany	—	1.5
Italy	0.8	4.3
Spain	0.5	3.8

In 1992, around 60% of EU countries' exports were to other EU countries. Given the weakness of European domestic demand, the strength of export volumes in Italy and Spain last year—and in France and western Germany this year—is partly the result of net export growth to fast-growing regions such as North America and Asia. The value of the four European countries' exports to Asia rose by 16% last year, while their total non-EU exports fell by 1%.

Potential problems, however, with the new method of collecting European trade statistics mean that caution is needed in drawing firm conclusions. In March, Eurostat (the Statistical Office of the European Communities) said that, in the first nine months of 1993, recorded intra-EU exports exceeded intra-EU imports by ECU 19 billion. So it is possible that difficulties with the new statistical method may have boosted Europe's net exports artificially.

Despite the sharp depreciation in Italy and Spain in 1992 and 1993, to date domestic inflation has not risen greatly. (This has also been true for other countries whose currencies have depreciated in the last two years—including Canada, Sweden and the United Kingdom.) Domestic deflationary pressures have overcome the effects of import price rises. But as output growth rises and the amount of spare capacity falls, it is possible that inflation pressures will rise in Italy and Spain. Inflation was 3.6% and 4.8% respectively in the two countries in the year to July, higher than the EU average of 3%. If inflation continues to exceed the EU average, some of the competitive gains from the fall in nominal exchange rates will be eroded.

Chart 6
Business investment

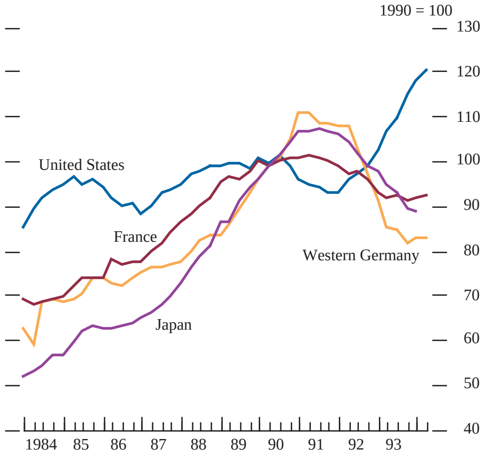
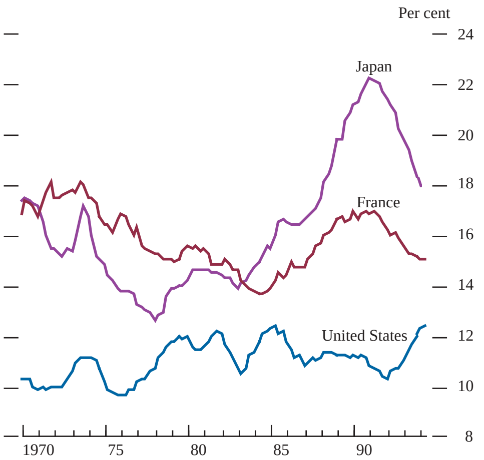
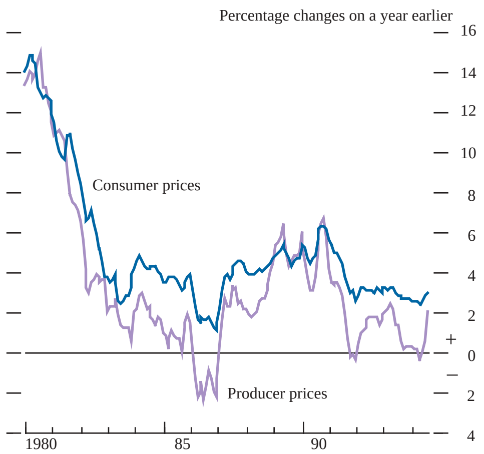


Chart 7
Business investment/GDP(a)



(a) At constant prices.

Chart 8
US consumer and producer prices



business investment account for about three quarters of output; their contraction in the second quarter therefore raises a question about the solidity of the Japanese recovery. But there may be some seasonal adjustment problems with the measure of Japan's GDP; in each of the last three years, output has risen in the first quarter and fallen in the second. In the third quarter, consumption was boosted by income tax cuts in June and the effect of hot summer weather. Real earnings, which fell by $\frac{1}{2}$% last year, rose in the first half of this year and may underpin consumption in the rest of the year.

Although the latest Bank of Japan Tankan survey showed business confidence improving for the second consecutive quarter, many more firms were pessimistic about the outlook than were optimistic. Manufacturers again reported that stocks were higher than necessary and expected this to continue for the rest of the year. Major firms expected to cut capital spending by around 4% this fiscal year—the third successive year of declining investment. Japanese companies borrowed and invested heavily in the mid to late 1980s, during a period of cheap finance and high economic growth (annual GDP growth averaged $4\frac{1}{2}$% between 1985 and 1989); it may be that the period of stock adjustment is not yet complete. Chart 7 shows that the share of non-residential investment in Japanese GDP rose sharply in the second half of the 1980s; it has since fallen, but remains higher than in the United States.

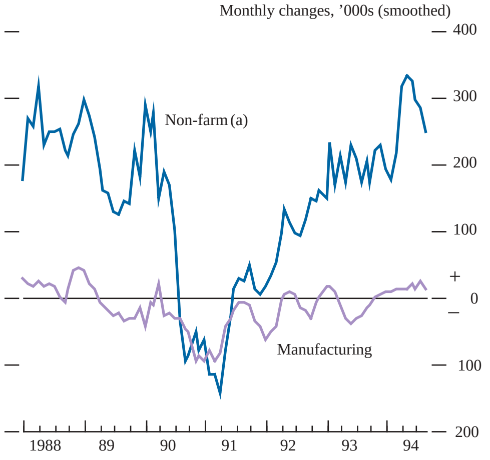
Economic activity has strengthened in a number of other industrialised countries. The recovery in Canada, which has broadly followed that in the United States, is well established. Canada's GDP rose by 1.6% in the second quarter, following an increase of 1.1% in the first quarter. Growth was thus more rapid than in the United States in the first half but, because Canada's recession was deeper and longer than in the United States, it has more spare capacity. For instance, although Canadian unemployment is on a downward trend, it remains high—at 10.1% in September; in the United States unemployment is around 6%. And the gap between actual and potential output may be around 3%–4% in Canada.

In Italy and Spain, whose currencies both depreciated sharply in 1992 and 1993, growth patterns are now diverging. Last year, recovery was led by net exports in both countries. Towards the end of last year and in the first half of this, domestic demand strengthened in Italy but it remained weak in Spain. In the Netherlands, which did not experience the sharp fall in GDP of western Germany and France, GDP rose by 1% in both the first and second quarters and domestic demand is recovering. Unemployment has also begun to fall, from 10% in the first quarter.

Outside the United States, inflation pressures are weak

In the United States, inflationary pressures may be rising. US consumer price inflation was 3% in the year to September, compared with a low of 2.4% in May. And Chart 8 shows that the annual rate of producer price inflation rose sharply in August. In part, this reflected last year's tobacco price cuts dropping out of the index, but it was also because of higher raw material prices. These price rises have probably not yet been fully passed on to consumers. But the annualised three-month rate of consumer price inflation has risen this year and was above the annual rate during the third quarter.

Chart 9
US employment



(a) Excluding manufacturing.

Chart 10
Real manufacturing earnings

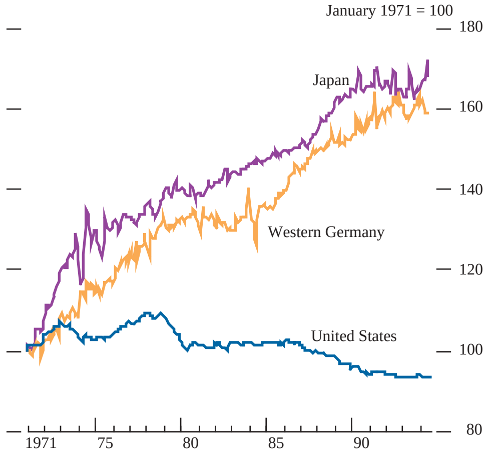
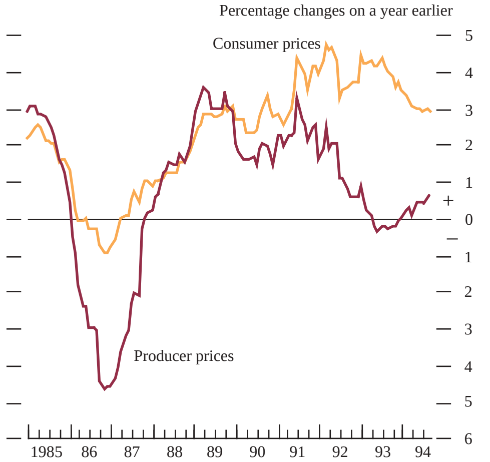


Chart 11
Western Germany: consumer and producer prices



During the early part of the US recovery, falling unit wage costs offset some of the pressures from rising raw material prices. In the second quarter, however, the tightening of the labour market led to a fall in labour productivity and a rise in unit wage costs. Chart 9 shows how non-farm employment has risen this year. Robust growth in employment has helped reduce the unemployment rate to 6% in the third quarter—probably around its 'natural' rate. Despite this, earnings growth has not picked up markedly. Manufacturing earnings rose by 2.5% in the year to September, around the same rate as in 1992 and 1993.

The stability of nominal earnings growth, despite the tightening of the labour market, is not altogether surprising, given that US inflation has also been stable over the last two years. Chart 10 shows that real earnings in the US manufacturing sector have been stable since 1971, in contrast to Japan and western Germany. The growth of firms' non-wage (particularly healthcare insurance) costs has probably been an important factor in the low US wage growth. As a proportion of nominal labour compensation, non-wage costs increased by nearly 60% between 1970 and 1991, a much larger rise than in Germany. The flexibility of the US labour market has also limited real wage growth. And many of the jobs created during this recovery have been in contract or part-time work, which may also be restraining wage pressures.

In western Germany, consumer price inflation was 3% in the year to September; as Chart 11 shows, it has been around this rate since May. And the weakness of the consumer sector—which may be adversely affected by next year's tax rises—will probably limit firms' ability to pass through increases in input prices. In addition, unit wage costs in manufacturing were lower in the first half of this year than in the same period last year, and seem unlikely to pick up sharply.

In January next year, indirect tax increases will drop out of the year-on-year comparison, lowering the measured inflation rate. In addition, western Germany's consumer price index will be rebased: the existing 1985 weights will be replaced with 1991 weights. The prices of some of the consumer durables whose weights are likely to increase are currently being discounted; if this discounting continues, measured inflation could fall early next year.

The rate of growth of German M3 has also slowed in recent months. In August, M3 grew at an annualised rate of 8.2% compared with the fourth quarter of 1993; the three-month growth rate was 0.3%, its lowest this year. Part of this lower growth reflected a switch from M3 deposits to money-market funds (which were legalised from the beginning of August). In its mid-year review, the Bundesbank said that M3 growth was likely to remain outside its 4%–6% target growth range this year, but left the target unchanged.

Average hourly earnings in western Germany rose by around 1% in the year to the second quarter, as the weakness in the labour market enabled firms to secure cuts in real earnings growth. But with unemployment beginning to fall and employment growing, workers may be more resistant in the 1995 annual wage round to an erosion of their real earnings. The prospect of tax increases in the new year is likely to add to their concerns.

Other European economies have made good progress in reducing inflation over the last two years. In France, Italy and Spain, inflation in the first half of the year was at, or near to, its lowest-ever level. Further progress in the third quarter was slow, perhaps partly because it is unusual in some countries for firms and workers to accept continued low increases (or falls) in prices and wages; it is also possible that in parts of Europe demand pressures are beginning to be felt and are preventing further falls in inflation in some sectors.

Table D
Unit wage costs in manufacturing[(a)]

Percentage changes on a year earlier

	1992	1993	1994	
	Year	Year	Q1	Q2
Canada	-2.9	-2.8	-1.6	-0.6
France	0.5	1.5	-1.6	-3.1
Italy	4.7	3.0	-0.7	. .
Japan	8.7	4.5	5.0	0.7
United States	-0.7	-1.2	-1.6	. .
Western Germany	4.9	1.5	-5.0	. .
Major six	**1.8**	**0.2**	**-1.3**	**. .**
Memo: United Kingdom	2.0	0.4	2.0	0.2

. . not available.

(a) Bank estimates for major six countries.

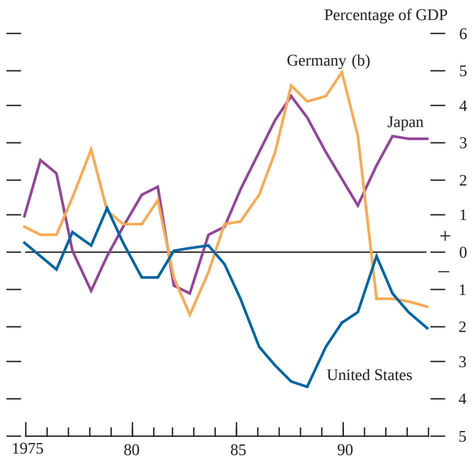
In Japan, consumer prices were unchanged in the year to August. It is possible that this measure overstates inflation, however, since discounting (which is widespread) is not fully recorded. Despite the large output gap in Japan, firms have not shed labour significantly: unemployment rose to 3% in July, compared with an average of 2.5% last year. This labour hoarding has led to rising unit wage costs, as shown in Table D. If output recovers in the second half of the year, there will probably be a cyclical recovery in productivity and a fall in unit wage costs (following other G7 countries' experience).

Futures markets imply that the turning-point for European interest rates is close

In the United States, the Federal Reserve increased short-term interest rates by 50 basis points in August, taking its federal funds target rate to 4.75%, compared with 3% in February. The 'real' federal funds rate, adjusted for current consumer price inflation, was 2% in the third quarter, compared with zero in the fourth quarter of last year. There has been speculation about the appropriate level of US interest rates; and officials at the Federal Reserve have occasionally referred to moving short rates back to more 'neutral' levels. Adjusted for current consumer price inflation, 'real' three-month interest rates were around 2% in the third quarter, compared with an average of $2^1/_2$% since 1970.

Official interest rates in Germany were unchanged in the third quarter. Rates in Italy and Sweden were increased by half a percentage point in August. Italian interest rates were increased partly to support the lira whereas the increase in Sweden was based on the outlook for inflation. After Sweden abandoned its currency peg to the Ecu in November 1992, the Riksbank announced an inflation target for the headline rate of 2% (with a range of plus or minus one percentage point) from January 1995. Import prices rose sharply last year and consumer price inflation also increased; both have been lower this year, though annual consumer price inflation rose from 1.7% in January to 2.5% in June.

Chart 12
Current account balances[(a)]



(a) First half of 1994 only.
(b) Western Germany before 1991.

By the end of the third quarter, financial markets appeared to be discounting higher interest rates in the G3 countries over the following year. Eurodollar futures prices, for example, implied a rise of half a percentage point in three-month dollar interest rates by the end of the year. Futures markets were discounting a similar rise in German rates over the same period, following strong second-quarter GDP figures and continued recovery. But futures prices are only a guide to the expected path of short-term interest rates; they did not, for example, accurately anticipate the cut in German short-term rates in May.

Japan's current account surplus stopped rising in the first half of the year

Chart 12 shows that German, Japanese and US current account imbalances are now smaller relative to GDP than they were in the late 1980s. Japan's surplus was 3% of GDP in the first half of the year, compared with 3.3% in the same period last year. The high value of the yen has slowly affected the Japanese current account. Import volumes have grown more quickly than exports for around 1½ years. But because export volumes are much larger, it will take time for changes in volume growth to cause a significant fall in the surplus. The surplus may, however, fall more quickly over the next 18 months if Japanese domestic demand picks up. The deficit may also fall because of rising imports from Japanese companies based in lower-cost centres in south-east Asia.

The US current account deficit was $37 billion in the second quarter, compared with $32 billion in the first. US competitiveness (as measured by the real effective exchange rate) has been broadly stable during the last 18 months, but the strength of domestic demand relative to that in the rest of the G7 has led to a rising deficit.

The US dollar depreciated by 2% (in trade-weighted terms) in the third quarter, and was 8% lower than at the end of 1993. This trade-weighted index does not, however, include Latin American countries' exchange rates, though last year they accounted for 17% of US exports. Measured against a wider group of countries—some of which have historically been subject to high inflation—the US dollar has not weakened as much. The dollar's depreciation against the major currencies meant that by the end of September it was around 11% lower than at the end of 1993 against both the Deutsche Mark and the yen. Its weakness against the yen partly reflected continuing concerns about the likelihood of progress in Japan-US trade talks; and concern about US inflation may have added downward pressure to the US currency. A box on page 315 looks at the financing of current account imbalances in Germany, Japan and the United States.

Higher economic activity will reduce cyclical budget deficits, and some governments have implemented policies to reduce structural deficits

Higher economic activity in the United States helped to cut the government's budget deficit by around a fifth between the 11 months of the fiscal year which ended in September and the same period in the previous year. Lower defence spending and last year's tax increases have also lowered the US deficit. As activity picks up elsewhere in the industrialised world, the cyclical parts of budget deficits should fall similarly. Falls in structural (or underlying) deficits will be slower. The OECD's June *Economic Outlook*, for instance, estimated that the (overall) deficit in European OECD countries would be 6.1% this year, compared with 6.3% last year.

A number of countries announced measures to cut deficits. In Germany, a rise in income tax—due to take effect in January—may raise an additional DM 22 billion (0.3% of this year's tax revenue). It follows a rise in mineral oil tax this year and higher value added tax last year. The OECD projects that Germany's general government structural deficit will fall from 5.2% of GDP in 1991 to 2.3% in 1994.

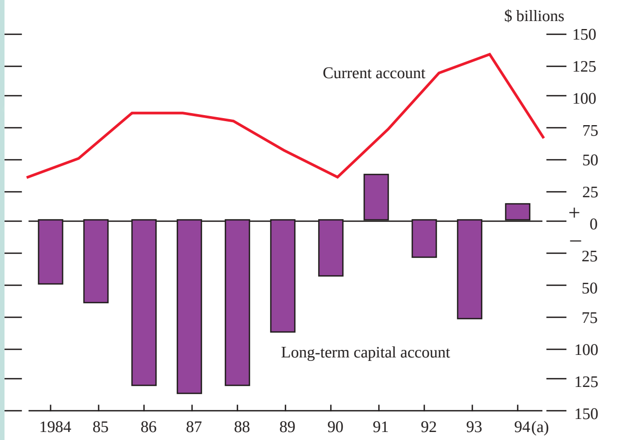
In its budget in September, the French government announced plans to cut the general government budget deficit from 5.3% of GDP this year to 4.6% next year. Public spending is to increase by 1.9%, probably implying no real growth. Increased revenue is projected to

The financing of G3 current account imbalances

Between 1990 and 1994, current account imbalances in Germany, Japan and the United States (the G3 countries) have been lower as a proportion of GDP than they were during the previous five years. This box looks at some of the cyclical and secular factors influencing the financing and recycling of current account imbalances. There is no reason to think that recent changes in the pattern of capital flows make current account imbalances any less sustainable.

Chart A shows that, in the first half of this year, Japan was a net *importer* of long-term capital, in contrast to its position over most of the last decade. The development mainly reflected a change in Japanese bond investment overseas and in foreign investment in the Japanese equity market. During the mid-1980s, Japanese investors were large purchasers of overseas bonds (particularly US Treasury bonds): between 1986 and 1989, Japanese net investment in overseas bonds was around $80–90 billion a year. It fell in 1992 and 1993, and in the first half of this year totalled $19 billion—the fall was partly a response to continuing currency losses as a result of the yen's appreciation.

Chart A
Japan: current and long-term capital accounts



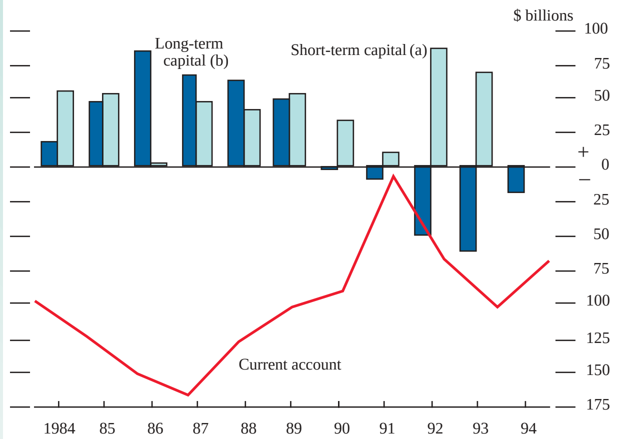
(a) First half.

Conversely, foreign investment in the Japanese equity market has risen since 1992—attracted by the rising yen (which provided capital gains) and, in the first half of this year, by the prospect of a growing economy and hence improved corporate profitability. In the first half of this year, net foreign investment in Japanese equities was $48 billion, more than in 1993 and 1994 put together.

Japan's net outflow of foreign direct investment has been lower between 1992 and 1994 than in the peak 1988–91 period, partly because of the weakness of foreign property markets. But its direct investment in the rest of Asia has increased as a share of total direct investment, as Japanese manufacturers—in response to the high yen—have shifted production to neighbouring countries with lower labour costs.

As Chart B shows, since 1992 the United States has been a net exporter of long-term capital—again in contrast to the mid-1980s, when its large current account deficit was offset by net inflows of long-term (and short-term) capital. Three factors help to explain recent developments. First, low US interest rates in 1992 and 1993 encouraged US investment in overseas markets to enhance nominal returns. Second, the fall in the US federal government deficit has meant that there has been less need to attract foreign capital to the US bond market. And third, as part of a longer-term trend, US investors may be investing elsewhere to diversify their portfolios.

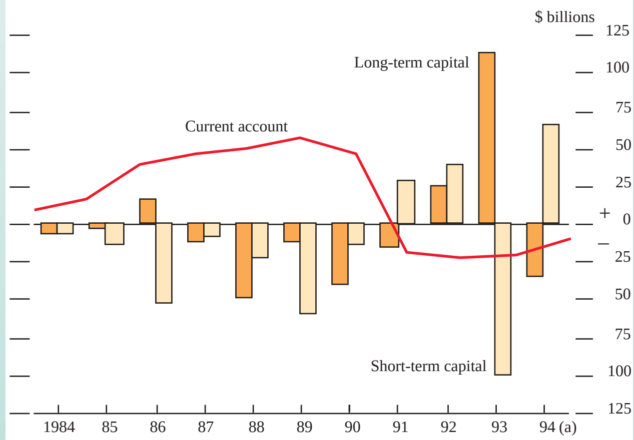
Chart B
United States: current and capital accounts



(a) Short-term capital data to 1993 Q3.
(b) Long-term capital and current account data to 1994 H2.

Chart C shows Germany's current and capital accounts. In 1993, long and short-term net capital flows rose sharply, with a large inflow of long-term capital and a large outflow of short-term capital. The flows were partly influenced by short-term interest rates: markets expected German short rates to continue falling, and this probably encouraged both an outflow of short-term capital seeking higher returns elsewhere, and an inflow of long-term capital as lower short rates were expected to lift bond prices and provide capital gains. During the first half of 1994, these flows have been partly reversed.

Chart C
Germany: current and capital accounts



(a) First half.

come from higher economic growth (forecast by the government at 3.1%), privatisation receipts (of FFr 55 billion, or $10 billion), and higher taxes on electricity, gas and petrol.

In July, the Italian government announced a three-year budget plan to cut its deficit from around $9^1/_2$% of GDP this year to $6^1/_2$% in 1996. Despite the plan, however, the lira depreciated during August and the Bank of Italy raised short-term interest rates partly to support the currency. Bond yields rose by around a percentage point in the third quarter. Because Italian government debt is of short average maturity, the rise in interest rates will add significantly to debt-servicing costs.

The Spanish government's budget for 1995 aims to cut the general government budget deficit to 5.9% from 6.7% of GDP this year. The projection relies largely on higher economic activity to boost revenue. Unemployment, at over 24% in the second quarter, will continue to impose high costs on the deficit.

In Japan, the government budget surplus was 0.3% of GDP last year; and the OECD projects a deficit this year. Excluding the social security surplus, the deficit to GDP ratio may be around 3–4 percentage points higher. Since August 1992, four fiscal packages totalling ¥45 trillion have added to the deficit (though the size of the stimulus has been less than the headline figure suggests). The weakness of the economy has also reduced tax revenues. The income tax cuts in June and December this year will reduce revenues by ¥5.5 trillion. The government plans to maintain these tax cuts in 1995 and 1996, but ¥2 trillion will be reversed in 1997. Japan's sales tax—which is low compared with other OECD countries—may be increased from 3% to 5% in 1997, but this is subject to review. Japan is the only G7 country which has recently announced a loosening of fiscal policy, but (based on IMF data) it is probably also the country with the largest output gap. It has, in addition, by far the lowest level of net government debt relative to GDP among the G7.

Canadian government sector debt, at more than 90% of GDP in 1993, is the second highest in the G7. The federal government's budget in February forecast that the federal deficit would fall from 5.4% of GDP this year to 3% by 1996/97. The prospects for achieving this depend partly on the level of interest rates; interest costs accounted for around a quarter of government spending in 1992/93. The budget assumed long-term interest rates of 6.4% in 1994 and 6.1% in 1995. In the first nine months of the year, ten-year Canadian bond yields averaged 8.3%. Apart from interest costs, unemployment benefits are one of the largest areas of spending and, as part of a review of the social security system, the government is changing the unemployment insurance system. In addition, if growth this year is higher than anticipated, the deficit may be lower.