The international environment

This article considers economic developments in the European Union, North America and Japan since the February 1996 Quarterly Bulletin. *These countries account for about half of world GDP, but three quarters of UK external trade.*

Two topics are considered separately in boxes: the relative performance of services and manufacturing output in the G7 economies; and fiscal consolidation in Europe.

- *GDP in the major six (M6) international economies barely grew in the last quarter of 1995. Activity in continental Europe weakened further. There were signs of recovery in Japan, but it was not broadly based. The US economy was affected by several special factors over the winter, but underlying growth was probably near its long-run trend.*

- *Inflation remained at around 2% a year in the M6 economies in the year to February 1996. Consumer price inflation fell noticeably in Germany and Italy at the start of 1996.*

- *Official interest rates were unchanged in the United States and Japan. The United Kingdom, France, Spain, Canada and the Scandinavian countries all cut their rates in March. The Bundesbank cut rates in Germany by 1/2% in mid-April; several European central banks followed suit. Yield curves steepened over 1996 Q1, reflecting market perceptions of a turning point in interest rates.*

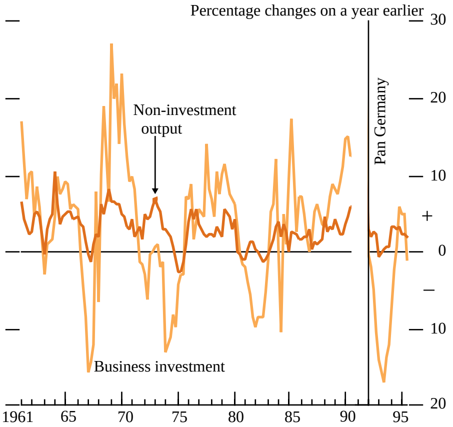
Table A
GDP growth

Percentage change over previous quarter

		United States	Canada	Japan	Germany	France	Italy	Major six (a)
1994	Q3	0.9	1.4	0.6	0.6	0.9	1.6	0.9
	Q4	0.8	1.1	-1.1	0.6	1.0	—	0.4
1995	Q1	0.1	0.3	0.1	0.3	0.7	1.5	0.3
	Q2	0.1	-0.2	0.6	1.1	0.1	—	0.3
	Q3	0.9	0.3	0.6	0.1	0.1	1.8	0.7
	Q4	0.1	0.2	0.9	-0.4	-0.4	-0.9	0.1

(a) UK trade-weighted average.

Chart 1
Business investment and non-business investment output in Germany



GDP fell in Germany, France and Italy in the final quarter of 1995

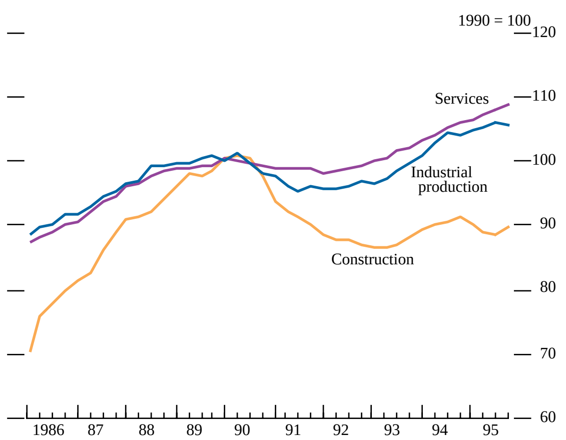
The weakness of the German economy (see Table A) is of particular concern, because some of the causes are structural rather than cyclical, and because of the importance of the German economy in Europe. While German exports picked up strongly during 1995, reflecting the softening of the Deutsche Mark since spring 1995, this has not, as in the past, fed through to investment, employment and consumption. Business sentiment was successively weaker in January, February and March 1996. Direct investment abroad has been strong, but domestic investment remains well below levels usually associated with the current stage of the business cycle (see Chart 1). Structural problems have contributed to an upturn in unemployment since autumn 1995. An end to the construction boom, exacerbated by bad weather in January, pushed unemployment up further. Seasonally adjusted unemployment reached 4.0 million in March. The sharp rise in unemployment may explain why tax cuts in January have not yet affected spending; the possibility of tax increases ahead may be another factor.

In France, GDP fell by 0.4% in the last quarter of 1995, following two weak quarters—an identical pattern to that seen in Germany. Depressed household consumption and a reduction in stocks—particularly in the strike-affected fourth quarter—were the main contributions to the weakening in domestic demand (see Table B). The first quarter in 1996 is likely to have been stronger,

Output growth in the G7 countries by type of activity

Since 1990, the service sector has grown more quickly than manufacturing in the United Kingdom, as the chart shows, and construction has fallen. Manufacturing and construction grew relatively quickly during 1994 and then much slower during 1995. This note examines experience elsewhere in the major economies of Europe and the United States.

UK output



As the table shows, the UK experience is similar to that of other economies. In all countries other than Germany, construction has been the slowest-growing sector of the economy; and in all countries other than Italy services have been the quickest growing. But within this period, manufacturing and construction performed particularly poorly during the recession. When economic recovery started, manufacturing picked up, growing temporarily more quickly than services, but construction remained weak. In 1994, construction grew quickly everywhere. In 1995, however, there was a general slowdown in manufacturing and construction—with the exception that in Italy manufacturing continued to grow strongly.

Output growth by sector 1990 Q1–95 Q3

Per cent

	Service	Industrial	Construction
United Kingdom	7.8	5.8	-12.1
Germany	23.5	-16.9	-9.2
France	7.5	2.4	-9.6
Italy	8.6	9.4	-11.1
United States	17.6	2.0	-6.1

What explains this? Sectoral growth has been closely linked with economic activity, but services are much less cyclical than the rest of the economy. This is for several reasons: the counter-cyclical parts of government spending are centred in services, and manufacturing is much more accurately measured than services in the national accounts: if people trade down in services in times of recession it might not be reflected by the statistics.

This begs the question of why growth in the major economies slowed in 1995. Real interest rates were very low during 1993 and early 1994, but fears of incipient inflationary pressures, especially in the United States, led to a sharp rise during 1994. This resulted in slower growth in residential investment and consumption during 1995. The Deutsche Mark appreciated sharply in early 1995, and German business competitiveness was further eroded by large wage rises. This aggravated the slowdown in Germany and resulted in a rise in unemployment, which in turn has led to very weak demand. In France continuing high unemployment and fiscal tightening, driven by the need to reduce the fiscal deficit, have aggravated low confidence and weak demand.

In addition to its effect on demand, the rise in interest rates may have led to a greater slowdown in the industrial than in the service sector. This is because industrial firms are typically more capital intensive, and so are more prone to being unable to service their repayments in times of high interest rates. Construction work is very interest sensitive, and the rise in interest rates explains much of its slowdown.

There are also long and short-term trends. Services have grown more quickly than industrial output on average throughout the post-war period in Western Europe and North America. This is partly because of growing incomes and wealth, which have led to a relative increase in demand for leisure services, and partly due to the comparative advantage in industrial production in Japan and more recently the NIEs. The information technology revolution has recently led to fast growth in communications, which in the short run will favour services, but in the long term is likely to raise output throughout the economy.

An important influence on the relative performance of different countries' sectors is the real exchange rate. If a country's real exchange rate has appreciated, it will hit the manufacturing sector—which produces a higher proportion of tradables—harder than the service sector. This largely explains the relatively poor performance of manufacturing in Germany and its relatively good performance in Italy over the last few years, as illustrated in the table.

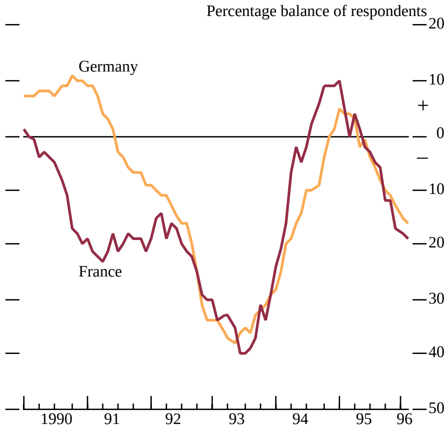
In 1996, growth in continental Europe may remain weak during the first half, but could strengthen towards the end of the year. This means that industrial activity and construction may remain relatively weak. In the United States, growth could be around trend, with services growing slightly more quickly than the other sectors.

Table B
Contribution to growth in GDP in 1995 as a whole

	United States	Germany	Japan	France
Stocks	-0.4	-0.1	0.2	0.1
Investment	0.9	0.4	0.1	0.6
Net trade	-0.1	0.3	-0.7	0.2
Government	—	0.4	0.2	0.2
Consumption	1.6	1.1	0.9	1.1
Total (a)	2.0	2.1	0.9	2.2

(a) Totals may not sum due to rounding.

Chart 2
Business confidence



Source: European Commission.

Chart 3
Quarterly change in US non-farm employment

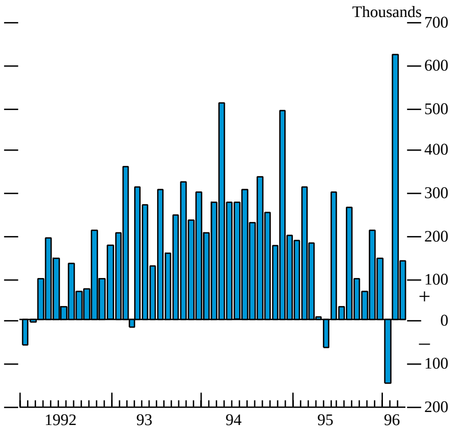
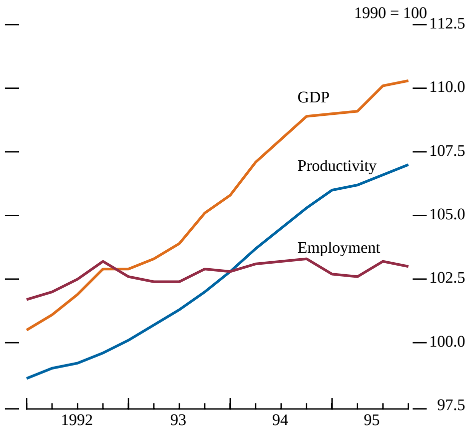


Chart 4
US employment and productivity



in part reflecting a rebound from the strikes. But, in addition, there have been one or two encouraging signs. The survey of investment intentions in January predicted an 11% rise in investment in the year. Even if investment turns out somewhat lower, it will nevertheless contribute significantly to growth. Household consumption of manufactured goods in January also increased by 5.1%, with car purchases particularly robust. In February, however, industrial production fell sharply. Over 1996 as a whole, growth in real personal disposable income may be limited, if fiscal consolidation continues and wages growth is restrained. With unemployment on the increase, consumption is unlikely to be an engine of growth.

The fall in GDP in Italy in the last quarter of 1995 was surprising, given the exceptionally strong third quarter. The data are volatile, however, and so too much weight should not be given to a single quarter. A deteriorating external outlook and slower growth of domestic demand may result in some slowdown this year in GDP growth this year.

In Europe as a whole, lower interest rates, low inflation and growth in the rest of the world point to some recovery in activity later in the year. The need for further fiscal consolidation is likely to hold back growth, however, and confidence has yet to recover (see Chart 2).

US economy seems to be growing near long-run trend

The exceptionally large increase in non-farm employment (see Chart 3) in February supported the notion that the softness in the US economy during the winter months was largely due to temporary factors such as strikes, bad weather and government shutdowns.

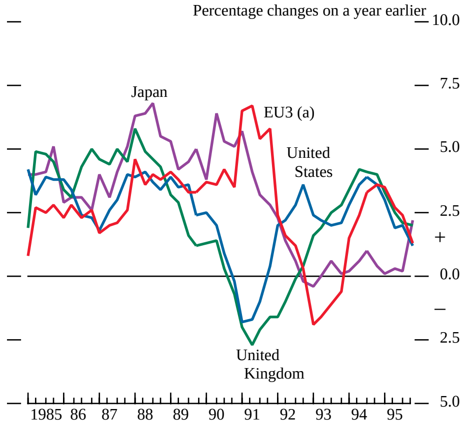
Recent data suggest that output growth is returning to around its long-run trend of about 2.2% (see Chart 4). Even though the economy is in its fifth full year of expansion, there appear to be none of the imbalances which usually characterise the peak of a cycle. Indeed the balance of risks to growth may be on the upside.

The high level of consumer indebtedness is probably the main downside risk to continued expansion in the United States. The ratio of consumer indebtedness to personal disposable income reached a new peak in the fourth quarter, and there is some evidence that defaults on mortgage and other consumer debt have been rising, albeit from very low levels. But consumption should be supported by continued growth in incomes and by the rise in equity prices.

The Japanese economy picked up in the fourth quarter

In Japan, GDP grew by 0.9% in the fourth quarter, and third quarter growth was revised up to 0.6%. Growth came entirely from public sector investment—reflecting the fiscal packages announced in September—and residential investment. Other components of domestic demand were more subdued, and net external trade made a negative contribution to growth. Data in early 1996 were mixed.

Chart 5
GDP in the major economies



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

Chart 6
Consumer prices

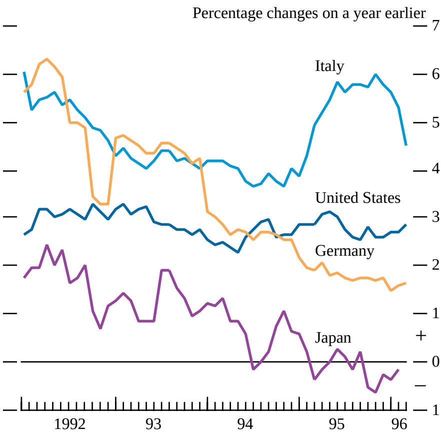
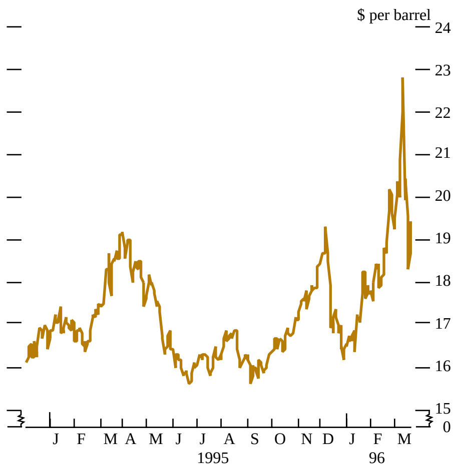


Chart 7
Price of Brent crude



The recovery in the Japanese economy may continue during 1996, as the effects of the fiscal stimulus announced last September continue to feed through. The main risk is that the momentum may falter as this effect comes to an end in the latter part of this year. Financial sector fragility also remains a concern, with progress in tackling the jusen (housing corporation) problems proving difficult.

Inflation—the short-term outlook is benign

The annual rate of consumer price inflation in the M6 overseas economies has remained around 2%–2¹/₄% over the past two years. Differences between areas persist, however; recorded consumer prices in Japan were around ¹/₄% lower in February 1996 than a year earlier (the statistics almost certainty underestimate the extent of the fall in prices) and around 2³/₄% higher in the United States. In Canada, core inflation, which excludes food and energy, was 1.6% in the year to February, well within the Bank of Canada's 1%–3% target.

Consumer price inflation in Germany fell further to around 1¹/₂% in the first couple of months of 1996, and the increase in prices in France, that had been expected following earlier tax increases, proved modest. In Italy, consumer price inflation has moderated considerably since November. Technical factors, including a reweighting and a rebasing of the consumer price index, together with tax increases being removed from the index, brought consumer price inflation down to 4.5% a year in March (see Chart 6). This was still above the Banca d'Italia's inflation objective of 4% for 1996, but the consensus among private sector forecasters in April was that inflation would fall to 4% in Q3.

There is little sign of immediate upward pressure on inflation in the pipeline. On the latest figures, producer prices were lower than a year earlier in Japan, France and Germany and producer price inflation fell in Italy and Canada. Producer price inflation picked up a little in March, but this largely reflected temporary rises in the prices of seasonal foods and energy.

Oil prices rose sharply in March, (see Chart 7), but this appeared to be a short-term supply problem; certainly the futures markets indicated that the high prices were not expected to persist. A surge in demand due to cold weather in the United States and Europe was one factor pushing up prices. Further ahead supply may increase if UN negotiations with Iraq are resolved.

Looking further ahead, however, the upside risks to inflation have increased since the February Quarterly Bulletin

In the United States, the main risk comes from the labour market. The possibility of above-trend output growth as the stock cycle ends could push unemployment lower, and put pressure on wage costs. Unemployment has been close to estimates of its natural rate for some time, and wages growth has been stable. A further reduction in unemployment could lead to escalating wage costs. There has already been some pick up in average hourly earnings, (see Chart 8) but this probably reflects a shift towards more skilled employment. The recent acceleration in unit labour costs may lead to an increase in inflationary pressure.

Chart 8
US prices

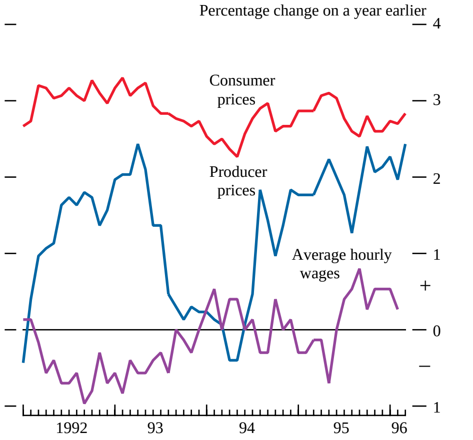


Chart 9
Ten-year government bond yields

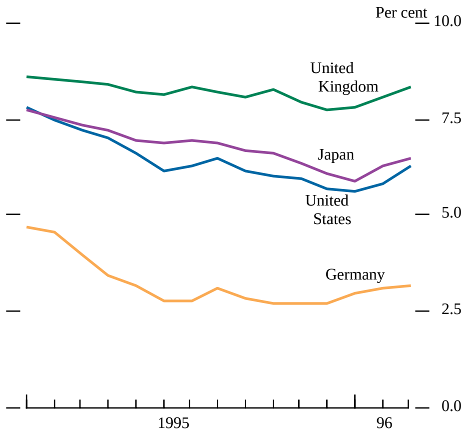
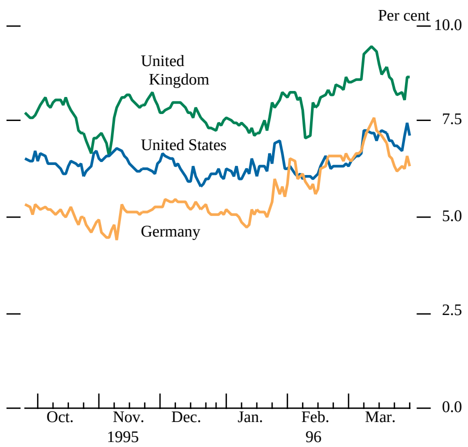


Chart 10
UK implied bond market volatility(a)



(a) The expected standard deviation of annualised price movements in LIFFE's long-gilt future.

Expectations of inflation further ahead may have increased

Nominal bond yields in the United States, the United Kingdom, Canada, Germany and Italy have been rising steadily since mid-January, with the increasing perception that the global cycle of interest rate cuts might be coming to an end (see Chart 9). The upwards drift in yields accelerated sharply in the United States following publication of the much stronger-than-expected employment data. Elsewhere bond yields rose by less.

What explains the rise in bond yields? Historically financial markets' inflation expectations have been the main influence on nominal long bond yields. In the United Kingdom about two thirds of the rise in long bond yields to mid-March was attributable to an increase in implied forward inflation rates, and the remaining third reflected an increase in the real rate of interest. (This decomposition is based on analysis of yield differentials between conventional and index-linked gilts.) It is not possible to break down nominal yields in other countries in this way, but, given that real interest rates tend to be determined by global factors, it would not be surprising if the rise in real interest rates had been similar. This would imply a general increase in implied forward inflation rates, which could reflect higher inflation expectations and possibly an increase in the risk premia demanded by investors. The increase in implied bond market volatility since the start of the year (see Chart 10) provides some evidence that uncertainty has increased. This is only likely to account for a small part of the rise in implied forward inflation rates, however. Most of the rise is likely to be due to higher inflation expectations.

Both narrow money and broad money growth accelerated

Growth rates of narrow and broad money aggregates have been increasing in most of the G7 countries since the end of 1994 or early 1995 (see Charts 11 and 12). In the fourth quarter of 1995 average broad money growth reached its highest rate since end 1991. Over the past 20 years narrow, and, to a lesser extent, broad money growth have been relatively good leading indicators of inflation in the majority of the G7 countries, although the relationship between money growth and inflation has weakened in the 1990s. In the case of narrow money, this may reflect a change in velocity associated with a lower inflation environment. Alternatively, the fall in inflation expectations may have lengthened the transmission lags from money growth to inflation. If the latter explanation were true, it would imply that inflation will pick up in the future.

Narrow money

Japan had the highest growth rate of narrow money in 1995 Q4; M1 grew by 12.9%, in part reflecting the Bank of Japan's measures to boost liquidity. In February M1 accelerated again (to 16.1% annually), probably reflecting the extremely low interest rates offered on deposits.

In Germany, currency in circulation accelerated in Q4 1995, though its growth rate is still low compared with the average over the post-unification period. M1's growth rate increased from 3.5% in Q3 to 6.3% in Q4. Narrow money growth in France continued to be erratic, especially in December when three-month annualised growth was 29.0%. January's growth rate, however, was more

Chart 11
Average narrow money growth in the G7

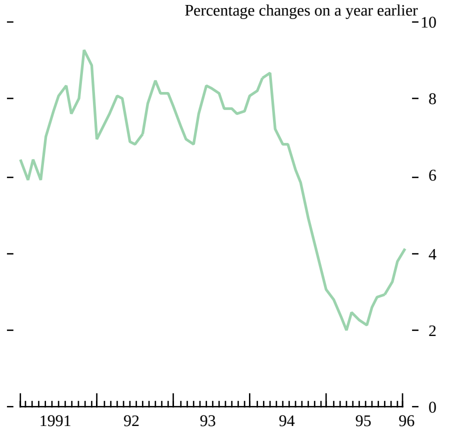


Chart 12
Average broad money growth in the G7

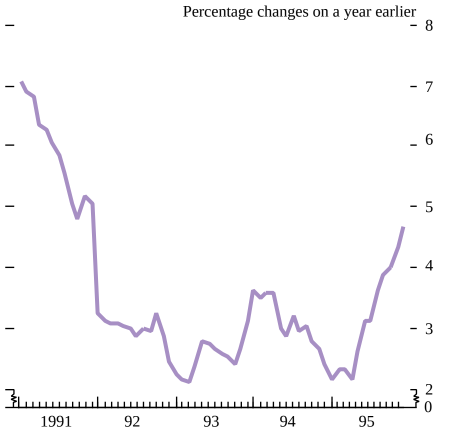
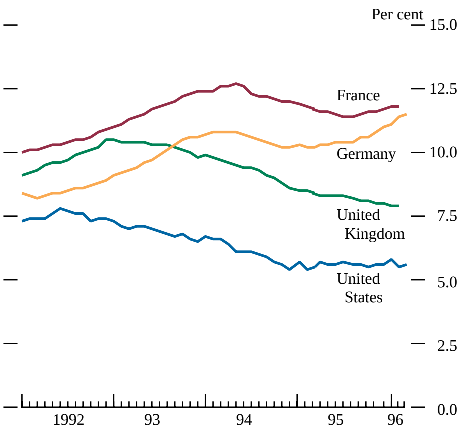


Chart 13
Unemployment rates



modest. Italian M1 increased by 1.4% annually in 1995 Q4, but its growth fell again slightly in January.

In the United Kingdom, annual growth was 5.7% in 1995, but rose to 6.0% in February again.

In contrast, the annual growth rate of currency in circulation in Canada and the United States has continued to slow down—to 2.7% in Canada and 5.4% in the United States.

Broad money

Among the G7 countries, broad money grew most strongly in the United Kingdom in the fourth quarter of 1995, with a growth rate of 9.9% for M4. This was well above the 3%–9% monitoring range. From January 1996, M4 outturns include the effects of the open gilt repo market, which may increase the volatility of M4 monthly growth rates. But the general picture, is one of continuing strength. Broad money growth also rose in the United States, indeed M3 growth exceeded its range of 2%–6%, at the end of 1995. Canada's M2+ growth rate was relatively stable over the period under review at 4.4%. German M3 picked up strongly in Q4, and continued to grow well above target in the first three months of 1996. Lending to the private and public sector increased, whereas monetary capital formation slowed down as investors became uncertain about the future level of interest rates.

In France, M3's annual growth rate fell slightly, but M2 increased strongly after an exceptionally high figure for December. Broad money in Italy continued its recovery (+3.1% in Q4).

Interest rates

Official interest rates have been unchanged in Japan and the United States since the February *Quarterly Bulletin* was published on 14 February 1996. France trimmed both its intervention rate and five to ten-day repo rate by 10 basis points on 7 March and the United Kingdom cut base rates by $^{1}/_{4}$ percentage point the following day. Spain reduced its 10-day repo rate by 50 basis points on 12 March, and by a further 50 basis points on 3 April. All the Scandinavian countries reduced their official interest rates in March, though by varying amounts ranging from 10 basis points in Denmark to 75 basis points in Sweden. On 18 April the Bundesbank cut both the discount and Lombard rates by 50 basis points, to 2.5% and 4.5% respectively, citing the fall in inflation as the reason for the cut. The German move was immediately followed by cuts in interest rates in Austria, Belgium, Denmark and the Netherlands. Greece, Ireland and Portugal cut their rates the following day.

Fiscal policy

The French and German governments responded to the decline in consumer confidence and rise in unemployment (see Chart 13) with a series of measures.

The German government announced details of a 50 point 'Action Programme for Investment and Jobs'. The objectives, which are to be met by the year 2000, are to halve unemployment, reduce state spending from 51% to 46% of GDP and reduce social security contributions. The package is a series of supply-side measures to

Fiscal developments in the European Union

The marked slowdown in GDP growth in the second half of 1995 has implied a slower-than-anticipated reduction in fiscal deficits across the European Union. This box assesses general government debt and deficit outturns in 1995 and considers the progress being made by Member States towards the criteria set out in the Maastricht Treaty[(1)].

In autumn 1995, the European Commission forecast that the average general government fiscal deficit in 1995 for the European Union as a whole was expected to be 0.8 percentage points lower than in 1994, at 4.7% of GDP. This compares with the estimate of 4.5% of GDP made early in 1995. According to the most recent data, the average deficit was reduced by only 0.5 percentage points, to 5.0% of GDP.

Table A shows that the general government deficit to GDP ratios continued to vary widely across the European Union in 1995. Compared with 1994, the deficit to GDP ratio fell by more than two percentage points in Greece and Sweden and between 0.7 and two percentage points in the United Kingdom, Belgium, Denmark, France, Italy and Finland. Smaller reductions were made in Spain, and Ireland. The ratio rose slightly in the Netherlands and by one percentage point or more in Germany and Austria. In Luxembourg, the fiscal surplus fell by one percentage point.

Table A
Deficit outturns in EU Member States[(a)]

As a percentage of GDP

	1995	1994	1993	1992	1991
Belgium	4.5	5.3	6.7	7.1	6.5
Denmark	1.5	3.5	3.9	2.9	2.1
Germany	3.6	2.6	3.5	2.8	3.3
Greece	8.9	11.4	12.1	11.7	11.6
Spain	5.8	6.2	7.4	4.1	4.9
France	5.0	5.9	5.9	3.9	2.2
Ireland	1.9	2.0	2.2	2.4	2.2
Italy	7.2	9.0	9.6	9.5	10.2
Luxembourg	-1.1	-2.2	-1.7	-0.8	-1.9
Netherlands	3.7	3.2	3.2	3.9	2.9
Austria	6.1	4.5	4.1	1.9	2.6
Portugal	5.2	5.7	6.9	3.6	6.4
Finland	5.6	6.3	8.0	5.9	1.5
Sweden	7.8	10.8	12.3	7.8	1.1
United Kingdom	6.0	6.8	7.8	6.3	2.6
European Union	5.0	5.5	6.2	5.0	4.1

Source: Member States' data or submissions to the EU Commission (March 1996). 1995 data provisional.

(a) Shading shows where the Maastricht criterion has been satisfied.

In 1995, the average ratio of general government expenditure to GDP across the European Union declined to 50.9%, compared with 51.5% in 1994 and a peak of 52.5% in 1993. The ratio of current and capital expenditure and transfer payments fell. But the ratio of interest payments to GDP continued to increase as a result of the rapid debt accumulation in recent years. The ratio of general government receipts o GDP rose marginally, from 45.9% in 1994 to 46.2%. This reflects a minor increase in receipts from direct taxes and social security contributions. The ratio of indirect tax receipts to GDP was unchanged, although several countries raised indirect tax rates in 1995.

Comparing these results with the Maastricht Treaty criteria, only one Member State, Luxembourg, met the reference values for both the deficit and government debt ratio in 1995 (Table B). In Ireland, the deficit remained below 3% of GDP but the debt level was 86% of GDP: the Irish debt ratio has, however, been falling for several years, from 118% in 1986. In Denmark the deficit ratio was reduced below the 3% reference value, while the debt ratio fell for the second consecutive year, reaching 72% of GDP. In Germany, France and the United Kingdom, deficit ratios were above 3% and in these countries, debt ratios were rising but remained below the reference value of 60% in 1995. In all other countries, both the deficit and debt ratios exceed the reference values specified in the Treaty.

Table B
Gross debt in EU Member States[(a)]

As a percentage of GDP

	1995	1994	1993	1992	1991
Belgium	133.8	136.0	137.9	131.5	130.1
Denmark	72.1	76.0	80.1	68.7	64.6
Germany	58.1	50.4	48.2	44.1	41.5
Greece	114.5	113.0	114.5	91.6	86.1
Spain	65.2	62.6	60.1	48.0	45.8
France	52.2	48.4	45.4	39.7	35.8
Ireland	85.4	91.7	98.0	95.0	96.9
Italy	125.1	125.4	119.4	108.4	101.3
Luxembourg	5.8	5.7	6.2	5.2	4.2
Netherlands	78.7	79.1	81.1	79.4	78.8
Austria	69.2	65.0	62.8	58.3	58.7
Portugal	71.4	70.0	67.7	63.7	70.2
Finland	59.4	59.5	57.3	41.5	23.0
Sweden	76.9	79.3	76.0	67.1	46.9
United Kingdom	54.3	50.5	48.5	41.9	35.7
European Union	71.7	68.2	66.0	59.1	54.7

Source: Member States' data or submissions to the European Union Commission (March 1996). 1995 data provisional.

(a) Shading shows where the Maastricht criterion has been satisfied.

While some progress has been achieved in fiscal retrenchment, deficits are still high and debt ratios have risen further for the European Union as a whole. The fact that deficits were not reduced below the reference value in 1995 illustrates the magnitude of the adjustment task which remains, as well as the extent to which weaker-than-expected growth affects fiscal targets.

(1) Economic criteria for the evaluation of budgetary and debt developments are given in Maastricht Treaty Articles 104c(2) and 103c(3) in connection with Article 1 of the Protocol on the excessive deficits procedure. The reference values for general government deficits and debt are 3% of GDP and 60% of GDP, respectively.

promote enterprise, cut taxes and reform social welfare. But many of the measures are no more than proposals at this stage, and several will require parliamentary approval before they can be implemented.

In France, the objective was to increase employment and boost consumption. Initiatives included tax relief on consumer credit and subsidies on housing renovation and a reduction in the rates of interest on certain deposit accounts. It is too early to assess the effect of these measures. There may be stronger effects in certain sectors, such as housing and cars, than in others. On the other hand the measures may be partly offset by an increase in savings, particularly if the expected future value of pensions has fallen. This would account for the recent upsurge in the take-up of life insurance.

Employers in France have been requested to ensure that 50% of new recruits are aged under 25. Subsidies are also being provided to employers taking on apprentices. The most successful measure to boost employment seems to have been the reduction in the cost of unskilled workers over the recent past. By contrast, some surveys have suggested that subsidies to firms taking on particular groups of unemployed workers (such as the young or long-term unemployed) have not increased employment overall.

The structural reforms needed in both economies are made more difficult by the continued need to reduce fiscal deficits. Germany has announced that its general government deficit for 1995 was around 3.5%, overshooting the Maastricht target of 3%. In France the central government deficit was near its target at 4.2% of GDP. This was partly due to an inflow at the end of the year of non-fiscal receipts, such as dividends from state-owned enterprises. More details are given in the box on page 152.