The international environment

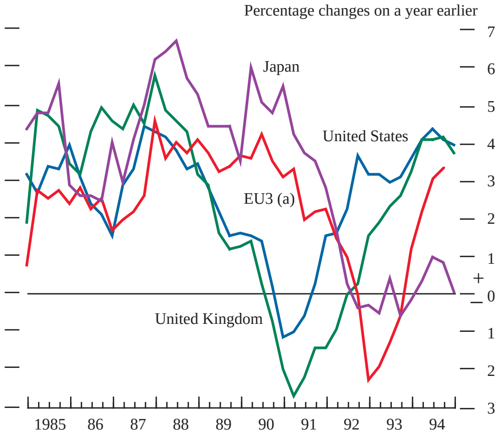
- *In the first quarter of 1995, growth slowed in the United States and was very low in Japan. In continental Europe, the recovery remained generally strong; and growth rates quickened in some economies. In the second quarter, US growth weakened further.*

- *Non-oil commodity prices were, on average, 2½% lower in the second quarter than in the first, according to the dollar-denominated Economist index. Oil prices rose sharply and then fell: by June, they were only slightly higher than in March.*

- *Producer and consumer price inflation have risen in those major economies whose currencies have depreciated this year.*

- *Inflationary pressures have diverged within Europe; as a result, official interest rates have been raised in some countries and cut in others.*

Chart 1
GDP in the major economies



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

Overview

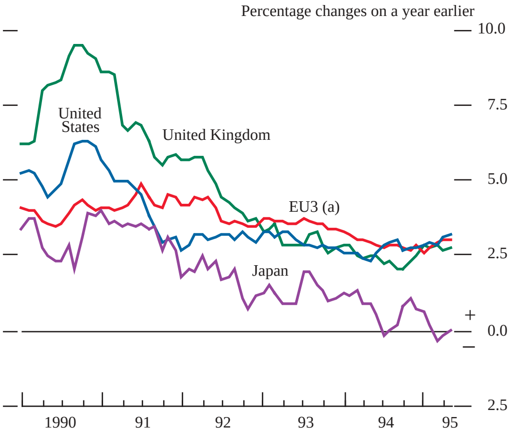
Economic growth slowed in North America in the first quarter. In the United States, GDP grew by 0.7%—only half as fast as in the previous quarter. But domestic demand slowed less than total growth. The slowdown followed increases in interest rates last year and at the beginning of this, and 16 consecutive quarters of growth; firms may increasingly have been approaching capacity constraints. In the second quarter US growth weakened further, according to monthly data. Firms have cut back production, probably to reduce stocks; and falling production has fed through to lower manufacturing employment, which has in turn influenced consumer confidence and, probably, consumption. Unexpected delays in receiving tax rebates may have contributed to the slower retail sales growth. In Canada, GDP grew by only 0.2% in the first quarter, after four consecutive quarters of growth above 1%.

In Japan, the earthquake in January affected activity in the first quarter. Very low growth in that period followed a large fall in GDP in the fourth quarter of 1994. Although the economy appeared to be recovering last year, GDP in 1995 Q1 was virtually unchanged from a year earlier and no higher than at the end of 1991.

In Europe, growth remained strong in Italy and Spain, but slowed slightly in France and, perhaps, in Germany. French GDP grew by 0.7% in the first quarter, but consumption increased by only 0.4% after falling in the fourth quarter of last year. Uncertainty over the result of the presidential election may have been a temporary factor reducing spending, but high unemployment may continue to subdue confidence—and therefore consumption—for some time. Chart 1 shows that the annual growth rates of the major economies have converged at above 3%, except in Japan.

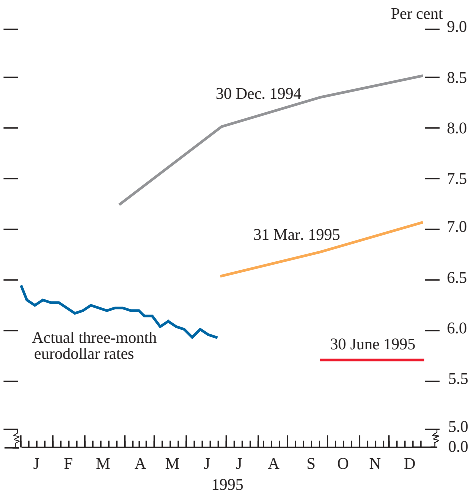
Between December and May, annual consumer price inflation rose in every Group of Seven (G7) country whose nominal effective exchange rate depreciated over the period. It rose particularly fast

Chart 2
Consumer prices in the major economies



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

Chart 3
US three-month interest rates(a)



(a) The path of three-month US dollar rates implied by the prices of futures contracts on the dates indicated.

Table A
Contributions to US GDP growth

Percentage points (a)

	1993	1994		1995
	Year	Year	Q4	Q1
Consumption	2.2	2.4	0.8	0.3
Total investment	1.6	1.9	0.5	0.6
Government expenditure	-0.1	-0.1	-0.2	—
Stockbuilding	0.3	0.6	-0.1	—
Domestic demand	**4.0**	**4.8**	**1.1**	**0.9**
Net external trade	-0.8	-0.7	0.2	-0.2
GDP	**3.1**	**4.1**	**1.2**	**0.7**

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

in Italy. But as Chart 2 shows, inflation in the G7 countries remained generally lower than in the early 1990s. In a number of other countries, for example Spain, inflation has risen significantly since the start of the year; most of these countries have undergone exchange rate depreciations.

In the same period, producer price inflation rose in every G7 economy except Japan. Even in Germany, where the effective exchange rate appreciated by 3½% in the first five months of the year, annual producer price inflation rose by 0.3 percentage points. Non-oil commodity prices fell in the second quarter, but producer prices may still be adjusting to the rise in commodity prices during 1994.

Official interest rates were raised in Finland, Italy, Spain and Sweden in the second quarter as consumer and producer price inflation increased. The cut in official interest rates in Germany at the start of the quarter triggered reductions in other ERM member countries. And as exchange rate fluctuations diminished over the period, further cuts were implemented. The Bank of France reintroduced its 5–10 day repurchase rate and cut it by 25 basis points at the end of the second quarter, and again at the start of the third.

Chart 3 shows the large change in the expected future path of US interest rates during the first half of the year. The change in expectations was mainly the result of a faster slowdown in activity than had previously been expected. Early in the third quarter, the US federal funds rate was cut by 25 basis points to 5¾%—the first cut since 1992. The reduction was matched by the Bank of Canada, which had reduced interest rates three times in the preceding five weeks.

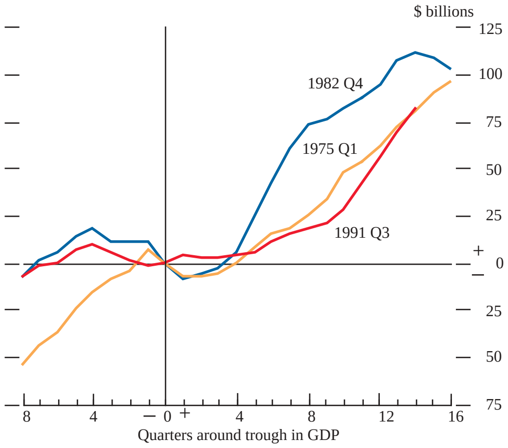
The US economy grew by around ¾% in the first quarter, but probably by much less in the second

In the United States, GDP grew by 0.7% in the first quarter, significantly less than its 1.2% growth in the previous quarter. But there was much less of a slowdown in growth in domestic demand—which fell from 1.0% to 0.9% and remained above its average over the past 30 years. Table A shows that consumption's contribution to growth fell in the first quarter and that net trade reduced growth. Following the devaluation of the Mexican peso in December and the subsequent slowdown in activity there, US net exports to Mexico fell by more than $3 billion in the first quarter. This more than offset an increase in net exports to the rest of the world.

Monthly indicators suggested a further slowdown in activity in the second quarter. Industrial production fell between March and June; and non-farm employment growth slowed significantly in the quarter. By June, capacity utilisation in industry had fallen by two percentage points from its recent peak of 85.5% at the start of the year. But this may have reflected increased capacity as a result of past investment as well as falling production.

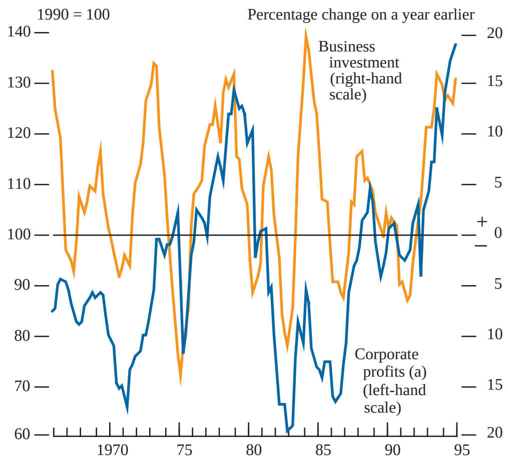
The cause and extent of the slowdown are still uncertain. US interest rates and bond yields increased sharply in 1994, and some sectors of the economy may have been hitting capacity constraints by the end of the year. Production may have been cut back to

Chart 4
United States: stock accumulation over the cycle[(a)]



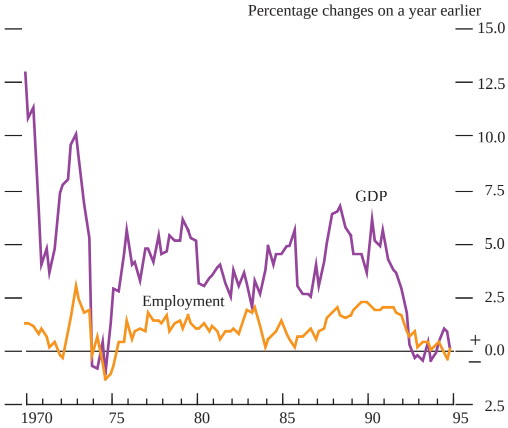
(a) In constant prices; dates shown indicate the quarter in which the trough in output was reached.

Chart 5
United States: corporate profitability and business investment



(a) Before tax, in constant prices.

Chart 6
Japan: GDP and employment



prevent stocks rising further. As Chart 4 shows, the accumulation of stocks during this recovery has not been out of line with previous cyclical experience.

After a period of sustained growth, it is not unusual for industrial production to grow more slowly than whole-economy output; for instance, between 1984 and 1986 US GDP grew more than twice as quickly as industrial production. Increased flexibility of labour markets may have allowed US firms to adjust employment to revised production plans more easily than in the past, as suggested by the accumulated fall of 104,000 in manufacturing employment in the second quarter. So a slowdown in industrial production growth may now have wider effects on the economy than in previous cycles.

Growth in the volume of retail sales slowed significantly in the second quarter. There are a number of reasons why consumers may have cut back their spending plans so far this year. First, a desire to increase savings: the household saving ratio had fallen to 3.6% of disposable income at the start of last year—its lowest level since 1989—but recovered to 5.1% by the first quarter. In the face of falling employment, confidence has fallen and consumers may have wished to raise precautionary savings further. Second, a temporary reduction in disposable incomes: there was a surprise delay in tax rebates in the second quarter; these were reported to be worth an average of $1,000 per household.

Faster growth may resume in the second half of the year, as falling long-term interest rates so far this year feed through to cheaper mortgages and consumer credit. Consumption may also be boosted as tax rebates are received. And in the corporate sector, pressure to cut costs may not be high, and further growth in corporate investment may more easily be financed internally; corporate earnings were at their highest level for at least 30 years in the first quarter. Chart 5 shows the past correlation between corporate profits and investment. Although the dollar stabilised against a basket of currencies in the second quarter, it was still 10% lower in June than a year earlier. So net exports may contribute to growth as the depreciation feeds through to higher export—and lower import—volumes.

Output in Japan in Q1 was no higher than at the end of 1991

In Japan, GDP rose by 0.1% in the first quarter—and was only 0.1% higher than a year earlier—after contracting by 1% in the final quarter of last year (the largest quarterly fall since 1973). Japan entered recession in 1992; it appeared last year that the economy was recovering modestly. But data for the final quarter and the first quarter of this year have revealed a setback to the recovery. In the first quarter, business investment grew for the third consecutive quarter, but growth in personal consumption was weak. As Chart 6 shows, apart from a short, sharp recession after the first oil price shock in 1974, the Japanese economy has not grown so slowly in the past 25 years.

Industrial production fell by more than 1% in the first two months of the second quarter, after increasing by 1.3% in the first quarter. According to the Bank of Japan's May Tankan survey, short-term corporate sentiment improved modestly between February and May, although by less than expected at the time of the previous survey. Manufacturers did not expect business conditions to improve over the next three months. And non-manufacturers and small firms were less optimistic than major manufacturers. Optimistic firms included basic material companies, such as steel and petrochemicals firms, which have benefited from strong external demand in the rest of Asia. But the survey revealed concern about the outlook for exports, as the appreciation of the yen continued to worsen the competitiveness of Japanese exporters.

Inventories of finished goods rose by nearly 2% in the first quarter compared with the previous quarter. This may have partly reflected temporary factors, such as a disruption to distribution following the earthquake and the ‘window dressing’ of balance sheets before the end of the fiscal year. But stocks rose further in April and May while production fell, suggesting that consumption was lower than expected, perhaps partly because of the Kobe earthquake and recent terrorist attacks. Uncertainty over job prospects—in April, unemployment rose to its highest level since the Second World War—and the impact of the large fall in the Japanese stock market in the first six months of the year will have also affected spending. The appreciation of the yen is reducing import prices, however. Provided these falls are reflected in prices paid by the consumer—and not absorbed within wider margins in the distributive sector—they should boost consumption.

The Japanese banking sector has been affected by the weakness of the economy since 1991 and, in particular, by the large falls in property and land prices. The fall in Japanese equity prices in the first half of this year affected banks’ capital adequacy ratios, since many banks count unrealised gains on shareholdings as capital. But in March, the ratios for the major 21 banks remained above the 8% set by the Basle Accord in 1988, and the sharp rise in equity prices in the first two weeks of July will have reduced pressure on them. When the recovery strengthens, however, the banks might find it hard to meet all of the demand for credit without jeopardising their capital ratios, if Japanese share prices were to start falling again. The government has announced the start of a study into ways of dealing with troubled financial institutions, including the possible use of public funds.

The Economic Planning Agency’s report for June noted that the economy remained on a gradual recovery path, but that a weak tone had emerged in some sectors, particularly the personal sector. As reconstruction following the earthquake begins, domestic demand will probably receive a boost in the second half of the year. Despite slow domestic demand growth, net exports fell by nearly ¥2 trillion between the second quarter of last year and the first quarter of this, probably reflecting past appreciation of the yen. Given its further appreciation in the first half of the year, net exports may continue to reduce GDP growth over the rest of this year, particularly if reconstruction materials are imported.

European consumption growth remained weak, but investment has been recovering more quickly

In France, GDP grew by 0.7% in the first quarter and the estimate of growth in 1994 was revised up to 2.8%. Table B shows that net trade made a significant positive contribution to growth in the final quarter of 1994 and in the first quarter of this year, but that consumption growth remained low. As noted in the May *Bulletin*, consumption in France and Germany has not recovered as quickly as in the United States or the United Kingdom during this recovery.

Table B
Contributions to French GDP growth

Percentage points (a)

	1993	1994		1995
	Year	Year	Q4	Q1
Consumption	0.1	0.9	—	0.2
Total investment	-1.3	0.3	0.2	0.3
Government expenditure	0.6	0.2	0.1	0.2
Stockbuilding	-1.8	1.6	0.3	-0.4
Domestic demand	**-2.3**	**3.0**	**0.5**	**0.3**
Net external trade	0.8	-0.2	0.2	0.4
GDP	**-1.5**	**2.8**	**0.8**	**0.7**

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

Employment grew by only 113,000 (½% of the labour force) in the first two years of the French recovery, so it is perhaps not surprising that consumption growth was weak. Recently, uncertainty over the result of the presidential election in the second quarter may also have restrained spending temporarily. French business investment was 6.4% higher in the first quarter than a year earlier and the French statistical agency has projected continued strong rises throughout the rest of 1995.

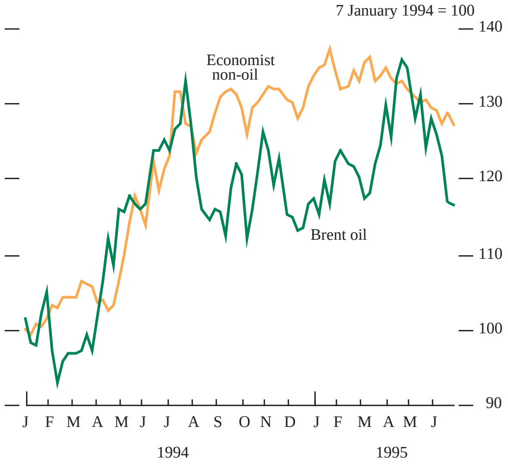
Analysis of activity in Germany since the start of the year has been difficult because many of the monthly series have been reweighted to adopt EU classifications. The box on page 236 examines the available indicators and considers what survey data reveal about activity. Consumption may have been affected by tax increases at the start of year, if these were not fully anticipated. Although higher-than-expected wage settlements in the first quarter may boost workers' disposable incomes this year and next, employment creation will probably be curtailed. In its June report, the Bundesbank said that the combination of sharp wage increases and the appreciation of the Deutsche Mark had resulted in a considerable burden on enterprises and that, although a cyclical slump is not to be expected, a slowing of growth is.

GDP rose by 1.5% in Italy in the first quarter and was 4% higher than a year earlier. Domestic demand was lower than in the previous quarter, but net exports increased significantly—contributing 1.8 percentage points to first-quarter GDP growth. Spanish GDP rose by 1% in the first quarter and was 3.1% higher than a year earlier. In both countries, private consumption growth was weak in the first quarter. The corporate sector has been more buoyant in both countries so far during this recovery, because of significant improvements in competitiveness since 1992. Although manufacturing production increased quickly last year, employment in that sector fell in both Italy and Spain.

Non-oil commodity prices fell in the second quarter

Non-oil commodity prices, as measured by the Economist dollar-denominated index, were on average 2½% lower in the second quarter than in the first, although the fall between March and June was much larger (nearly 4½%). All three of the sub-indices—for food, metals and non-food agriculturals—fell. But as Chart 7 shows, non-oil prices remained some 30% higher than at the start of 1994. Brent crude oil prices rose to over $19 a barrel towards the end of April, but by June had fallen back to just over $17 a barrel.

Chart 7
Commodity prices(a)



(a) In dollars.

Because of exchange rate movements, the fall in commodity prices since the first quarter was even larger for countries whose currencies have appreciated against the dollar, particularly Japan and Germany. This may put upward pressure on dollar-denominated prices if it leads to increased demand for commodities outside the United States. The fall in dollar prices may reflect lower-than-expected industrial demand: industrial production fell in North America and the United Kingdom between January and May. In continental Europe, the picture was less clear but industrial production growth appeared to be slowing.

Producer price inflation continued to rise in most countries

Falls in commodity prices should help to relieve upward pressure on producer prices. In the United States, producer output price

Activity in Germany

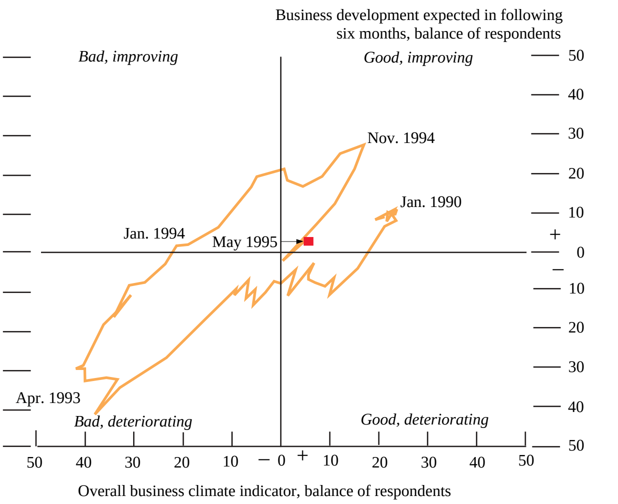
Data on activity in Germany this year have been delayed by the change-over to a new industrial classification—based on European standards—for reporting production and new orders. As well as delaying the publication of data, the reforms have meant that the series have been volatile and that direct comparisons with previous releases have not been possible. First-quarter GDP data will not be published until September, and even then comparisons with earlier data will be complicated by a new reporting structure: for the first time, demand components will only be published for the whole of Germany.

At the same time, a number of recent developments have raised uncertainty about the outlook for the German economy: notably, the sharp appreciation of the Deutsche Mark this year and higher-than-expected wage settlements. This box examines the state of the economy in the light of these different developments.

The appreciation of the Deutsche Mark so far this year will reduce German export growth, which has already been affected by slower demand growth in the first quarter in a number of European economies. Survey evidence, including that compiled by the Munich-based Ifo Institute of Economic Research, suggests firms have deferred planned increases in production in response both to expectations of weakening exports and larger than desired stocks. And although capacity utilisation rose in the first quarter and the length of order books was unchanged, it is likely that production growth rates were levelling off. The chart summarises recent trends: it plots the manufacturing business climate index—a measure of current trading conditions—against the expected business development index. It suggests that conditions in May remained good and improving, but that firms were less optimistic about the current climate—and future prospects—than they had been six months earlier.

In June, indices of leading industrial share prices were lower than in January, as discounted dividends declined with the worsening of external trading conditions and the uncertain performance of the domestic economy. Largely as a result of falling market interest rates, lending to domestic non-banks continued to rise in the first few months of the year, but less quickly than in the second half of 1994.

The Ifo business cycle



Labour market conditions are affected by changes in corporate profitability. In Germany as a whole, conditions began to improve in the first few months of this year after a prolonged period of weakness. Unemployment fell to 9.0% in May—its lowest level since September 1993—and employment growth resumed in February and March. Nonetheless, western German manufacturing employment continued to fall and remained the major source of weakness in the labour market. Higher-than-expected wage settlements are likely to increase German firms' incentives for capital investment and for the transfer of production abroad. Employment creation is likely to be reduced.

In the second half of the year, consumption growth may rise. Tax increases in January reduced real disposable incomes by around 1.5%. But compensating wage settlements have boosted employment incomes, and income expectations have been supported by anticipated tax cuts in 1996, despite continuing uncertainty about employment prospects. In other sectors, surveys of firms' investment intentions have suggested that business fixed investment will be more buoyant than consumption in the immediate future. But growth in the construction sector may fall, now that fiscal incentives and subsidies have expired. In eastern Germany, most forecasters expect GDP growth of around 9% this year, and the German government's forecast for all-German growth is 3%. The balance of growth is likely to shift further towards the domestic economy over the next few quarters.

Chart 8
Producer prices

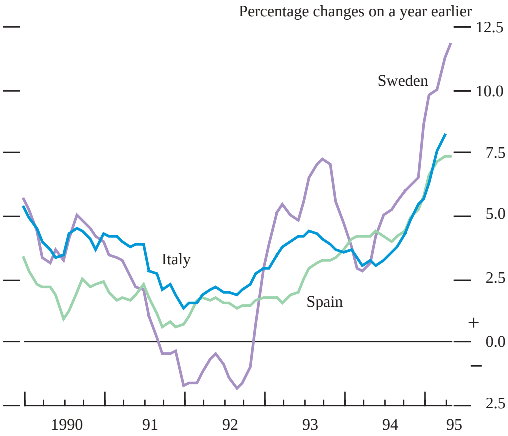
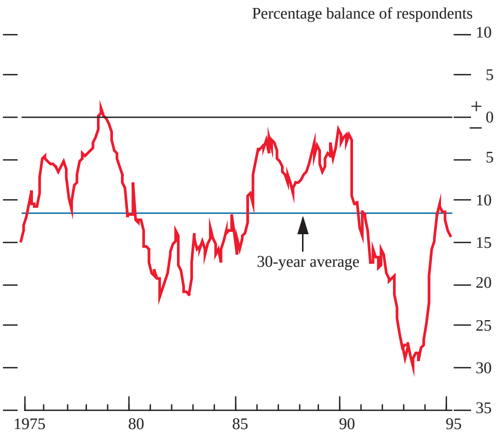


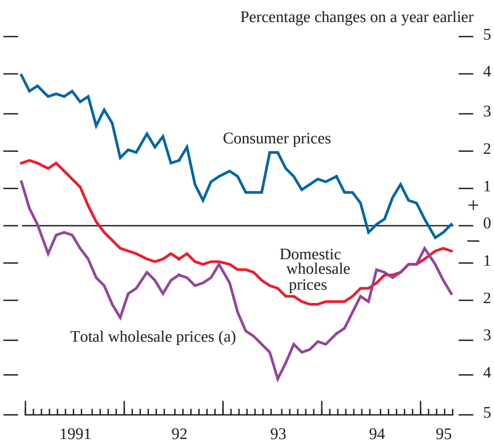
Chart 9
European consumer confidence(a)



Source: European Commission.

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

Chart 10
Japanese prices



(a) Includes import and export prices.

inflation has remained low; it was around 2% in the year to June, even though intermediate goods price inflation was nearly 7% in the same period. Import prices, in dollar terms, were 6.7% higher in May than a year earlier, but because import penetration in the United States is low by international standards, the feed-through to total costs will be less than elsewhere. Average hourly earnings for non-farm employees were 3.1% higher in June than a year earlier.

As Chart 8 shows, in Italy, Spain and Sweden producer price inflation has risen since the middle of last year. This probably reflects past exchange rate depreciation. As well as increasing import costs, lower real exchange rates have allowed exporters in these countries to increase sales volumes significantly; and though the recovery in internal demand is fairly recent, capacity constraints may be appearing in export sectors. In each case, growth in capacity will have been curtailed by very large falls in investment during the recessions.

Since the start of the year, consumer price inflation has fallen in Germany and Japan, but risen in most other major economies

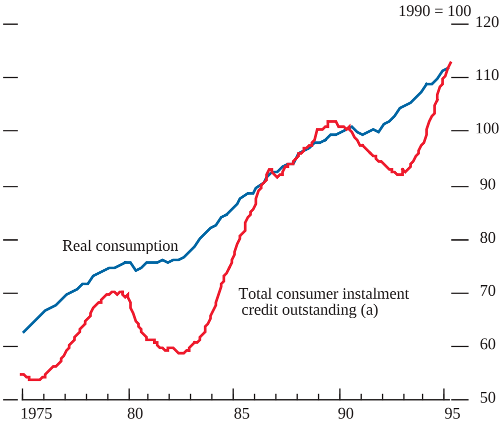
Different trends in consumer price inflation emerged in the major economies in the first half of the year. In Germany, France and Japan, annual consumer price inflation fell or remained unchanged between December and May. In Canada, Italy and Spain, it rose rapidly. In the United States and the United Kingdom it also rose, but by less. Of these countries, however, only Italy and Spain had annual consumer price inflation of more than 4% in April.

In the United States, despite continuing low producer price inflation annual consumer price inflation edged higher—to 2.9% in June—after reaching a trough of 2.4% during 1994. US retailers may have responded to the strength of domestic consumption by widening margins—this would be consistent with historically high corporate earnings. If so, the apparent weakening of consumption in the second quarter may prompt firms to narrow their margins to stimulate sales.

In France and Germany, consumer price inflation fell slightly between February and May. Consumer demand has remained weak, and the effective exchange rate appreciations in the first half have reduced import prices. Chart 9 shows that although consumer confidence in the major continental European economies recovered to its long-term average at the end of 1994, it fell by three percentage points between December and April. In such an environment, retailers may be reluctant to increase prices for fear of losing sales volumes. Despite this, the cost of living in Germany rose more than expected in June and annual inflation increased slightly. Although the prices of food and goods rose only slowly in the year to June, the prices of services and rents were 3.6% higher than a year earlier. Increases in consumer price inflation in Italy and Spain in the first months of the year reflected higher producer and import price inflation, and the effect of indirect tax increases.

Inflationary pressures in Japan have been very low. Indeed, some price indices have been falling: annual consumer price inflation was negative in March and April, and flat in May—as Chart 10 shows. And measured price indices may not be capturing widespread discounting, and so understating the real extent of deflation (and also understating retail sales volumes). Domestic wholesale price

Chart 11
United States: consumer instalment credit and consumption



(a) Deflated by the consumer price index.

deflation has been gradually diminishing since the beginning of 1994, but prices have remained lower than a year earlier. Total wholesale prices, which include traded goods prices, have been falling more rapidly since the start of the year. Import and export prices fell by around 7%–8% in the first five months, largely as a result of the appreciation of the yen. The effect of cheaper imports has also fed through directly to consumer prices, since some imports are of finished goods. Lower prices will help stimulate consumption, particularly if domestic prices are reduced to compete with cheaper imports.

Narrow money growth remained weak in a number of countries

In the United States, the stock of narrow money (M1) fell during the first two months of the second quarter: by May, it was unchanged on a year earlier. Annual broad money (M3) growth rose in the first quarter, and continued to rise in April and May. And consumer instalment credit grew by over 4% in the first five months (in real purchasing terms). Chart 11 shows that consumer credit has tended to be more volatile than consumption since 1975, and in the two previous cycles fell *before* consumption did. So the continuation of strong credit growth would suggest that consumption is unlikely to have slowed significantly in the second quarter.

M1 in Germany rose by only 0.2% in the first quarter, and M3 fell by over 1¼%. The extended measure of M3—which includes money-market funds, and deposits with foreign subsidiaries and branches of German banks—fell by nearly ¾%. But in the second quarter, M3 rose by 1.1% according to preliminary data. Even if German M3 were to grow at nearly 0.8% a month for the rest of this year, the Bundesbank's target range (of growth of 4%–6% between the fourth quarters of 1994 and this year) would still be undershot. In France, M1 fell in the first quarter; in Italy, it was unchanged.

Japanese narrow money growth has recently been very erratic, probably as a consequence of the earthquake, but generally has been growing strongly since the start of the year: by May, M1 was more than 6½% higher than at the end of last year. Broad money has been less volatile—annual growth had been increasing slowly since the start of 1993, but fell slightly in the first two months of the second quarter.

European official interest rates have diverged, and early in the third quarter the US federal funds rate was increased

As reported in the May *Bulletin*, official interest rates were cut in Germany and Japan at the start of the second quarter. A number of other European countries followed the German interest rate cut, as the turbulence in the ERM diminished in the second quarter. The Bank of France reintroduced its 5–10 day repurchase rate, and cut it by 25 basis points at the end of June and a further 25 basis points early in the third quarter as the differential between short-term market rates in France and Germany fell. The reductions in official rates followed the new government's mini-budget, which maintained the aim of reducing the fiscal deficit to 3% of GDP in 1997.

Interest rates were raised in Finland, Italy, Spain and Sweden during the second quarter. In each case, annual producer price inflation had been rising since the start of the year. And consumer price inflation rose over the same period in all except Finland. In Italy,

Table C
Three-month interest rates expected in December 1995[(a)]

Per cent

	30 December 1994	31 March 1995	30 June 1995
US dollar	8.5	7.1	5.7
Deutsche Mark	6.7	5.3	4.7
Yen	3.1	1.8	0.9
Sterling	8.9	8.0	7.5

(a) Expected rates as implied by futures contracts.

Chart 12
Effective exchange rates

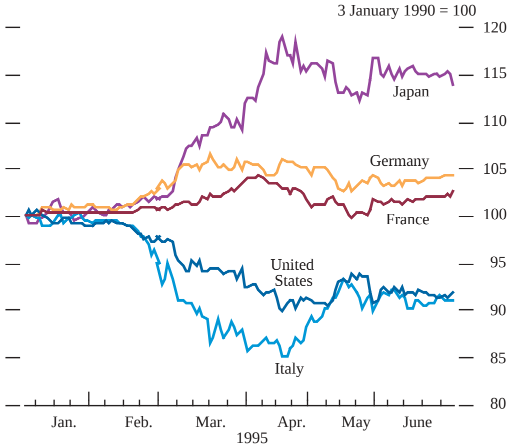


Table D
General government structural balances[(a)]

	1993	1994	Projections 1995	1996
Canada	-4.1	-3.4	-2.7	-1.7
France	-3.8	-3.9	-3.4	-3.0
Germany	-2.7	-1.9	-1.8	-1.7
Italy	-7.9	-7.4	-6.7	-6.1
Japan	-1.6	-2.9	-2.8	-2.8
United States	-3.2	-2.4	-2.5	-2.6
Memo:				
United Kingdom	-5.6	-4.8	-3.0	-1.7

Source: OECD June 1995 *Economic Outlook.*

(a) Structural balances estimate the general government balance assuming that the economy is producing at full potential.

Spain and Sweden, the interest rate increases continued a period of monetary policy tightening started in the second half of last year.

As Table C and Chart 3 show, the level of US interest rates expected at the end of 1995 fell during the first half of the year: by the end of the period, futures prices implied that the next move in US interest rates could be down. By contrast, at the start of the year, three-month US interest rates were expected to rise by 250 basis points by June (there was an actual rise of only 50 basis points), and by a further 50 basis points by December. The changes in expectations occurred despite rises in annual consumer price inflation in the United States, but probably reflected the ‘news’ about the slowdown in activity there. Early in the third quarter, the US federal funds rate was reduced by 25 basis points to 5.75%, following a total increase of three percentage points since the start of 1994.

Expected levels of interest rates also fell in Germany and Japan. At the end of the second quarter, German short-term interest rates were expected to remain unchanged throughout the rest of the year, and futures prices implied that interest rates in Japan might fall before the year-end. Early in the third quarter, the Bank of Japan allowed market interest rates to fall below the Official Discount Rate.

Nominal effective exchange rates in the major economies were less volatile in the second quarter than in the first, and measured in this way most G7 currencies were broadly unchanged between the end of the first and second quarters. But the yen’s nominal effective exchange rate appreciated by about $2^1/_2$% during the second quarter and the lira’s by nearly $4^1/_2$% (see Chart 12). By the end of the quarter, the lira remained significantly lower against a basket of currencies than at the start of the year.

Fiscal deficits remained high in a number of countries, but are projected to fall

General government deficits remained high in a number of countries last year, but fiscal policy is being tightened in most European countries. Government *structural* balances are not affected by cyclical improvements in, for example, unemployment benefits. Therefore, changes in structural balances show the direction of fiscal policy more clearly than actual government balances. Table D shows that, according to the OECD’s latest forecast, structural balances will fall in the major European economies and in Canada this year and next.

The new French government’s ‘mini-budget’—announced in June—aimed at reducing unemployment and stimulating consumption and the housing sector, while reducing the general government deficit from 6% of GDP last year to around 5% this, through tax increases and spending cuts elsewhere. The government still aims to reduce the fiscal deficit to 3% of GDP in 1997, to meet the Maastricht convergence criterion.

The Japanese government announced a supplementary budget in the second quarter, as well as a stimulus package. The former, mainly aimed at earthquake reconstruction, was approved in May. The latter brought forward spending of the public works budget into the first half of the fiscal year, without allocating new money. But a further supplementary budget is likely in the second half of the year, and income tax cuts may be repeated next year.