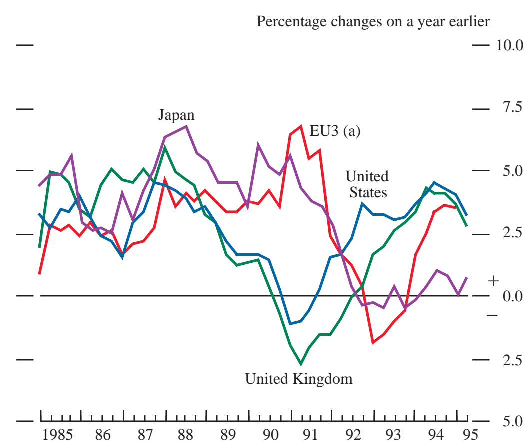
The international environment

- *Growth in the major six overseas economies slowed in the second quarter, in part because of stock adjustments. It slowed sharply in the United States; in Japan, growth in the second quarter was stronger than in the first, but the economy remained weak. In Europe, too, there was some evidence of a slowdown. Monthly data for the third quarter have been mixed.*

- *Inflation fell in all the major economies between June and July, and fell further in the United States and Germany subsequently. Commodity prices continued to fall in the third quarter.*

- *Official interest rates were cut in the United States, Japan, Germany and several other European countries during the third quarter. The dollar strengthened to a 14-month high against the yen. A further fiscal package to boost economic recovery was announced in Japan; contractionary budgets were announced in France and Italy.*

Chart 1
GDP in the major economies



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

Table A
Contributions to growth in 1995 H1

Percentage points (a)

	United States	Germany	Japan	France	United Kingdom
Consumption	0.8	0.5	0.6	1.1	0.5
Investment	0.8	—	0.3	—	0.3
Government expenditure	—	0.3	—	0.2	0.1
Stockbuilding	-0.3	-0.1	0.1	-0.8	—
Domestic demand	**1.4**	**0.7**	**0.9**	**0.5**	**0.9**
Net external trade	-0.4	0.3	-0.1	0.6	0.4
GDP	**1.0**	**1.1**	**0.8**	**1.1**	**1.2**

(a) Half-yearly contributions relative to the end-1994 position. Components may not sum to total because of rounding.

Overview

This article assesses economic developments in the European Union (excluding the United Kingdom), North America and Japan. These countries account for just under 50% of world GDP, according to IMF calculations, but for three quarters of UK trade.

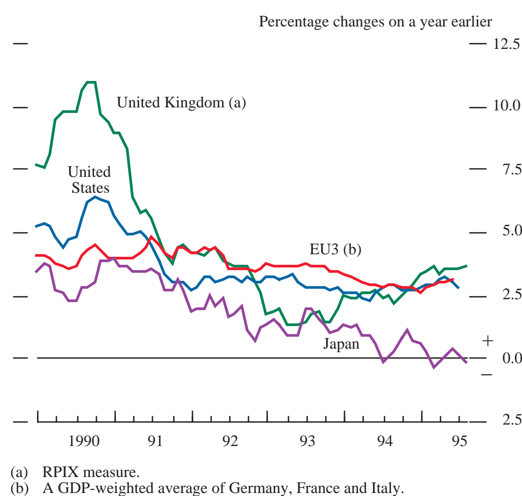
Year-on-year growth in the major six overseas economies slowed to 2.4% in the second quarter, down from 3.0% in the first and 3.3% in the fourth quarter of 1994. The stock cycle held back growth in the United States, Germany, France and Italy.

In all the major overseas economies other than Japan, GDP grew by around 3% or more year on year in the first quarter (see Chart 1). The Japanese economy barely grew at all; but over the second quarter, Japanese GDP grew by 0.8%, surprising most observers and possibly reflecting a recovery after the economic effects of the earthquake earlier in the year. The US economy slowed sharply in the second quarter, but fears of a standstill in growth were not realised. Growth slowed in Europe. Newly compiled GDP data for the whole of Germany showed much slower growth in the first quarter, but annualised growth of 4.3% in the second. Growth in Spain was strong in the first half. In France and Belgium, however, there was a marked slowdown in the second quarter, and in Italy GDP fell.

The slowdown in US growth largely reflected an inventory correction, as demand was met partly from stocks, rather than new production, so as to reduce stocks towards desired levels. A similar process may have occurred in Europe; stockbuilding cut growth in Germany, France and Italy in the second quarter.

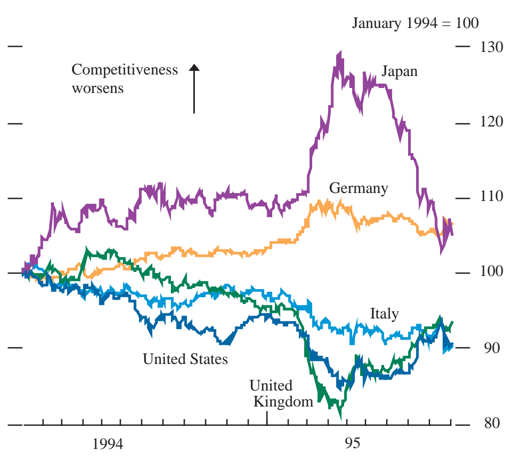
Outside the United States, investment was weak in the first half of the year (as Table A shows), in contrast to consumer spending. Business confidence was particularly low in France, Germany and Japan. External trade contributed positively to growth in Germany and France, despite real exchange rate appreciation.

Chart 2
Consumer prices in the major economies



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

Chart 3
Effective exchange rates



Inflation has generally remained low and may fall further. Commodity prices fell during the first three quarters of 1995, and by the third quarter lower oil prices had been passed through to producers.

Average producer and consumer price inflation in the Group of Seven (G7) major economies remained at an annualised rate of around 2½% in the first half of the year. In the third quarter, a key feature was the noticeable fall in consumer price inflation in August in both the United States and Germany. In the United States, this was despite a further fall in unemployment, from an already low level. The explanation for this may lie in increased labour market flexibility, which has prevented the emergence of wage pressures. Only in Italy does inflation remain an immediate concern.

The low-inflation environment and the news suggesting relatively soft activity led to a general easing of official interest rates in the third quarter. The main development on the foreign exchanges was a depreciation of the yen.

As reported in the August *Quarterly Bulletin*, the Federal Reserve in the United States cut its key interest rate by 25 basis points to 5.75% on 6 July. In Germany, the Bundesbank cut its discount and Lombard rates by 50 basis points, to 3.5% and 5.5% respectively, on 24 August—the second 50 basis point cut in the discount rate this year. It cited continuing weak M3 growth as the main factor behind its decision. Austria, Belgium, Denmark, the Netherlands and Portugal followed suit and in the following week France cut its 5–10 day repo rate by 35 basis points to 6.15%—the fifth cut since June.

In September, the Bank of Japan eased its monetary policy, halving the Official Discount Rate (ODR) to 0.5%, its lowest level ever and the lowest official rate anywhere in the world. Together with concerted central bank foreign exchange intervention in August, and earlier moves to facilitate outward investment from Japan, this helped to produce a turnaround in the yen/US dollar exchange rate, with the dollar rising to a high of ¥104.7 on 19 September. The strengthening of the dollar was accompanied in Europe by an appreciation of other currencies against the Deutsche Mark in the first part of the quarter, but later public concerns about the prospects for economic and monetary union (EMU) led to a partial reversal of the Deutsche Mark's fall.

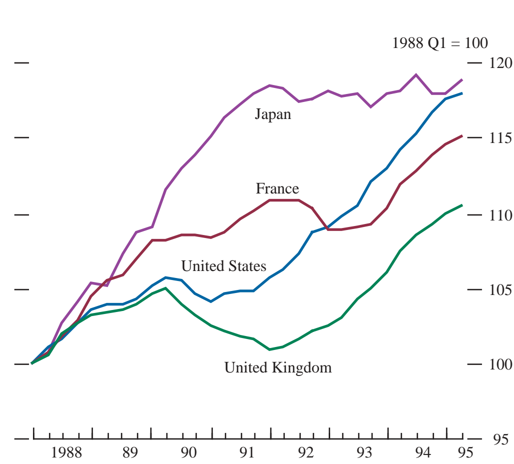
Fiscal policy was further relaxed in Japan in an attempt to stimulate the depressed economy, with supplementary packages in July and September. Elsewhere, fiscal tightening remained the objective.

US growth continued, but slowed sharply in Q2

After a quarterly rate of around 1% during 1994, US GDP growth slowed to 0.7% in the first quarter of 1995, and only 0.3% in Q2. In 1994, growth was boosted by 0.6 percentage points by restocking, as the economy readjusted from the recession in the early 1990s; during this year, an inventory correction has occurred—notably in the automobile sector—reducing growth by 0.3 percentage points in the second quarter. In fact, around half of the 0.8% fall in industrial production in the second quarter was in the automobile sector. It seems to have been in response to an unexpected slowdown in the growth of car sales, which led to a faster build-up of stocks and cutbacks in production.

Chart 4
United States: manufacturing inventories to output ratio

Chart 5
GDP in selected economies



Some further reduction in the ratio of stocks to output may have occurred in the third quarter, although automobile sales grew strongly, limiting the need for further destocking there (see Chart 4).

Other data on US activity in the third quarter have been mixed. The monthly employment data have been volatile, but stronger than in the second quarter. Industrial production increased in the third quarter, following a fall in the second, suggesting that industrial output may have passed a trough. Overall, activity probably returned towards—but not above—its trend rate of growth.

The Japanese economy grew in the second quarter, but has remained depressed

The early 1990s recession in Japan was long but mild by recent international standards, and GDP did not fall by much (see Chart 5). Equally, the upturn has been muted. Japanese GDP grew by only ½% in 1994 and the outturn for this year may be little higher. GDP was more or less flat in the first quarter, but grew quite strongly in the second. The stimulus to growth came from consumption and investment. The current account surplus has been falling; export growth slowed in the second quarter—though volumes continued to rise—while imports surged, despite lacklustre domestic demand.

The Bank of Japan's August Tankan survey of business expectations showed the first fall in business confidence for almost two years. It was unclear, however, to what extent the 11% depreciation of the yen against the dollar in August was reflected in the survey. Concerns that the decline in employment would accelerate and about the continued problems in the financial sector seem likely to have undermined confidence.

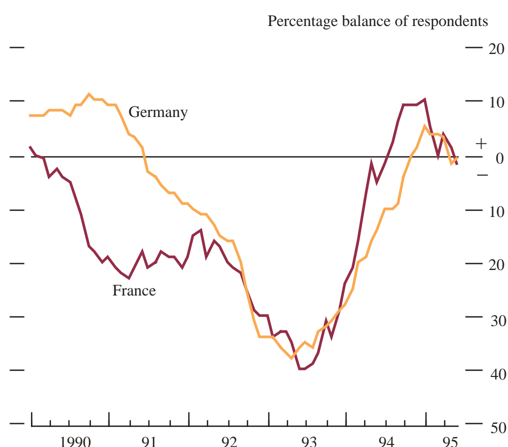
A major source of the weakness in demand has been the real estate sector. The collapse of a speculative boom in property has left the banking sector with bad loans totalling around 10% of GDP, according to official estimates. The major banks have had some success in reducing their bad loans, but by international standards their capital ratios remain low.

The so-called 'second tier' banks, particularly the agricultural co-operatives, are in a more serious position, with a substantial proportion of property loans on their books; there is little sign of any recovery in the real estate sector. It is possible that a shortage of credit is holding back recovery. The lower interest rates during 1995 have, however, led to a widening of banks' margins and will have boosted their profits.

European growth depends on consumption and investment

In the second quarter, growth slowed in France and Italy, but not in Germany. New GDP data for the whole of Germany showed growth of 0.2% in the first quarter and 1.1% in the second, suggesting a slightly lower rate of growth in the first half of this year than that in the second half of 1994. Growth in eastern Germany, at around 7% a year, was below the official projection of 9% or so for 1995. The rise in growth in the second quarter is, however, difficult to reconcile with survey evidence of a slowdown, and slower credit growth. Because of changes in the way the

Chart 6
Business confidence(a)



(a) Source: European Commission.

Chart 7
European GDP growth

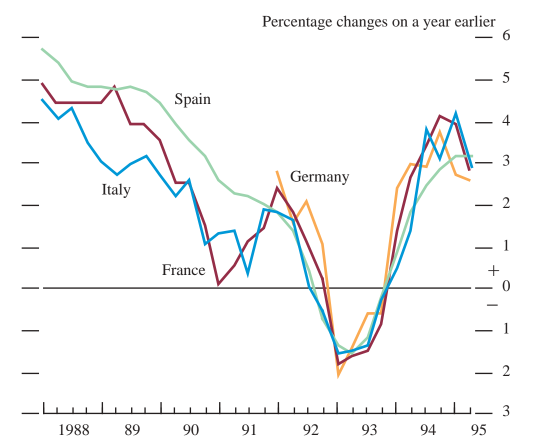
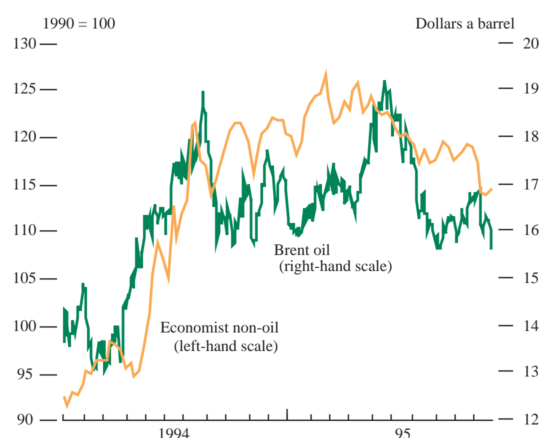


Chart 8
Commodity prices(a)



(a) In dollars.

industrial production statistics are compiled, quarter-on-quarter comparisons may be less reliable than usual.

Growth in France slowed markedly in the second quarter, despite the big boost to consumption from the government's scheme to subsidise purchases of new cars. Consumption in the third quarter is likely to have been affected by the increase in VAT in August, but may also have been bolstered by a pick-up in employment and a reduction in the relatively high saving ratio. As in Germany, investment and stocks held back growth in the second quarter, as business confidence fell (see Chart 6).

The Italian and Spanish economies grew very strongly in the first quarter. In the second quarter, Spanish GDP grew less quickly, but measured Italian GDP—which tends to be volatile—fell by 0.4% compared with the first quarter, reflecting a sharp fall in stocks.

The outlook for the continental European economies depends on whether other elements of domestic demand—notably household consumption and investment—sustain recovery, now that the impetus to growth from stockbuilding has passed. There is a risk that continuing high levels of unemployment and further fiscal consolidation may hold back consumption, and hence growth.

It is interesting that the year-on-year rates of growth in the major continental European economies seem to have converged at around 2½%–3% a year (see Chart 7). A key question for the international economy is whether economic cycles—not just in Europe, but globally—are becoming more synchronised. If so, this could increase the risk of larger upswings and downswings, as external demand would reinforce, rather than offset, the effect on output of fluctuations in domestic demand.

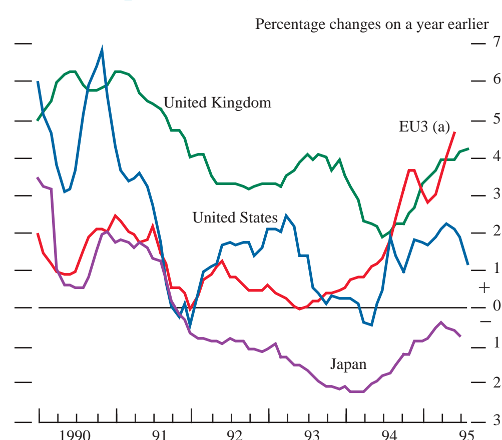
Inflation fell a little further

Weaker energy and commodity prices relieved some of the price pressures on producers in the first three quarters of the year. Oil prices fell from a peak of $19 a barrel in May to around $16 a barrel in September. Commodity prices, as measured by the Economist non-oil index, fell by 2.7% in the third quarter, taking the reduction since January to 7.2%. The sustained rise in commodity prices after the start of 1994 seems, therefore, to have come to an end. Falls in the prices of food and energy held down consumer price inflation in Europe—notably in Spain, Sweden and Italy.

G7 consumer price inflation has remained between 2% and 2½% over the past 18 months, and fell from 2.4% to 2.3% between June and July. Consumer price inflation subsequently fell further in the United States—to 2.4% in September—and in Germany, to 1.5% in August on reweighted data.

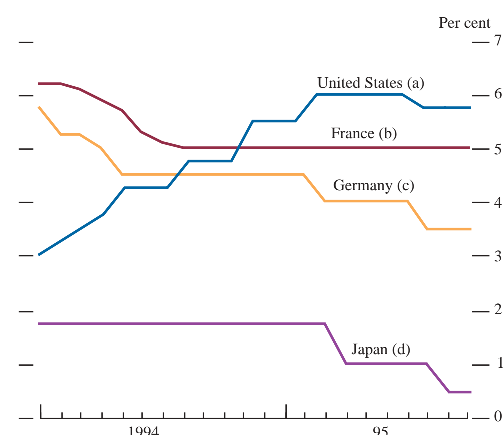
The fall in US inflation is particularly interesting, given the mature stage of the recovery and low level of unemployment. The explanation may lie in labour market developments. Despite the fact that the economy is probably close to 'full employment' when judged by historical standards, there has been no sign of a rise in earnings growth and unit labour costs have been flat. It is possible that the rate of unemployment consistent with stable inflation—or NAIRU—has fallen, perhaps because of greater labour market flexibility and business restructuring. Increased job insecurity,

Chart 9
Producer prices in the major economies



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

Chart 10
Official interest rates



(a) Federal funds target rate.
(b) Intervention rate.
(c) Discount rate.
(d) Official Discount Rate.

caused in part by rapid technological change, may have added to this effect. Investment in new technology may also have led to higher productivity growth.

In Germany, labour market developments have been less favourable for inflation. High wage settlements were conceded earlier this year, and the length of the average working week was reduced from October: as a consequence, unit labour costs are likely to rise this year and next. The very low level of consumer price inflation in August partly reflected sharp falls in seasonal foods, which provisional data suggest unwound to some extent in September.

In France, consumer price inflation rose by 0.5 percentage points to 2% between July and August, reflecting the increase in VAT imposed during the month. In September, prices rose a further 0.4%, but the annual rate of inflation remained around 2%.

Consumer price inflation has been around or just under zero in Japan for most of the year. In the second quarter, core consumer prices fell by 0.2% compared with a year earlier; over the same period, the consumers' expenditure deflator—which may give a more accurate reading of inflation—fell by 1.1 percentage points. The deflationary pressure reflected not only lower import prices resulting from the stronger yen in the first part of the year, but also structural changes leading to more competition and discounting in the retail sector.

Only in Italy and Canada has inflation picked up during 1995. In Canada, the annual rate rose from around ½% in January to 2.9% in May, but—as in the United States—the annual rate then fell, and was 2.3% in August; in Italy, inflation rose from around 4% in January to 5.8% in August. In Canada, the rise was almost all accounted for by the dropping out from the year-on-year comparison of a cut in tobacco taxes in February 1994. Some of the increase in Italian inflation reflected higher indirect taxes, which will fall out of the index in early 1996. But there is some risk in Italy that higher inflation will feed through to wage growth. The danger of such second-round effects was increased by measures in the budget for 1996 to allow public sector employees to recoup real earnings losses over the past two years. The box on page 336 looks more closely at inflation performance among countries in the European Union.

For the G7 as a whole, narrow money growth has remained modest, at 2.1% a year in June. But within this, there were considerable country differences. In the three months to July, Canadian M1 grew at an annualised rate of 18%. In Japan, the comparable rate was 15%. In continental Europe, however, narrow money growth has been very weak. M1 in Germany grew by 2.9% in the year to July, and in France and Italy its growth was even less.

Average broad money growth in the G7 as a whole was 3.2% in June, little changed from the average rate in 1994. But distortions arising from asset substitution have been significant.

Official interest rates have been cut in all the major regions

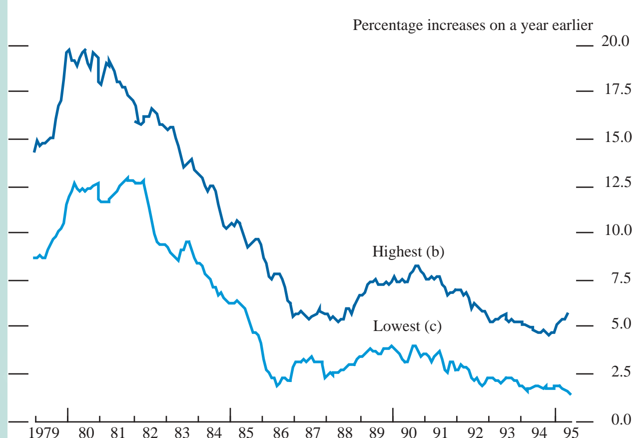
Following the 25 basis point cut by the US Federal Reserve on 6 July (discussed in the August *Bulletin*), a round of European interest rate cuts was initiated in Germany on 24 August. The Bundesbank cut both the Lombard and discount rates by 50 basis

Inflation in continental Europe

In the first eight months of 1995, inflation differentials widened between those EU economies with the highest inflation and those with the lowest. This box examines whether this is a temporary deviation or a break in the trend towards convergence.

Following the introduction of the exchange rate mechanism, the inflation differential between historically higher-inflation and lower-inflation countries has fallen. But, as the chart shows, in the first eight months of 1995 inflation fell in the historically lower-inflation countries, but rose elsewhere.

EU consumer prices(a)



(a) Inflation is weighted by GDP for each group of countries.
(b) The four countries with the highest inflation in December 1994: Greece, Italy, Portugal and Spain.
(c) The four countries with the lowest inflation in December 1994: Belgium, Denmark, Finland and France.

Consumer price inflation performance in EU countries

	Aug. 1995 Per cent	Change since Dec. 1994 (percentage points)
Austria	2.1	-0.5
Belgium	1.2	-0.7
Denmark	1.7	-0.6
Finland	0.4	-1.1
France	1.9	+0.3
Germany	1.5	-0.9
Greece	8.4	-2.4
Ireland	2.4	+0.1
Italy	5.8	+1.7
Netherlands	1.5	-1.1
Portugal	4.0	-0.1
Spain	4.3	—
Sweden (a)	2.5	—
United Kingdom (RPIX)	*2.9*	*+0.4*

(a) The figures for Sweden are for July.

To some extent, the different recent experiences reflect changes in tax rates. Changes in indirect taxes feed into headline consumer price indices fairly rapidly. In Germany, the impact of the mineral oil tax in 1994 dropped out of the index in 1995, reducing recorded inflation by 0.4 percentage points. Conversely, indirect taxes have been raised this year in both Spain and Italy. Under current budget plans, tax effects are likely to produce some convergence among inflation rates next year, as the headline rates in Italy and Spain fall back, while tax increases push up inflation in France and Belgium.

Underlying inflation rates, however, have also diverged in 1995. Whether or not convergence of underlying inflation rates resumes depends on a number of factors:

Exchange rates: There have been significant movements in exchange rates in 1995. But the depreciation of the weaker currencies in the first four months of the year was largely reversed in the third quarter, so any changes to cost pressures arising from this should prove to be temporary.

Producer prices: In a number of the historically higher-inflation economies, there has been some evidence of pressures in the supply chain. Producer prices have risen faster than consumer prices (possibly reflecting earlier exchange rate developments); in Sweden, for example, annual producer price inflation was nearly 11% in August. In the past, however, such pressures have taken some time to feed through to consumer prices.

Wage pressures: Wage settlements have been higher in Germany than elsewhere this year. On its own, this would increase inflation convergence within the European Union. But there is also a risk that the higher current inflation in some other countries will feed through into wages next year. In Italy, the 1996 budget allows for public sector pay increases partly to offset real wage declines over the past two years. And if such second-round effects persist, any impetus towards long-term convergence will be weakened. Such pressure is not uniform across higher-inflation economies, however; Spanish wage pressures may be reduced by the combination of high unemployment and labour market reforms.

Demand pressures: In the short run, stronger demand is likely to make it easier for retailers to pass on any rising costs, since consumers may be less resistant to price increases. If so, costs may be passed through more rapidly than they were following the last major bout of exchange rate depreciation (in 1992–93), which coincided with the European recession.

The balance of risks at present may suggest rising inflationary pressures in some economies. But these risks are generally concentrated in a small number of economies. Furthermore, the higher-inflation countries have shown a willingness to tighten monetary policy in response to inflationary pressures, so the divergence may be only a temporary phenomenon.

Chart 11
Nominal exchange rates

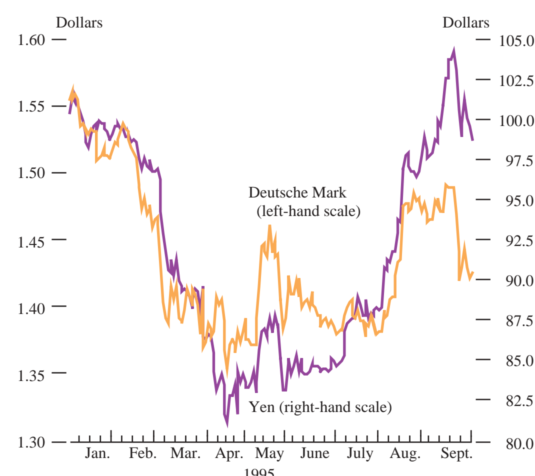


Chart 12
Ten-year government bond yields

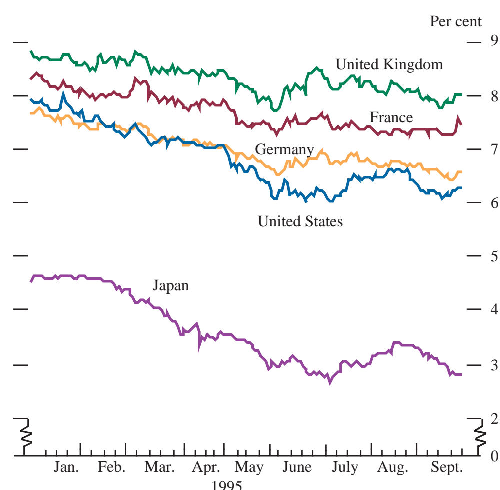


Table B
Three-month interest rates expected in March 1996(a)

Per cent

	1994	1995		
	30 Dec.	30 Mar.	30 June	29 Sept.
US dollar	7.22	6.94	5.77	5.73
Deutsche Mark	5.62	5.85	4.90	3.95
Yen	2.95	1.85	0.94	0.53
Sterling	7.47	8.37	7.72	6.71

(a) Expected rates as implied by futures contracts.

points, to 5.5% and 3.5% respectively—the second 50 basis point cut in the discount rate this year. Austria, Belgium, Denmark, the Netherlands and Portugal followed suit in cutting rates; and the Bank of France cut its 5–10 day repo rate by 35 basis points to 6.15% in the following week. Ireland reduced its interest rates by only 25 basis points, in the face of very strong growth (of around 6% a year) and a slight pick-up in inflation. Official rates were held steady in Sweden, Italy and Spain, following rises in the second quarter.

The Bank of Japan cut its ODR by 50 basis points on 8 September, to a record low level of 0.5%; Governor Matsushita said that the easing was to prevent the further spread of deflation and to secure economic recovery. The Bank of Japan also reaffirmed its intention of guiding market rates below official rates. The easing of Japanese monetary policy was further promoted by official purchases of US dollars which, helped by earlier moves to liberalise outward portfolio investment from Japan, helped push the yen to a 14-month low of ¥104 against the dollar on 19 September (see Chart 11). This was accompanied by a strengthening of other European currencies against the Deutsche Mark.

By mid-September, exchange rate movements had largely reversed the sharp changes which occurred in the first four months of the year, as Chart 11 shows. But in the latter part of September, some European currencies experienced turbulence related to market uncertainty about monetary union.

Government bond yields fell gradually throughout the first three quarters of 1995. Around July, yields in most countries increased sharply, but they subsequently fell back to earlier levels except in Italy and Spain. Nonetheless yield curves steepened in August/September, reflecting lower short-term rates and some market uncertainty concerning medium-term fiscal prospects and, within Europe, monetary union.

By the end of the quarter, markets appeared to expect little further change to short-term interest rates in the following six months (see Table B). Implied interest rates two years ahead fell during the third quarter. Expected interest rates more than two years ahead fell by less, and indeed they rose in France, suggesting that short-term cyclical factors—rather than a longer-term improvement in the credibility of monetary policy—were responsible for the fall in implied short-term rates there.

Fiscal stimulus in Japan contrasted with tightening elsewhere

Further fiscal measures were unveiled by the Japanese authorities in September, making a total of seven fiscal stimulus packages in the past three years. The total value of the most recent package was ¥14 trillion—equivalent to 3% of GDP—of which about ¥8 trillion is estimated to involve new spending. About half of the total package is in the form of capital expenditure.

Elsewhere, further fiscal tightening has been announced. In the United States, cyclical factors have led to a narrowing of the fiscal deficit, but there is also evidence of structural improvement. Although major uncertainty surrounds the budget for the fiscal year 1996, there appears to be a greater determination to achieve a balanced budget some time in the next decade. The US Congress

has passed a resolution on balancing the budget within seven years; the Administration has set out a ten-year plan to achieve a budget balance.

In France, the 1996 budget unveiled in September confirmed the government's intention to reduce its deficit to 3% of GDP in 1997, in line with the Maastricht convergence criterion. Tax receipts in the first eight months of 1995 were below target, however, because growth has been lower than forecast.

In Italy, robust growth in the first quarter and the completion of pension reforms in August both helped the three-year stabilisation plan which the authorities have put in place. The government deficit to GDP ratio this year may be lower than the original target of 8%. But attempts to stabilise the debt position are made more difficult by the risk premia on interest rates. At the end of September, Italian ten-year government bond yields were 368 basis points higher than those in Germany. The 1996 budget announced in September targeted a reduction in the deficit to GDP ratio in 1996 from 7.4% to 5.8%, to be achieved by a combination of cuts in spending and additional receipts.