The international environment

This article considers economic developments in the European Union, North America and Japan since the November 1995 Quarterly Bulletin. *These countries account for about half of world GDP, according to IMF figures, but three quarters of UK external trade. The effect of fiscal consolidation on world growth is considered in detail in a box.*

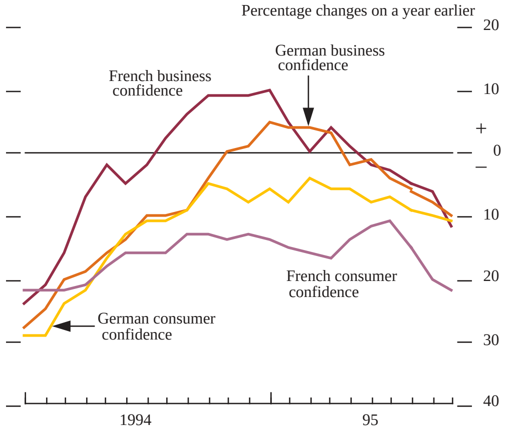
- *The international environment for UK exports weakened in the second half of 1995, mainly because of slower growth in Germany and France. Growth was surprisingly strong in the United States in the third quarter. In Japan, the foundations appear to be in place for a recovery in activity in 1996.*
- *Inflation in the G7 economies remained flat on average at under 2½% per year in the third quarter of 1995. Italy was the outlier, with inflation sticking at around 6%.*
- *Reflecting weaker growth and improved inflation prospects, official interest rates were cut in Europe and the United States in December 1995. Bond yields fell further in the fourth quarter, except in Japan.*

Table A
GDP growth

Percentage change over previous year

		United States	Canada	Japan	Germany	France	Italy	Major six
1992		2.3	0.8	1.0	1.8	1.3	0.7	1.7
1993		3.1	2.2	0.1	-1.2	-1.5	-1.2	1.0
1994		4.1	4.6	0.5	3.0	2.9	2.2	2.9
1995	Q1	4.0	4.4	0.1	2.7	4.2	4.2	3.0
	Q2	3.3	2.7	0.3	2.5	2.9	3.1	2.4
	Q3	3.3	1.9	-0.2	1.9	2.0	3.4	2.2

Chart 1
Business and consumer confidence



Source: European Commission.

Overview

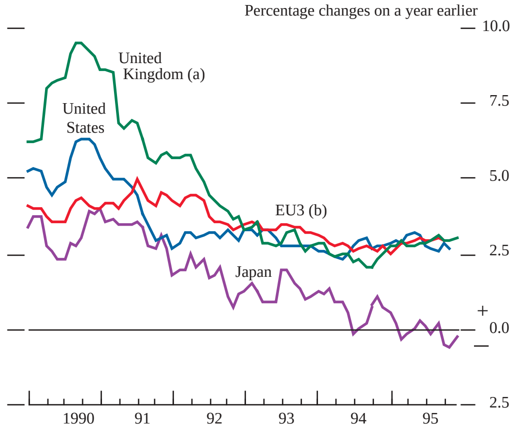
The third quarter of 1995 saw a further slowdown in growth in the major six (M6) overseas economies (the United States, Canada, Japan, Germany, France and Italy), largely reflecting events in Germany and France (Table A). GDP was flat in Germany over the quarter, and grew by only 0.2% in France. This slowdown seems likely to have continued in the fourth quarter. France and Germany between them account for almost one quarter of UK exports. There is a risk of the slowdown spreading to other countries in the European Union such as Italy, Spain and Sweden (which grew more strongly in the third quarter of 1995). A key issue is whether the confidence of European consumers and businesses will recover in 1996, in the face of continuing high unemployment and fiscal consolidation (see Chart 1).

In the United States, growth was surprisingly strong in the third quarter, but appears likely to have slowed to a more sustainable pace in the fourth quarter, as consumer spending moderated.

In Japan, GDP remained weak in the third quarter. There are early indications that business confidence in the fourth quarter was responding to earlier policies to stimulate the economy, and to the more competitive yen. The conditions for a recovery in 1996 now seem to be in place.

Inflationary trends have largely remained favourable, reflecting the anti-inflationary monetary policies in place in the major industrial countries. Recent news has generally been better than expected, reflecting weaker activity and lower commodity price inflation. In the European Union, consumer price inflation remained at around 3% during 1995 and may fall a little further as falls in producer price inflation feed through (see Chart 2). Interest rates were cut in most European countries, but not in Italy, where inflation remained around 6%.

Chart 2
Consumer price inflation in the major economies



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

Chart 3
Ten-year government bond yields

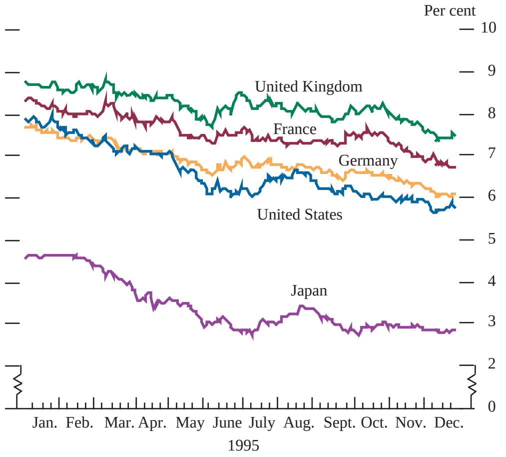
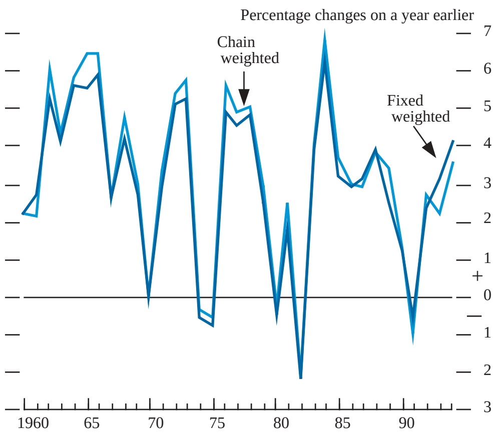


Chart 4
United States GDP growth



In mid-1995, inflation of 3%–3½% had been expected in the United States during 1995, but in the year to November consumer price inflation was only 2.6%. Lower inflationary pressure was the reason given by the Chairman of the Federal Reserve Board for the 25 basis point cut in the target federal funds rate on 19 December.

Bond yields fell further in the fourth quarter (see Chart 3), except in Japan. In the United States, this may have reflected a fall in inflationary expectations.

Equity markets performed strongly in the fourth quarter, with the Dow-Jones index in particular reaching new highs, driven by technology and financial stocks.

Detail

Forecasts of M6 growth in 1995 and 1996 were revised down over the final quarter of the year, to under 2½% on average, mainly reflecting a slowdown in Europe. North America was still expected to grow around trend.

In the United States, GDP data for the third quarter of 1995 supported the notion that the economy had largely recovered from the inventory correction seen earlier in the year. Real GDP grew by 0.8% over the quarter, with consumption particularly robust. Activity data for October and November were more mixed, confirming the impression of an economy slowing towards its trend rate of growth. US retail sales fell in October, and pre-Christmas shopping was reported to be restrained, possibly reflecting the high levels of consumer indebtedness.

In the second half of the year, manufacturing employment and business confidence were relatively weak, while the housing market was particularly strong.

The best estimate of the trend rate of growth has fallen, following a change in the basis of measuring GDP from a fixed to a chain-weighted index (see Chart 4). The new index more accurately allows for developments in high-technology products, which have been characterised by high output growth and falling prices. They were overweighted in the fixed-weighted index, biasing estimated growth upwards and estimated inflation downwards.

Growth has slowed in Germany and France

GDP in Germany is provisionally estimated to have grown by 1.9% year-on-year in 1995, while French GDP is likely to have grown by around 2½%, compared with forecasts of 2½%–3% in mid-1995. German exports were affected by the appreciation of the Deutsche Mark, and employment weakness depressed domestic demand. The phasing out of subsidies hit the construction sector. Despite this, unemployment continued to fall in eastern Germany in the third quarter (the latest for which data are available), though in western Germany, unemployment began to rise from August.

A particular puzzle, however, is the apparent discrepancy in Germany between GDP and other data for the third quarter of 1995. Official real GDP data show no growth between the second and third quarters. But these data have been less reliable following

Chart 5
Employment in Germany

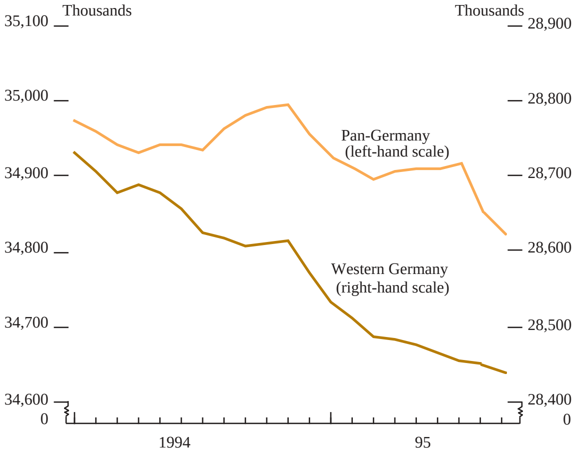


Chart 6
Changes in European industrial production

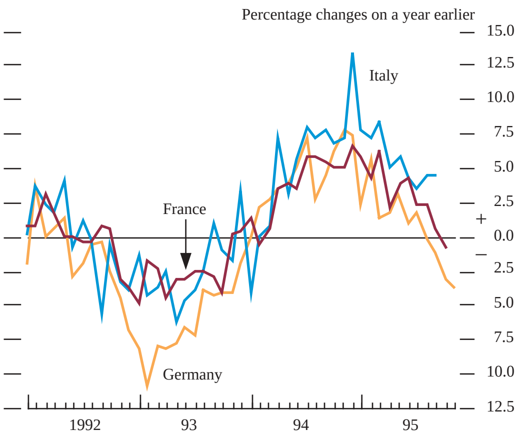
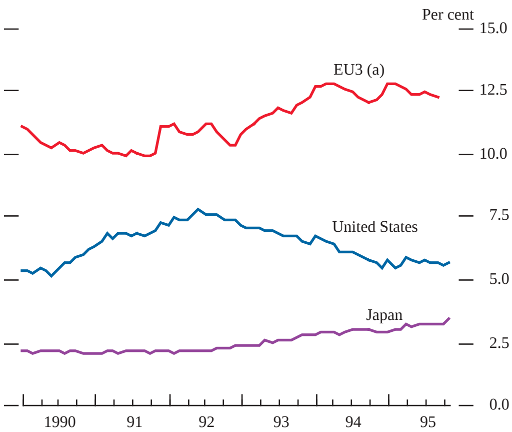


Chart 7
Unemployment rates



(a) Weighted average of Germany, France and Italy.

changes in the measurement of industrial production. Other data show that capacity utilisation in the non-durables sector rose in the third quarter, and there was no marked downturn in the investment-goods sector. The weakness of investment in the national accounts data is also hard to reconcile with the strong M3 lending over the summer. Also, surveys do not corroborate the suggestion in the GDP data that stockbuilding was the main source of demand growth. None of the evidence, however, contradicts the impression that growth slowed in the second half of 1995.

In France activity data pointed to a weak fourth quarter in 1995. Household consumption fell by 1.1% in December, giving a year-on-year fall of 0.8%. Industrial production in November was 0.7% lower than its level a year earlier, despite being boosted by energy production related to the cold weather.

The slowdown in Germany and France is likely to have affected the export sectors in other European countries. Data for the fourth quarter suggest that industrial production weakened across most of Europe (see Chart 6). Higher-than-desired stocks are likely to have held down production, and strikes in France—particularly in the transport sector—are likely to have depressed output in December (although this effect would have been partly reversed in January).

An upturn in production in Europe will depend largely on business and consumer confidence. Unemployment continues to hold back the latter; it is currently around eleven million, or 11% of the workforce, in the European Union, and there is little near-term prospect of any significant reduction (see Chart 7). In Japan, too, unemployment has restrained economic recovery, rising to a historically high rate of 3.4% in November. Even in the United States, where unemployment is lower than in Europe, fear of redundancy seems to be acting as a brake on both wage pressures and spending.

The conditions are in place for a recovery in Japan

The Bank of Japan's November Tankan survey showed that business had become less pessimistic in both the manufacturing and non-manufacturing sectors. This followed a recovery in equity prices and a stabilisation of the exchange rate at a lower level. Consumer confidence remains depressed, however, and the survey did not reveal a turnaround in actual business conditions; the balance of large manufacturers reporting excess stocks of finished goods increased further. Nonetheless, in October construction starts and contracts increased, which may indicate that the fiscal stimulus announced in September was beginning to have an effect.

While the signs of actual economic recovery are therefore very limited, and the possibility remains that the stock cycle and weak world growth will continue to hold back output, the earlier policy easings, the recovery in business confidence and the more competitive yen should be conducive to a recovery in output in 1996. Growth may be around 2½% or more, compared with around ½% in 1995.

Inflation remains flat

Inflation in M6 countries remained subdued in the third quarter of 1995 and most forecasters expect it to remain low during 1996 and 1997.

Chart 8
Producer price inflation

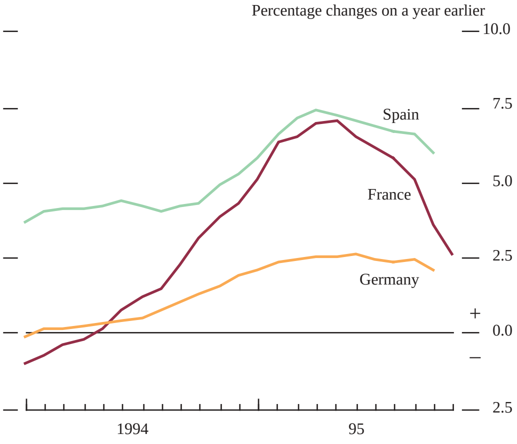
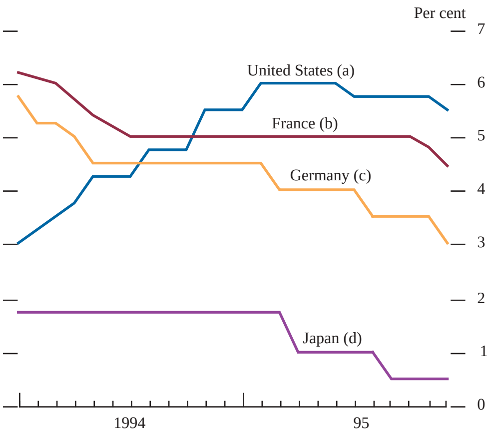


Chart 9
Official interest rates



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

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

Per cent

	1995 30 June	29 Sept.	29 Dec.
US dollar	5.77	5.82	5.08
Deutsche Mark	5.17	4.08	3.46
Yen	1.04	0.61	0.76
Sterling	7.93	6.75	6.07

(a) Expected rates as implied by futures contacts.

Producer price inflation in Europe weakened considerably (see Chart 8), because of falling commodity prices, slower growth and inventory adjustments. Consumer price inflation was 1.8% in the year to December in Germany, and only a little higher in France. Finland had the lowest inflation in Europe, at 0.3% per year, reflecting lower food prices since its entry into the European Union and the appreciation of the markka. The Finnish unemployment rate, however, is among the highest in Europe at almost 20%. In Spain, core inflation declined from its peak of 5.2% in July to 4.8% in December, and further falls are likely while domestic demand remains soft. Headline inflation is lower, and looks likely to be within the inflation target of 3.5%–4% in the first few months of 1996.

In Italy, consumer price inflation remained around 5¾%–6% in the last five months of 1995; slower wholesale and producer-price inflation in the fourth quarter should, however, feed through in 1996. The very early signs in the 1996–97 wage round—for instance, a settlement in the chemicals industry well below headline inflation—are encouraging. Although the current strength of activity may prevent inflation falling much in 1996, it is possible that the slowdown in Germany and France will have a knock-on effect on Italy.

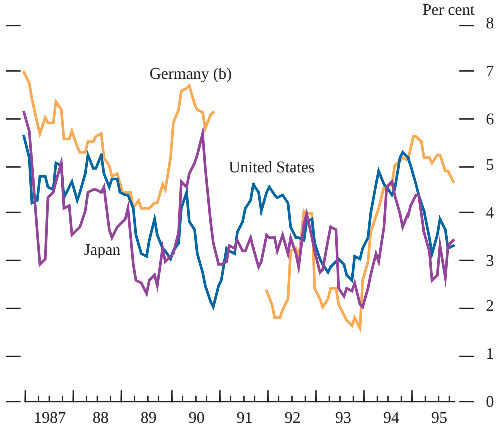
The summer drought which pushed up food prices in Europe in the autumn had a similar effect in the United States, but there it was offset by lower energy prices. Consequently US consumer prices were flat in November, and their annual rate of increase fell to 2.6%. In Japan, fresh-food prices fell by around 14% in November, taking twelve-month consumer price inflation to -0.7%, its lowest rate since February 1987. Export prices, on the other hand, rose sharply in November, suggesting that exporters were taking advantage of the weaker yen to rebuild margins.

Most forecasters expect inflation to remain subdued in 1996. But, in addition to external shocks, there are risks: wage pressures, particularly in the United States, where unemployment may have been below its natural rate for a while, but also in Europe, where workers may increase their pay demands in response to continued fiscal and wage restraint, especially in sectors where profitability has recovered. Fiscal slippage is a further risk to the inflation outlook, as is currency weakness. But the activity risks to the inflation outlook are on both sides, and there is a downside risk from greater price competition.

Policy

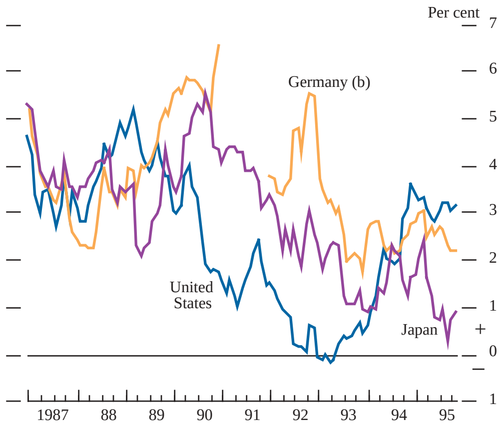
Although world growth and inflation in 1995 were lower than had been expected in the middle of the year, it is unlikely that the pause will turn into a recession, not least because interest rates have been cut (see Chart 9). The Bundesbank cut the discount and Lombard rates by 50 basis points each on 14 December, to 3% and 5% respectively. The cumulative reduction in the repo rate during 1995 was 110 basis points. Interest rate cuts followed in Austria, Belgium, Denmark, Ireland, the Netherlands, Portugal, Spain and Switzerland (this took the discount rate in Switzerland to 1.5%). France cut its intervention rate by 25 basis points to 4.45%. The United Kingdom had already cut base rates by ¼% to 6.5% on 13 December. In January, the United Kingdom, France and Spain trimmed official interest rates by a further 25 basis points.

Chart 10
Long-term real interest rates(a)



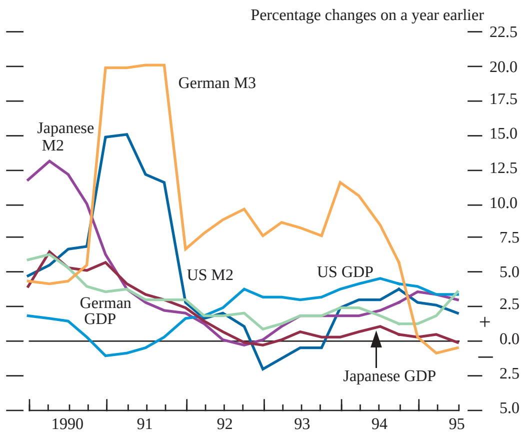
(a) Ten-year interest rates less annual consumer price inflation.
(b) German 1991 data not included due to reunification.

Chart 11
Short-term real interest rates(a)



(a) Three-month interest rates less annual consumer price inflation.
(b) German 1991 data not included due to reunification.

Chart 12
Broad money and nominal GDP growth



On 19 December the Federal Reserve Bank cut the target federal funds rate by 25 basis points to 5.5%, citing an improvement in inflation prospects. The Bank of Canada followed suit, cutting the Bank rate by 16 basis points to 6.06%. As of mid-January, Canadian interest rates are still significantly above those in the United States, in the wake of the Quebec referendum, although inflation and growth are considerably lower. Table B shows that further cuts in interest rates are expected in the first half of 1996.

Assessing the stance of monetary policy is not straightforward. Charts 10 and 11 show that long-term real interest rates in Germany are relatively high, but short-term rates, as in Japan, are relatively low, at least according to the measures chosen. (To the extent that actual inflation and inflation expectations are lower than recorded inflation in Japan, real rates are overstated.) In the United States, by contrast, long-term real rates appear to be lower than they have been for most of the past ten years, but short-term real rates have risen sharply since 1993. The yield curve has therefore flattened in the United States, mainly as a result of falling long rates, while yield curves have been historically steep in Germany and Japan, as short rates have been cut. One explanation may be that long rates incorporate risk premia related to the longer-term fiscal outlook in Japan, and uncertainty in Germany about a single European currency. In the United States, ten-year bond yields fell by more than 50 basis points in the fourth quarter, despite uncertainties about fiscal policy.

Monetary aggregates are even harder to interpret. Both broad and narrow-money growth rates have displayed considerable volatility in the main overseas economies in recent years. Financial deregulation, technological change, changes in inflation regimes, and problems in one part of the financial sector can all distort the usual relationship between money growth and nominal GDP.(1)

In the United States and Canada, for example, the growth of narrow money continued to fall in the period under review, reflecting the continuing proliferation of sweep accounts. By contrast, the three-month annualised growth rate of German currency in circulation more than doubled to 8.5% in Q3. Narrow-money growth in Japan was boosted as a result of the Bank of Japan's diversification of monetary policy tools from repo agreements to outright purchases of government bonds and certificates of deposit.

Broad-money growth in the G7 continued on an upward trend; annual growth was 4.1% for October, compared with 2.1% at the start of 1995. In the United States, the acceleration of M2 during 1995 is likely to have reflected in part a switch from money-market mutual funds, where investors sustained losses in 1994, to retail bank deposits. Consumer credit growth, however, slowed down in Q3. Japanese broad-money growth had slowed earlier in the year. It picked up in November, following sluggish lending by financial institutions in the third quarter (see Chart 12).

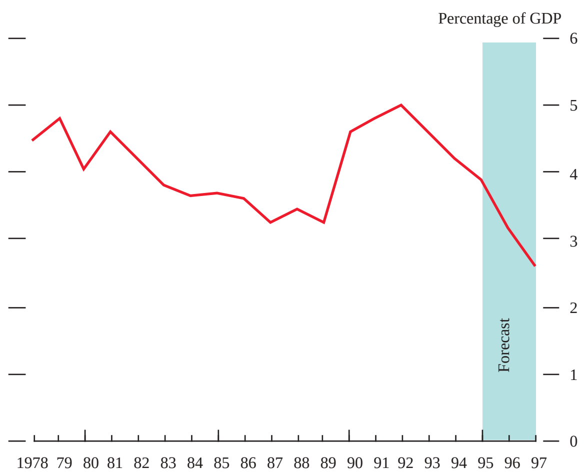
In Germany, broad-money growth in 1995 undershot the 4%–6% target range, reflecting very weak growth in the first five months of the year, particularly in January and February. The Bundesbank announced the new target for monetary growth in 1996 of 4%–7%.

(1) See Janssen, N 'Can we explain the shift in M0 velocity? Some time-series and cross section-evidence' on pages 39–50.

The impact of European fiscal consolidation on growth

The aggregate structural deficit of the 15 European Union countries was reduced from 5% of GDP in 1992 to a projected 3.9% in 1995. The OECD expect a further reduction by 1.2 percentage points over the next two

Chart A
EU15 structural fiscal deficit[a]



Source: OECD.

(a) GDP weighted.

years. This would result in the largest and most sustained decline on record. This box assesses the impact of fiscal consolidation on growth in Europe.

There is no consensus on the implications for aggregate demand, either theoretically or empirically. The hypothesis of Ricardian equivalence is that agents realise that the present value of government expenditure and debt cannot exceed the present value of government revenues—the government, like individuals, faces a budget constraint. This implies that a cut in the fiscal deficit will have no effect on aggregate demand. It will mean lower taxation in future. Consumers know this and will simply save less than they otherwise would have done to compensate. The two effects will exactly offset each other. This hypothesis assumes that individuals face the same interest rates as government, and that they take the whole of the future into account when they make their spending plans, and are not credit constrained. If either is not the case, a temporary adverse effect on growth is likely. At the same time, smaller public deficits should reduce real interest rates, and this may increase long-run productive potential.

There are also efficiency arguments. If private investment is more effective than public, a switch from public to private spending will, in itself, boost economic growth. The form the government spending takes, and therefore the form of the consolidation, is crucial. Because the EU is such a closely integrated trading bloc, synchronised consolidations are likely to have a mutually reinforcing effect.

The table summarises the results from an IMF simulation of industrial economies. They assume forward-looking

Industrial countries: simulation of balanced government budgets in five years[a]

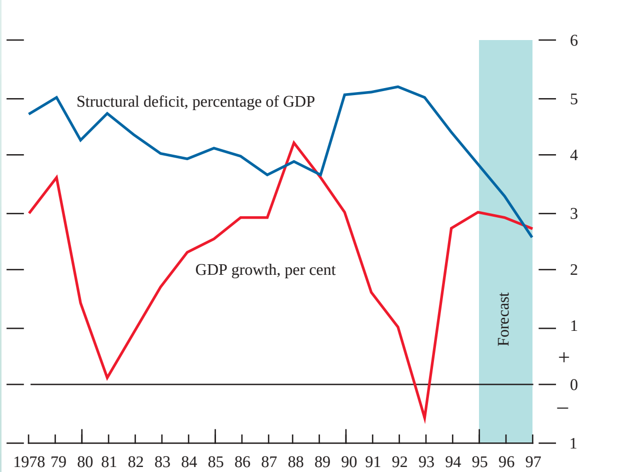
	1996–97	1998–99	2000–01	Long-run
General government balance (percentage of GDP)	0.8	1.9	3.4	0.9
Government debt/GDP	-1.7	-4.5	-9.3	-17.9
Real GDP	-0.4	1.5	1.2	2.3
Inflation (GDP deflator)	0.5	-0.5	-1.0	—

(a) Deviation from base in percentage points.

consumer behaviour and emphasise the crowding-out effects of public spending. This implies more positive effects on output than alternative models would suggest. Results are derived under the assumption that the fiscal tightening includes measures which result in less labour-market rigidity, raising long-run productive potential by 1%. Lower real interest rates are expected to increase output by a further 1.3%. Other models, however, suggest that the long-run effects are less positive and the short-run effects are more negative.

As Chart B shows, it is possible to have a period of fiscal consolidation at the same time as fast growth. However, previous periods of consolidation were shorter lived, and it is impossible to say what growth would have been had they lasted longer. Budgetary reforms have had a limited effect on long-run interest rates thus far, but this could be due to a lack of credibility of the convergence programmes. It does not rule out significantly lower real interest rates if the consolidations continue: recently, however, a number of revenue projections have been thwarted by weaker-than-expected activity.

Chart B
EU15 structural deficit and GDP growth



The upper limit for M3 growth has been raised, in part because of greater uncertainty about short-term movements in the demand for broad money.

The Banque de France reaffirmed its objective to keep inflation below 2% in 1996 and in the medium term.

The Japanese authorities announced a mildly expansionary budget for the fiscal year 1996/97. However there may be supplementary budgets during the year, so the overall fiscal outlook is uncertain. Low growth and fiscal stimuli during the 1990s have resulted in an increasing Japanese debt/GDP ratio. The OECD forecasts that the ratio will have risen to 97.3% by 1997, from around 75% in 1994.