The international environment

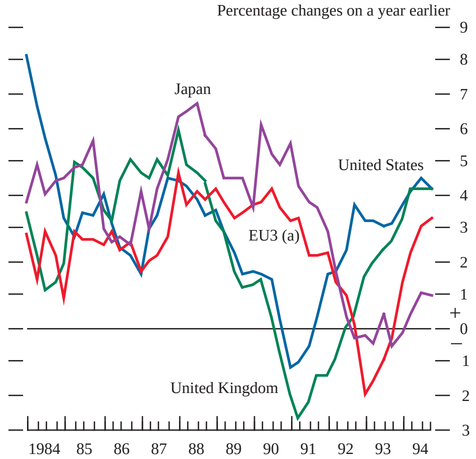
- *In the fourth quarter of 1994, GDP growth was strong in the United States, but slowed in France and western Germany. US growth may have weakened early this year after the sharp rise in interest rates last year. The earthquake in Japan will have affected its growth in the first part of 1995; its impact in the longer term is uncertain, but probably less important than prospects for the real exchange rate.*

- *Non-oil commodity prices, in dollar terms, rose by 3% in Q1. Metal prices fell sharply in February, but the fall was offset by other commodity price rises. Oil prices rose by less than non-oil prices.*

- *Producer price inflation has risen further, reflecting the effect of earlier increases in raw material prices and, in some cases, lower exchange rates. Consumer price inflation has remained low.*

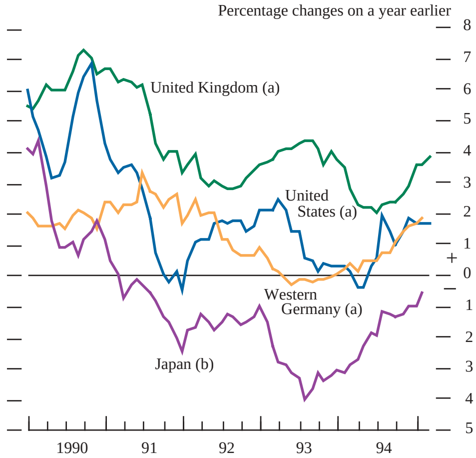
- *The exchange rate movements of recent months have affected the economic background. The effects on growth and inflation will depend largely on why they have occurred and where rates settle.*

Chart 1
GDP in the major economies



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

Chart 2
Producer prices in the major economies



(a) Output prices.
(b) Wholesale prices (includes prices for exports, unlike other series).

Overview

In the major overseas economies, growth continued in the fourth quarter of last year. In the United States it strengthened, but in France and western Germany the rate of growth was lower than earlier in the year. In Japan, where recovery is still at an early stage, output fell in the final quarter.

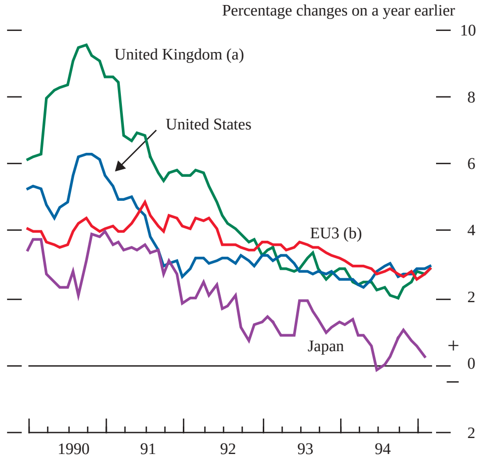
In the fourth quarter, GDP in the Group of Seven (G7) economies as a whole rose by 0.6%, compared with 1% in the third. In the United States, GDP rose by 1.2%, its fastest rate last year. In France and western Germany, it rose by 0.6% and 0.7% respectively. In Japan, output fell by 0.9%, and was 0.9% above its recent trough: this was similar to the position of other G7 countries at the same point in their recoveries, but sluggish by Japanese standards. Chart 1 shows that, by the fourth quarter, all the major economies except Japan were growing at around 3%–4% a year.

In the United States, growth remained broadly based: consumption and investment both rose strongly in the fourth quarter. In France and western Germany, by contrast, personal sector spending has remained weak for this stage of the economic cycle. High unemployment may be preventing a faster recovery in the French personal sector. In western Germany, the tax rises that took effect in January may have curtailed growth in consumer spending.

While growth continued into the first quarter, producer price inflation showed no sign of falling from the rates reached last year (see Chart 2). But consumer price inflation has remained low in most economies (see Chart 3): in the G7, it was 2.3% in the year to February, compared with 2.2% in December. In Italy, annual inflation rose in the first quarter.

As growth continued above its long-run potential rate and producer price pressures remained high, the US Federal Reserve increased its target federal funds rate by 50 basis points in February, taking

Chart 3
Consumer prices in the major economies



(a) RPIX measure.
(b) A GDP-weighted average of France, Italy and western Germany.

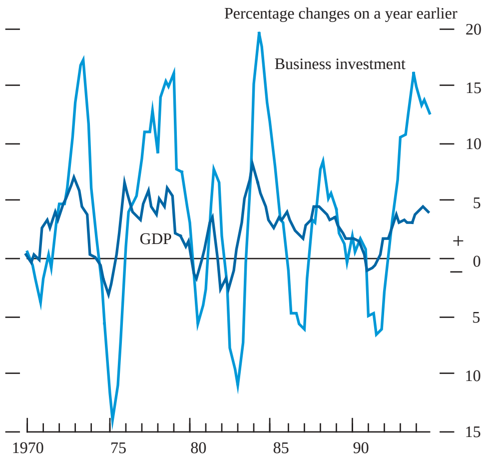
Table A
Contributions to US GDP growth

Percentage points (a)

	1993 Year	1994 Year	Q3	Q4
Consumption	2.2	2.4	0.5	0.8
Total investment	1.6	2.0	0.3	0.5
Government expenditure	-0.1	-0.1	0.3	-0.2
Stockbuilding	0.3	0.6	—	-0.1
Domestic demand	**4.0**	**4.8**	**1.1**	**1.1**
Net external trade	-0.8	-0.7	-0.1	0.2
GDP	**3.1**	**4.1**	**1.0**	**1.2**

(a) Quarterly contributions are relative to the previous quarter. Components may not sum to total because of rounding.

Chart 4
United States: GDP and business investment



interest rates to a level three percentage points higher than twelve months earlier.

In the early part of the first quarter, interest rates were also increased in Belgium, Canada, Denmark, France, Italy, Spain, Sweden and the United Kingdom. Some of the rises in Europe were in response to exchange rate weakness. In March, the central rates of the Spanish peseta and Portuguese escudo were devalued within the exchange rate mechanism (ERM)—by 7% and 3½% respectively.

In the United States, the yield curve flattened during the first quarter, as market perceptions that US official interest rates might be near to their peak strengthened. This was one factor contributing to the dollar's weakness—and the accompanying strength of the Deutsche Mark and the yen—in the first part of this year.

Later in the quarter, following subdued M3 growth and the strengthening exchange rate (which offset some of the pressure from rising raw material prices), the Bundesbank lowered its discount rate by 50 basis points—the first cut in the rate since June 1994—and its repo rate by 35 basis points. Austria, Belgium, Denmark, France, Greece, the Netherlands and Switzerland subsequently cut official rates.

Early in the second quarter, the Bank of Japan cut its official discount rate by 75 basis points to a new low of 1%. The cut was announced on the same day as an emergency fiscal package and was aimed partly at alleviating some of the effects of the strong yen.

Following the devaluation of the Mexican peso in December, the United States and the IMF announced rescue packages of $20 billion and $17.8 billion respectively in the first quarter. The packages, together with a new economic programme in Mexico, helped to support the peso and the Mexican equity market in March. Estimates of the overall impact of the Mexican crisis vary widely, but if there were to be a sustained adverse effect on other emerging markets, world trade growth could be affected significantly.

The United States grew by around 4% last year, but growth probably fell in the first quarter

In the United States, GDP rose by 1.2% in the fourth quarter, compared with 1% in the previous two quarters. As Table A shows, consumption and investment both contributed strongly to the rise. Overall last year, business investment rose by 14%. As Chart 4 shows, this increase in business investment relative to GDP is not out of line with previous cycles.

In the past few months, there has been the first significant evidence that in parts of the US economy growth may be slowing. In the first quarter, employment growth was weaker than in the second half of 1994 and retail sales fell by 0.3%—the first fall for two years. Other indicators of activity have slowed less. Industrial production rose by 1.2% in the first quarter and although capacity utilisation stopped rising, it was still about four percentage points above its 25-year average.

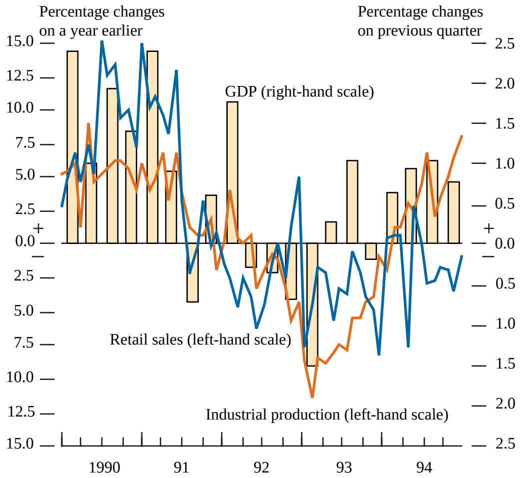
It would be surprising if US economic growth did not slow down this year. Interest rates were increased sharply in 1994, and after two years in which GDP grew at above the rate of growth of productive capacity, some sectors of the economy are likely to hit capacity constraints. A key question is by how much growth will slow; it is possible that it will remain above the growth rate of productive capacity (estimated to be around 2½% per year) this year.

France, western Germany and Italy each grew by 2%–2½% last year

The major continental European economies grew at similar rates last year. But the composition of their recoveries differed; the box on page 142 looks at the differing pattern of recovery in the major economies.

In western Germany, GDP rose by 0.7% in the fourth quarter, compared with 1% in the third. Net external trade accounted for all of the rise in the fourth quarter. Domestic demand was flat: private consumption fell by 0.2%, investment rose, and stockbuilding—which had boosted growth earlier in the year—reduced growth. Despite the sharp rise in net exports in the quarter, the west German recovery has not been export-led: between the first quarter of 1993 (the trough in GDP) and the fourth quarter of 1994, net exports (including to eastern Germany) accounted for only about a fifth of the rise in GDP.

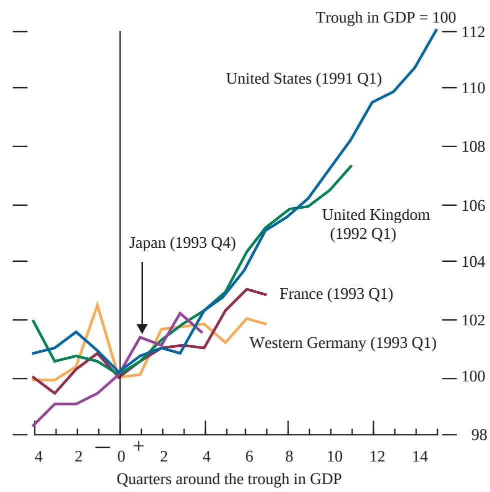
Chart 5
Western Germany: activity indicators



In the year to the fourth quarter, consumption made no contribution to growth, although the rest of the economy grew strongly. Chart 5 shows the divergence in economic activity in western Germany: retail sales growth has been weak but industrial production buoyant.

In eastern Germany, GDP rose by around 9% last year, with construction and manufacturing growing strongly. Unemployment averaged around 16%. Productivity growth continued at high rates, narrowing the differential with western Germany; eastern German productivity rose to around 45% of that in western Germany. Government net transfers to eastern Germany remained more than 50% of its GDP.

Chart 6
Consumption over the cycle(a)

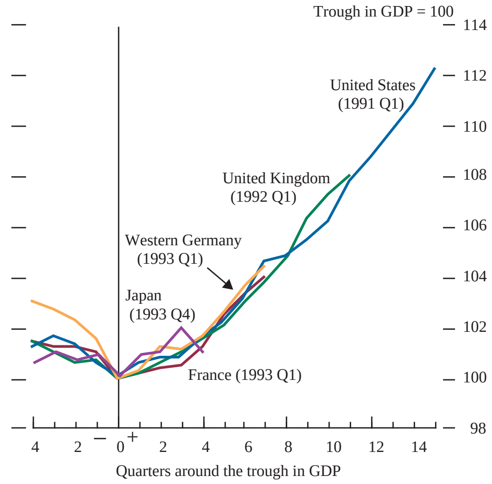


(a) Dates shown in brackets indicate the quarter in which the trough in output was reached.

In France, GDP growth was also weaker in the final quarter than in the middle of the year: output rose by 0.6% in the quarter, with domestic demand and net trade contributing equally. Business investment rose by 1.8%, but household consumption fell. Chart 6 compares French and western German consumption over the cycle with that in the United Kingdom and the United States. Consumption in these two continental European countries has not recovered as quickly. In France, most of the growth in consumption took place in the first half of last year, perhaps suggesting that, as the effect of government stimulus to the car market has faded, 'underlying' consumption has remained weak. Two main factors probably lay behind this weakness: high unemployment and slow growth in disposable income. Unemployment in France fell slightly in January to 12.3%, but most of the fall was among those aged under 25 (partly because of government schemes). The unemployment rate for those aged between 25 and 49 has not fallen as quickly—and it is this group which generally has a high propensity to consume.

By contrast, in Spain GDP rose by 0.8% in the fourth quarter—its highest for the year. Private consumption rose by 0.6%, having

Chart 7
GDP over the cycle(a)



(a) Dates shown in brackets indicate the quarter in which the trough in output was reached.

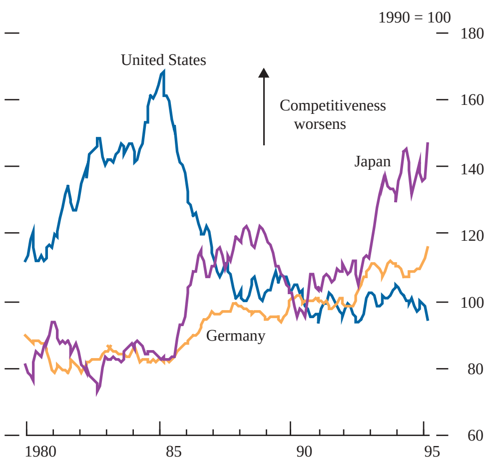
Table B
Contributions to Japanese GDP growth

Percentage points (a)

	1993 Year	1994 Year	Q3	Q4
Consumption	0.6	1.3	0.7	-0.4
Total investment	-1.8	-1.2	0.1	-0.2
Government expenditure	1.3	0.6	0.2	—
Stockbuilding	-0.2	0.2	—	0.1
Domestic demand	**-0.1**	**1.0**	**1.0**	**-0.6**
Net external trade	-0.2	-0.4	-0.1	-0.3
GDP	**-0.2**	**0.5**	**0.9**	**-0.9**

(a) Quarterly contributions are relative to the previous quarter. Components may not sum to total because of rounding.

Chart 8
G3 real exchange rates(a)



(a) Nominal effective exchange rates adjusted for changes in relative consumer prices. The figures used for March are derived from changes in the nominal effective exchange rate only.

strengthened throughout last year after export-led growth earlier in the recovery. In the year as a whole, consumption rose by nearly 1%, compared with a fall of 2% in 1993. And the visible trade deficit, which fell by around 2% of GDP in 1993, was broadly unchanged last year. As in Italy, however, the corporate sector has probably been more buoyant than the personal sector; Italian and Spanish industrial production each rose by around 14% in the year to January. The depreciation of both countries' currencies in the first part of this year may further support export industries.

Japan's output fell in the fourth quarter and was adversely affected by the earthquake early in 1995

In Japan, GDP fell by 0.9% in the fourth quarter, offsetting the rise in the third quarter. In 1994 as a whole, Japan's GDP rose by 0.5%, compared with a fall of 0.2% in 1993. The fall in the fourth quarter has led some commentators to question the strength of the Japanese recovery, particularly in view of the high real interest rates, rising real exchange rate, and falling or weak asset prices. But although the fall in GDP was large, the rise in output since the trough has been similar to that in other G7 countries at the same point in their recoveries (see Chart 7). Nevertheless, by Japanese standards, the recovery has been slow.

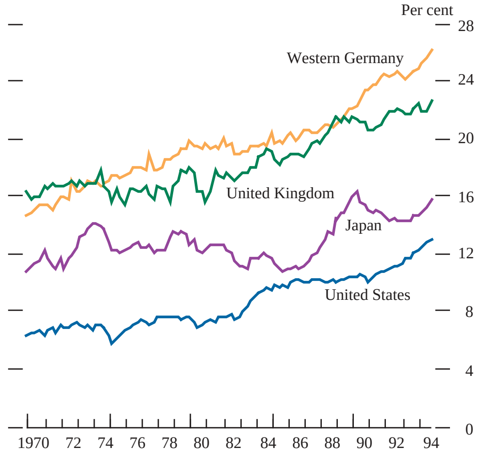
Table B shows the contributions to Japanese GDP growth. In the fourth quarter, consumption fell, having risen strongly in the third quarter following tax rebates in June. Over the year as a whole, it rose by 2.2%. There were further tax rebates in December, but their impact on consumption may have been offset in the first part of this year by the effects of the Kobe earthquake.

Business investment rose in the fourth quarter, as in the third, consistent with the modest recovery in confidence seen in the Tankan survey. It remained below its pre-recession peak, however. Manufacturing firms expected profits to rise sharply in the 1995/96 fiscal year, although investment intentions were, on balance, still negative. Some of the firms worst affected by the Kobe earthquake were excluded from the survey. The Tankan survey was conducted when the exchange rate was ¥99 per dollar, compared with an average rate of ¥96 in the first quarter (and an end-quarter rate of ¥86). Many Japanese firms report that it is very difficult to compete at such a high exchange rate, and in the first quarter there were further anecdotal reports of severely affected profits and sales, and of further production being shifted overseas.

The short-term effects of the earthquake on economic activity are becoming clearer. Industrial production fell in January, though inventories rose (partly because of the difficulties with transportation and distribution networks); according to the Ministry for International Trade and Industry, about half of the fall was due to the earthquake. But production more than fully recovered in February. Kobe is one of Japan's largest ports, and in January whole-economy export and import growth fell. Because of the presence of spare capacity at other ports, however, the earthquake's effect on the trade balance may be short-lived. Consistent with this, export and import growth rose in February.

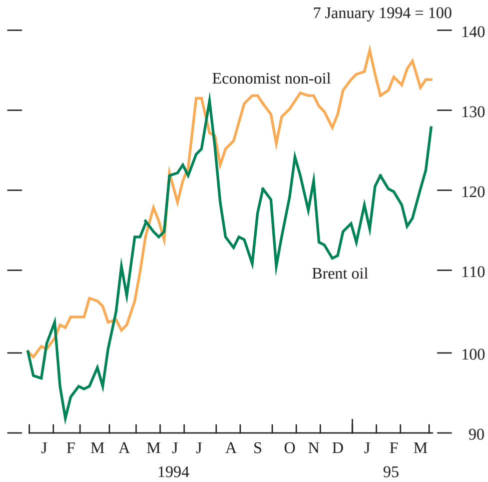
The longer-term economic effects of the earthquake are less clear. Overall, activity in the first part of the year will probably be weaker

Chart 9
Import penetration(a)



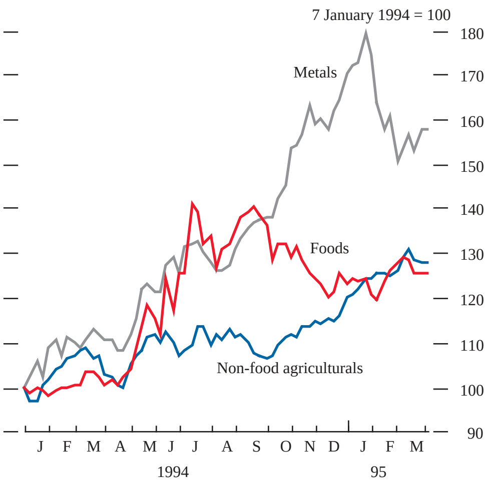
(a) Imports as a percentage of total final expenditure, in constant prices.

Chart 10
Commodity prices(a)



(a) In dollars.

Chart 11
Non-oil commodity prices(a)



(a) The Economist's sub indices in dollars.

than it would have been, but this may be reversed later as reconstruction begins. Because of 'multiplier' effects from increased spending, the net long-term effect may be to stimulate economic activity mildly.

In the fourth quarter, Japan's current account surplus fell to 2.5% of GDP, compared with 2.9% a year earlier. The US deficit rose, however, as strong import growth offset export growth. Recent changes in exchange rates have affected the outlook for current accounts. Chart 8 shows that Japan's competitiveness has worsened over a long period. In the past, Japanese exporters may have been able in part to offset this by cutting costs, shifting some production overseas and improving non-price competitiveness (such as the quality of goods and after-sales service). The dollar's real effective exchange rate—in contrast to the widely-held view of dollar weakness—has been broadly stable for seven years.

The volatility of exchange rates in the early part of this year may affect the macroeconomic outlook in some countries; the sharp changes in exchange rates in 1992—and subsequent changes in real exchange rates—had a significant impact on European trade. The box on page 144 looks in more detail at trends in current account balances and competitiveness. If this year's nominal exchange rate changes are followed by persistent changes in real exchange rates, trade volumes might also be affected.

Large exchange rate changes can add to domestic price pressures through the prices of imported goods. The extent of these additional pressures will depend partly on the importance of imported goods in an economy. Chart 9 shows the proportion of total final spending accounted for by imports in a number of countries. Because of relatively low (though rising) import penetration, the Japanese and US economies are more sheltered than European countries from imported good price pressures.

Metal prices fell in the first quarter, but other commodity prices were firm

Non-oil commodity prices, as measured by the Economist's dollar-denominated index, rose by 3% in the first quarter; a sharp fall in metal prices was offset by rising non-food agricultural prices. Oil prices were broadly unchanged in the quarter, but rose sharply in early April. Chart 10 shows the path of oil and non-oil commodity prices since the beginning of last year; since September, non-oil prices have been on an gentle upward trend.

Chart 11 shows the three main components of the Economist's non-oil index. Metal prices rose sharply last year, after a long period of weakness. The price rises were linked to stronger than expected industrial demand and also, perhaps, to an inflow of new money into metal futures markets. The fall in metal prices in February followed evidence that the US economy slowed in January. Some of the new money invested in metal markets last year may have shifted out on this news.

Although metal prices fell sharply, by the end of the first quarter they were still 40% higher than a year earlier. And non-food agricultural prices rose in the first part of the year, supported partly by higher cotton prices following poor harvests and higher demand. So although lower metal prices will help to ease some firms' raw

Output in the major economies during recovery

The composition of the recovery in the major economies by categories of expenditure (consumption, investment etc) was considered in the last *Bulletin*.[1] This box analyses activity in this recovery by sector, making cross-country and cyclical comparisons.

Services account for around 55%–70% of GDP in the major economies, compared with industrial production's share of only 20%–35%. The UK economy lies at about the middle of both ranges. Over the last 20 years, services have become a slightly larger component of GDP in all major economies, at the expense of industrial production.

The table below compares the falls in output in the two sectors during the last recession (and the previous one). As it suggests, the output of services is generally less cyclical than industrial production in the major economies. This may partly reflect the inclusion in services of government activities that are typically countercyclical. The output of services has grown steadily in all the major economies during the recovery, in line with previous cyclical experience.

Cyclical falls in sectoral output[a]

Per cent

	Industrial production		Services	
France	3.8	*2.7*	1.0	*0.5*
Italy	5.0	*7.7*	—	—
Japan	13.5	*2.5*	2.0	*1.6*
United Kingdom	6.4	*12.7*	2.0	*1.6*
United States	3.4	*8.1*	—	*3.2*
Western Germany	10.7	*10.0*	0.2	—

(a) Falls in output from sector's peak to trough in the last cycle; sectoral falls in previous cycle given in italics. — indicates no fall.

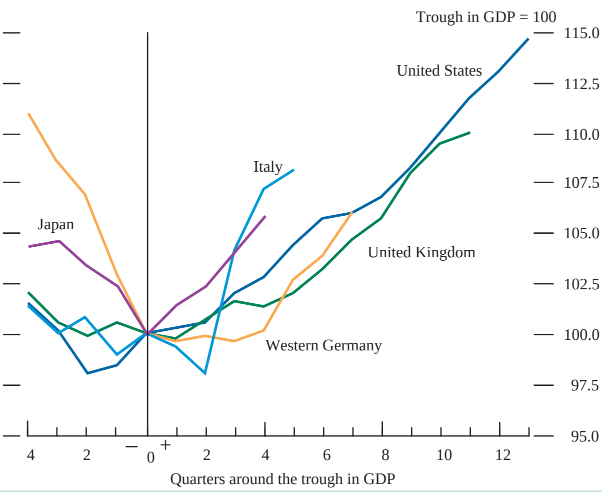
In the United Kingdom and the United States, the fall in industrial production was less in the recent recession than in the previous one. This probably reflected the significant improvements in the two countries' trade balances—caused by changes in relative demand—during the latest recession. The two countries were the first major economies to enter recession and so external demand helped offset falls in internal demand. By contrast, at the time of the early 1980s recession real exchange rate appreciations of sterling and the dollar may have exacerbated the fall in industrial output.

Growth in industrial production in the major economies has risen rapidly in recent quarters, but this is not out of line with previous experience. The chart shows industrial production around the trough in GDP in five of the G7 economies. In Italy, the recovery in production has been particularly quick, reflecting a significant improvement in competitiveness in 1992. It followed a similar path in its 1970s recovery, which was also preceded by a large exchange rate depreciation. Industrial production in Japan has also been recovering more rapidly than in most other economies, though its recovery began more recently. The speed of recovery may reflect the bigger fall in industrial production during recession than elsewhere.

The construction sector has so far recovered little in all the major economies. In the United Kingdom and United States, the sector's fortunes have contrasted sharply with the early 1980s, probably reflecting the sharp property market falls in the late 1980s. In the United States, construction started to recover more strongly last year, but recently higher interest rates may have reduced growth: private housing starts fell significantly in the first part of this year, after reaching a peak at the end of 1994. The sector remains very subdued in western Germany and France, though this is not out of line with previous cyclical experience. In Japan, construction has also been affected by the end of the speculative bubble in the late 1980s; reconstruction after the Kobe earthquake may mask a continuing underlying weakness in the sector in the next couple of years.

Given the likelihood of continued steady growth in services this year and next, any changes in GDP growth will be largely determined by the outlook for construction and industrial production. Higher interest rates and capacity constraints are likely to slow growth in these two sectors in the United States. A recovery in continental European construction may contribute to a strengthening recovery there in the next two years.

Industrial production in recovery



(1) See the box on page 17 of the February *Quarterly Bulletin*.

Chart 12
United States: producer prices

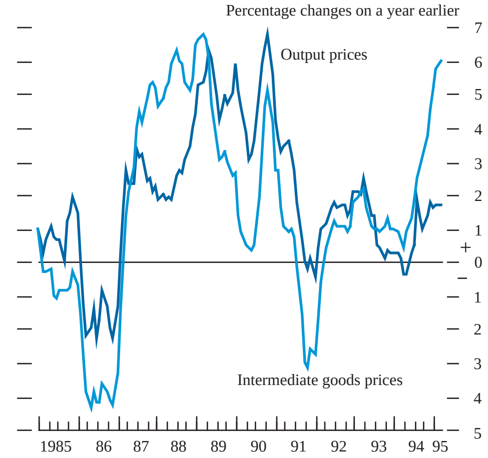


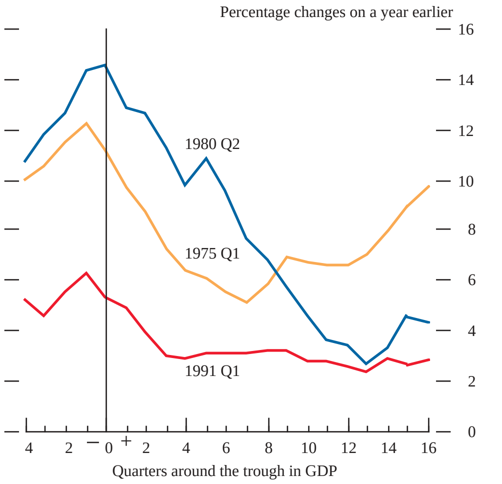
Table C
Unit wage costs in manufacturing(a)

Percentage changes on a year earlier

	1993 Year	1994 Year	Q3	Q4
Canada	-2.8	-2.4	-3.4	-3.2
France	3.5	-0.9	-2.0	-1.7
Italy	3.0	-3.6	-5.2	-6.5
Japan	4.5	-0.8	-4.0	-4.6
United States	-1.2	-0.9	-1.1	-1.0
Western Germany	2.0	-7.1	-7.8	-7.4
Major six	**0.5**	**-2.6**	**-3.6**	**-3.6**
Memo:				
United Kingdom	0.6	-0.2	-1.5	-0.7

(a) Bank estimates for major six countries.

Chart 13
United States: consumer prices over recent cycles(a)



(a) Dates shown indicate the quarter in which the trough in output was reached.

material price pressures, by mid April there was no evidence of an easing in overall commodity price pressures.

Producer price inflation has risen further in some countries

Firm raw material prices and, in some cases, upward pressure on unit wage costs have put further pressure on producer prices. Pressures have been strong at intermediate stages of production, but producer output price inflation has not risen as sharply. As Chart 12 shows, in the past there has been a strong link between intermediate goods price inflation and output price inflation in the United States. The relationship has been less strong in recent months, suggesting that there may have been a fall in profit margins.

Because nominal earnings growth has been weak throughout the G7, cyclical improvements in labour productivity have helped to keep unit wage cost pressures weak (see Table C). In the fourth quarter, the smallest falls in unit wage costs were in the United Kingdom and the United States; these two countries were among the first to recover, so cyclical productivity improvements might be expected to fade there first.

Consumer price inflation was generally subdued in the first quarter

Consumer price inflation generally remained low in the G7 economies in the first quarter of the year. The annual rate of consumer price inflation averaged 2.3% in February, compared with 2.2% in December. But rates of inflation have begun to rise in some countries (including some outside the G7).

In the United States, consumer price inflation remained low in the first quarter. The US economy has now been growing for four years. At the same point in the last two recoveries, consumer price inflation was higher—as Chart 13 shows. Probably one reason why US inflation has not risen as much during this recovery is that global growth was initially lower this time, putting less upward pressure on import and raw material prices. Increased competition, particularly in the retail sector, may also be a factor keeping inflation lower in this recovery.

In western Germany, the annual rate of consumer price inflation fell sharply in January, as indirect tax increases last year fell out of the year-on-year comparison. Underlying consumer demand pressures seemed to remain weak, following further tax increases in January. But the wage settlement agreed with IG Metall—usually a benchmark for subsequent agreements—was at the upper end of expectations.

The IG Metall deal was worth around 4% in 1995, compared with 1% last year. But manufacturing labour productivity may have risen by 10% or so in western Germany last year, and real personal disposable incomes fell in 1993 and 1994. The agreement also fixed wage growth for 1996 at 3%, which may reduce uncertainty in the run-up to next year's wage round. The risks of rising inflation in Germany have been partly offset by the strength of the Deutsche Mark (though the short-term effects of its appreciation may be reduced by invoicing in Deutsche Marks, which covers perhaps a half of all imports).

French inflation was unchanged at around 1.7% in the first quarter, broadly the same as in the second half of last year. And because

Recent current account trends

Current account imbalances in the major economies have changed quite sharply in the past few years—as the table shows. This box analyses the recent trends. Changes in both relative demand and competitiveness help to explain current account trends. But in view of the volatility of currencies in the first part of this year, the box focuses mainly on the role of exchange rates and competitiveness.

Current account balances

As a percentage of GDP

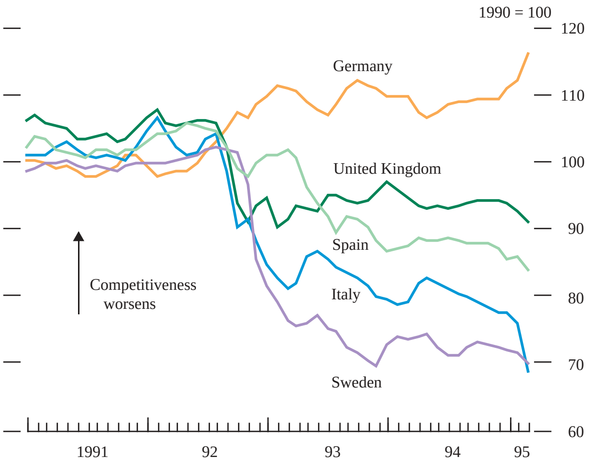
	1992	1993	1994 (a)
Canada	-3.9	-4.3	-3.3
France	0.3	0.8	0.7
Germany	-1.2	-1.2	-1.9
Italy	-2.3	1.1	1.4
Japan	3.2	3.1	2.8
Spain	-3.0	-0.5	-0.9
Sweden	-3.5	-2.1	0.4
United Kingdom	-1.6	-1.9	—
United States	-1.1	-1.6	-2.3

(a) First three quarters for France, Italy and Spain.

Changes in US, Japanese and German real exchange rates, measured using nominal effective rates adjusted for relative changes in consumer prices, are shown in Chart 8 on page 140. The most significant recent change has been for Japan, where the real exchange rate appreciated by around 30% in the two years to March. Germany's real exchange rate rose by less and the US real rate has fallen, but only gently. The relative stability of the dollar's real exchange rate, despite the currency's weakness against the Deutsche Mark and the yen, reflects both its appreciation against the Canadian dollar and a higher rate of consumer price inflation than in some of its major competitors, particularly Canada and Japan (which account for 55% of the weight in the US effective exchange rate).

Within Europe, some countries' real exchange rates fell sharply after the ERM crisis in 1992, as the chart shows. In the 2½ years after September 1992, Italian, Spanish and Swedish rates fell by at least 20%. Sterling's real exchange rate fell by around 10% over the same period, while French and German real exchange rates appreciated. These changes in competitiveness have contributed to changes in current account balances, and within Europe those countries whose real exchange rates fell most have experienced the greatest improvement in the last few years. Between 1992 and 1994, for instance, Italian and Swedish current accounts improved by around 4% of GDP, compared with 2% in Spain and around 1% in the United Kingdom.

European real exchange rates(a)



(a) Nominal effective exchange rates adjusted for changes in relative consumer prices. The figures used for March are derived from changes in the nominal effective exchange rate only.

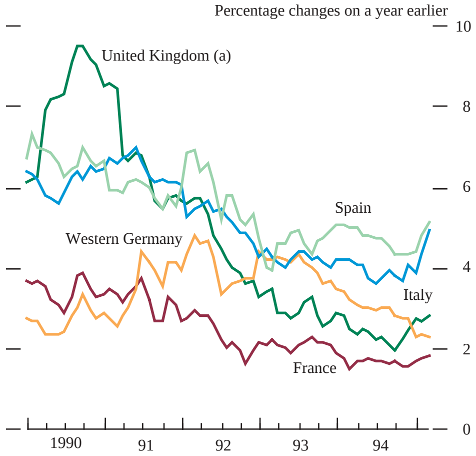
Germany's current account deficit rose in 1994, largely because of a sharp fall in its balance on interest, profits and dividends, which may have reflected its currency appreciation. In France, the current account moved into surplus in 1992 and, by the third quarter of last year, this was around 0.8% of GDP. This partly reflected the weakness of French demand relative to its major competitors, but also an improvement in the terms of trade following the franc's appreciation.

The US current account deficit rose from 2% of GDP in the first quarter of 1994 to 2.6% by the fourth. The rise was mainly the result of a rising visible trade deficit stemming largely from the strength of US relative demand. US domestic demand rose by 4½% in 1994, compared with 2%–2½% in the rest of the G7; US import volumes rose strongly, by 13%. Export volumes also rose—partly in response to improved competitiveness—but by less than import volumes. If domestic demand grows by less in the United States than in its competitors this year, the US current account deficit may stop rising. But the dollar's appreciation against the Canadian dollar and Mexican peso over the last year may partly offset the effects of any changes in relative demand.

Japan's current account surplus fell by 10% in yen terms last year. The yen's strength over the last few years has affected trade volumes. But the fall in the surplus to date has been less than after the currency's sharp appreciation between 1985 and 1987. A rise in Japanese relative demand would reinforce the effects of the rising real exchange rate.

In recent years, Canada has had the largest current account deficit in the G7: over the last ten years or so, it has averaged more than 3% a year. Its visible balance has, however, been in surplus for most of the last 20 years (and this is likely to be reinforced by recent improvements in competitiveness). The main counterpart to its current account deficit has been a high public sector deficit and consequently there has been a large net outflow of interest, profits and dividends, reflecting the high level of foreign-held debt.

Chart 14
Europe: consumer prices



(a) RPIX measure.

unemployment remains high, there may be few wage pressures in France this year. In Italy, inflation increased in the first quarter. Consumer prices rose by 4.9% in the year to March, compared with a low of 3.6% last year; indirect tax increases explained part of the rise this year. Chart 14 suggests the beginnings of a divergence in the inflation rates of the major continental European countries.

Broad money growth remained weak in a number of major countries

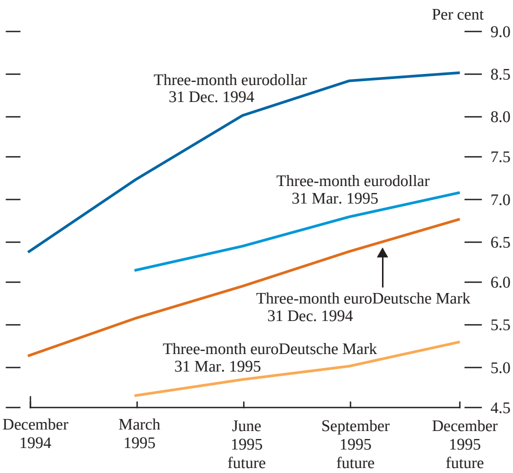
In the United States, annual growth of M2 was 1% in the first two months of the year, weaker than in the early part of last year. Bank lending growth has continued to be much stronger than broad money growth and eased little in the first part of the year, suggesting that the economic slowdown was modest.

In Germany, broad money growth slowed in the early part of this year. In February, annualised growth in M3 since the fourth quarter of 1993 was 3.7%; this compared with a target range of 4%–6% for growth between the fourth quarters of 1994 and 1995. The slowdown in M3 was partly the result of a switching out of M3 deposits into longer-maturity assets. The Bundesbank also monitors an extended M3 aggregate, which includes, among other things, money-market funds. Extended M3 growth also fell in the first months of the year.

In Japan, annual growth of M2 plus CDs was higher in the first quarter than last year. Part of the rise may have been the result of an increased demand for cash after the Kobe earthquake. Bank lending was broadly unchanged in the year to February, although there was some increase in the level of corporate bonds and commercial paper outstanding in the final months of last year.

US interest rates were increased further, but German and Japanese rates were cut

Chart 15
US and German interest rates(a)



(a) Three-month interest rates implied by futures prices.

In response to high growth towards the end of last year and further intermediate goods price pressures this year, the Federal Reserve raised its target federal funds rate to 6% in February. Subsequent statements by Federal Reserve officials, and evidence that growth was slowing in the first quarter, led market expectations of future US interest rate rises to be revised downwards. Chart 15 shows the change in the three-month interest rates implied by eurodollar and euroDeutsche Mark futures contracts between 31 December and 31 March.

The change in interest rate expectations during the first quarter was probably only a partial explanation of the subsequent weakening of the dollar. The rise in the US visible trade deficit in January and the failure to pass the ‘balanced budget amendment’ in March may also have affected market confidence, by focusing attention on two key structural factors (the current account and fiscal deficit) affecting the supply of dollars on world markets.

The strength of the Deutsche Mark in the early part of the quarter led to strains within the ERM. In Belgium, Denmark, France, Ireland, Italy, Portugal and Spain, official interest rates were increased, partly to support currencies. And in March, the Spanish peseta and Portuguese escudo were both devalued. Towards the end of March, the Bundesbank cut its discount rate by 50 basis points to 4% and its repurchase rate by 35 basis points, citing low M3 growth and the strength of the Deutsche Mark—which had reduced some of the threat from higher commodity prices—as justifications for the cut. Austria, Belgium, Denmark, France, the Netherlands and Switzerland subsequently cut official rates. (The exchange rate developments in the first quarter are discussed in detail in the review of the operation of monetary policy on pages 125–36.)

Early in the second quarter, the Bank of Japan cut its official discount rate by 75 basis points, the first cut since September 1993. Japanese inflation was 0.2% in the year to February, but some analysts suggested that prices were falling by 2% a year because of widespread and unrecorded discounting. Adjusted for current inflation, therefore, Japanese interest rates were still high by international standards and for this stage of the recovery. (They were around the same level as US official interest rates adjusted for US inflation.) And because of the yen's real appreciation of around 30% over the past two years (including the sustained upward pressure in recent months), Japan's overall monetary policy stance has been tighter than the level of real interest rates suggests.

Fiscal deficits remained high in some countries

After the devaluation of the Mexican peso in December, and subsequent currency tensions elsewhere this year, the prospects for fiscal policy may have become a more important influence on market behaviour. Stronger growth in most European countries should help to cut the cyclical part of fiscal deficits this year, but structural imbalances are still large. Higher interest rates would add to funding costs and countries with high debt, short average debt maturities (such as Italy) or a high proportion of floating-rate debt (such as Canada) would be affected most.

In Italy, this year's fiscal plans were supplemented with a mini-budget of Lit 20 trillion (1.2% of GDP), introduced partly because of higher funding costs following interest rate increases. The OECD estimates that a one percentage point rise in interest rates at all maturities increases the government deficit by 0.4% of GDP in Italy and 0.3% in Canada, the highest in the G7 (see Table D). It also estimates that budget deficits in Belgium, Greece, Portugal and Sweden would increase by at least 0.3% of GDP.

In Canada, the budget announced in February included large spending cuts (including cuts in federal transfers to the provinces), higher business taxes and privatisations. The budget was based on higher long-term interest rate projections than those of many outside forecasters.

Table D
Effect of an interest rate rise on government deficits(a)

Increase as a percentage of GDP

Canada	0.3
France	0.1
Germany	0.1
Italy	0.4
Japan	0.1
United States	0.1
Memo:	
United Kingdom	0.1

Source: OECD December 1994 *Economic Outlook*.

(a) The estimated effect of a one percentage point increase in interest rates at all maturities on government deficits in 1995.