The international environment

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

- *GDP growth in the first quarter was quite strong at first sight; in the major six (M6) international economies, output was 1% more than in the last quarter of 1995. But much of that reflected special factors, particularly in Japan, France and Italy, that are likely to have unwound in the second quarter. The strength of the US economy appeared more robust. And domestic demand in Germany was stronger than the markets expected. In Europe, cyclical conditions improved, but structural problems remained.*

- *Consumer price inflation remained subdued. In the United States, however, there were some signs of emerging price pressures earlier in the production chain, and labour market conditions continued to tighten.*

- *At the time of going to press, there were no changes in official interest rates in the G3 countries, following the Bundesbank's ½ point cut in mid April. Several other European countries, however, including France and the United Kingdom, trimmed interest rates in June. Yield curves steepened at the short end, reflecting market expectations of interest rate rises ahead, notably in the United States but also in Germany and France.*

Two special topics are considered: consumer indebtedness in the United States; and the extent to which eastern Germany has converged with western Germany.

Table A
GDP growth

Percentage change over previous quarter

	United States	Canada	Japan	Germany	France	Italy	Major six (a)
1995 Q1	0.1	0.4	0.1	0.2	0.7	1.4	0.3
Q2	0.1	-0.3	0.6	0.9	0.1	—	0.3
Q3	0.9	0.3	0.6	—	0.1	1.8	0.7
Q4	0.1	0.2	1.2	-0.2	-0.4	-1.1	0.2
1996 Q1	0.6	0.3	3.0	-0.4	1.2	0.5	1.0

(a) UK trade-weighted average.

GDP growth in the M6 countries in the first quarter of 1996 was not as strong as the reported data suggest

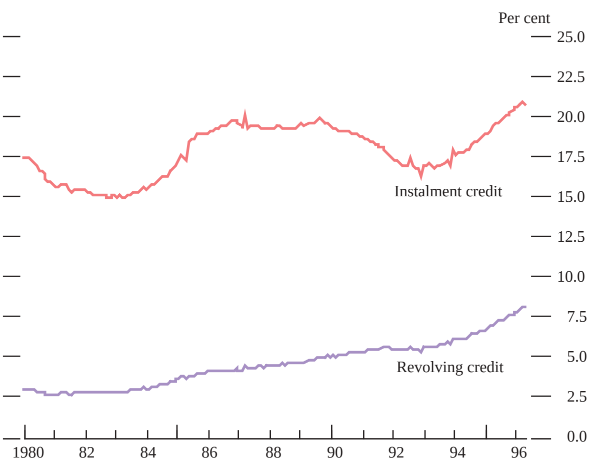
The exception to this was in the United States (see Table A), where growth was slightly above trend, despite the adverse effects of bad weather, government shutdowns and strikes. This was well above most market expectations. Data available so far for the second quarter suggest that above-trend growth continued and is likely to turn out even higher than the first quarter. Industrial production grew strongly in April, May and June, led by the automobile sector. The National Association of Purchasing Managers' index in June rose to its highest level since February 1995, indicating a growing manufacturing sector. Consumer spending also remained strong; although consumer credit growth has been slowing, the level of consumer debt is still rising, and may hold back consumer growth at some point. (See the box on page 259 for a fuller discussion of consumer indebtedness in the United States.) Growth of retail sales slowed a little in the second quarter, particularly for big ticket items. Employment growth was particularly strong, rising at about double the normal rate in the first five months of the year.

Prospects for the second half are less certain, but with signs that the recent inventory correction has been completed, and demand strengthening in major overseas markets, notably Japan, Mexico and Canada, activity should hold up well, even if policy is tightened.

Consumer indebtedness in the United States

High consumer indebtedness is a possible downside risk to consumption growth. Chart A illustrates the evolution of instalment and revolving (credit-card) debt. After a period of rapid expansion in the mid-1980s, consumer credit declined as the economy went into recession during the early 1990s before picking up again in the present cycle.

Chart A
Consumer debt (disposable income)

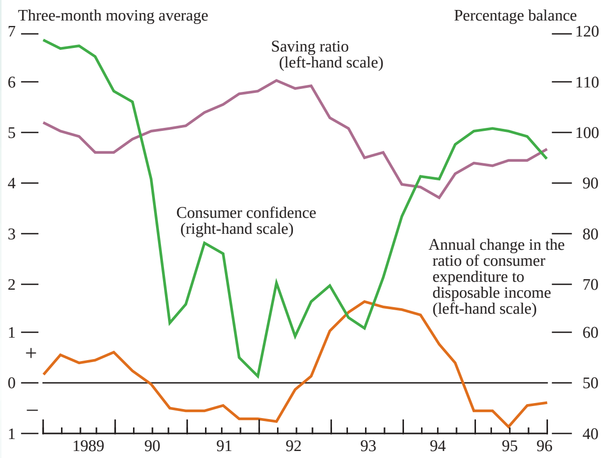


The growth in credit-card debt has been particularly noteworthy. Stimulated by increased competition in the credit-card industry, credit-card debt has risen rapidly since 1993. Easier availability of credit has contributed to the long-term decline in US personal savings. Although delinquency rates have increased in the present cycle, it appears that this is because consumers of poor credit standing have obtained greater access to credit. There is no evidence to suggest that rising default rates are the first sign of a decline in aggregate consumption.

The pattern of consumer credit appears to contradict consumption-smoothing theories of consumer behaviour which suggest that debt-income ratios should increase during recessions as consumers borrow to cover expenses while income is temporarily low. When consumers experience income uncertainty they face a trade-off between *impatience*, in the sense that they could borrow against future income to finance current consumption, and *prudence*, in the sense that they have a precautionary savings motive. Faced with this tension, changes in the probability of adverse developments such as unemployment have a significant influence on saving and consumption.

Chart B shows that there was a marked reduction in consumer confidence (a proxy for employment expectations) between 1990 and 1992. During this period consumption fell and the saving rate rose significantly. Net wealth therefore began to rise, in time inducing a recovery in consumption and a steady decline in savings. Since 1994 there has been a pick-up in the saving ratio, which may have reflected the rebuilding of wealth following the fall in bond prices in 1994. If consumers have target buffer-stocks of wealth, then these may have been raised in the light of the perceived increase in job insecurity that accompanied the 'jobless recovery', generating an unwillingness to spend. The more recent phenomena of rising stock prices and lower interest rates in 1995 have helped repair consumer balance sheets, allowing targeted wealth levels to be attained more rapidly. The slowdown in the accumulation of savings since 1995 appears to support this. The reduction in precautionary savings as wealth increases can therefore be expected to generate extra growth in consumption.

Chart B
Insecurity, savings and consumption



Recent academic work (for example, Cabellero 1991, Carroll 1992) suggests that precautionary motives and employment expectations are quantitatively important determinants of consumer behaviour.(1) In their models, risk aversion and earnings uncertainty have direct effects on individual consumption in the United States. Over time, as precautionary savings add to wealth, consumption becomes less depressed. Increases in the degree of relative risk aversion and earnings uncertainty also raise the target level of liquid assets for the typical consumer.

It thus appears that if consumer indebtedness is an issue, the appropriate focus is not the level of indebtedness, but rather, the behaviour of savings and consumption in the presence of increased risk aversion and job uncertainty. The behaviour of consumption in the present cycle is consistent with the predictions of buffer-stock explanations of consumption behaviour. If consumers do behave in this fashion then the consequences, for aggregate consumption, of a downturn in income are ambiguous and dependent on the proximity of consumers to their target levels of wealth. Consumers at, or near, their targets will be less inclined to engage in precautionary savings. In this regard, beliefs about income risk are important—anecdotal tales of job insecurity may be sufficient to have a significant impact on desired target levels of wealth.

(1) Cabellero, R (1991),'Earnings Uncertainty & Aggregate Wealth Accumulation', *American Economic Review*, 81, pages 859–71.
Carroll, C (1992),'The Buffer Stock Theory of Saving—Some Macroeconomic Evidence', *Brookings Papers on Economic Activity.*

Table B
Contribution to growth in GDP in 1996 Q1

	United States	Germany	Japan	France
Stocks	-0.3	0.6	0.1	-0.9
Investment	0.4	-1.1	0.6	—
Net trade	-0.2	-0.4	-0.3	0.4
Government	0.1	0.2	1.1	0.3
Consumption	0.6	0.3	1.5	1.4
Total (a)	**0.6**	**-0.4**	**3.0**	**1.2**

(a) Totals may not sum due to rounding.

Chart 1
French household activity

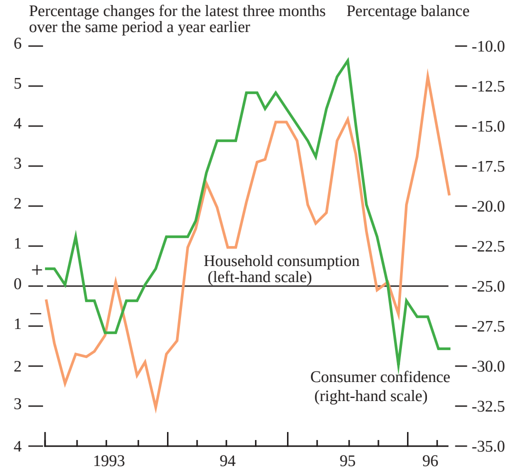
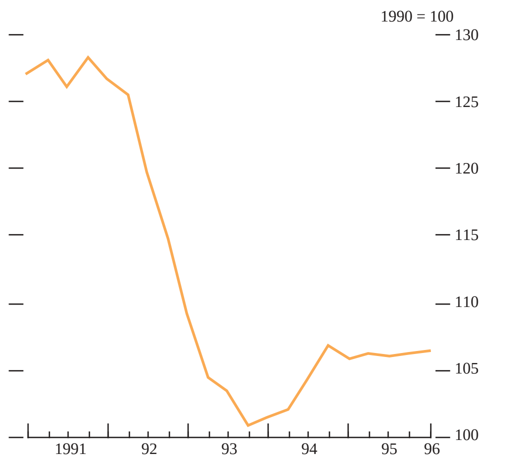


Chart 2
Investment in plant and machinery in Germany



The most striking increase in reported GDP in the first quarter was in Japan where the economy grew by a remarkable 3% on the quarter. The figure is, however, distorted by statistical and temporary factors. GDP data in Japan are not adjusted for the leap year, which is estimated by the Economic Planning Agency to have added 0.8% to consumer spending, and 0.5% to GDP growth in the quarter. Moreover, a considerable part of the remaining growth reflected the effect of last autumn's fiscal package. Table B shows that public investment and government consumption accounted for over 1% of the 3% quarterly growth. The direct effects of the fiscal package may have ended, as budgets were used up by the end of the fiscal year. Equally, the growth in residential investment may not be sustained. It tends to be highly interest rate sensitive and there seems to have been a surge in residential investment with investors feeling that the interest rate cycle had bottomed out.

Nonetheless, while the first quarter Japanese GDP figure is probably exceptional—and is likely to be followed by negative reported GDP growth in the second quarter—the chances of a broadly based recovery seem to have improved. Even allowing for special factors, growth in the first quarter was strong. A particularly encouraging sign of recovery was the large increase in consumer spending in the first quarter, even after allowing for the leap year effect. The May Tankan survey also substantiated the impression of a continuing improvement in the economy, but underlined the fragility of the recovery. Small and medium-sized enterprises (SMEs) in particular still faced difficulties, and there were concerns that stocks were still too high, implying a constraint on production at least in the second quarter. The survey reported modest investment intentions for large companies, but SMEs planned to *reduce* investment by 11% in the fiscal year 1996/97.

As Table B shows, GDP grew by 1.2% in France, but fell by 0.4% in Germany. Special factors account for much of the measured increase in French GDP. As in Japan, GDP data are not adjusted for the leap year, which added as much as 0.5% to the quarter-on-quarter growth, and at least part of the remaining 0.7% growth reflects a rebound from the strike-related weakness of the fourth quarter of 1995. Moreover, the exceptionally strong increase in consumer spending was partly explained by special government incentives on car purchases, while consumption of energy was boosted by the cold weather. It is likely therefore that recorded GDP growth in the second quarter will be flat or negative. Since the first quarter, consumer confidence has slipped back, and household consumption fell in April and May (see Chart 1). Unemployment went back up to 12.4% in May, on the Internatioanl Labour Organisation (ILO) measure. Real disposable income is likely to be flat in 1996. Against this background the near-term outlook is for subdued growth in demand and output.

In Germany, by contrast, the underlying picture for the economy in the first quarter was probably stronger than the GDP data—which are adjusted for the leap year—suggested. An exceptionally harsh winter hit the construction sector badly with a fall in output of nearly 8% on the previous quarter. But, significantly, the 1.3% increase in domestic demand excluding construction investment was stronger than the markets expected. Private consumption increased, perhaps because the effects of the income tax cuts introduced in January offset those of the sharp rise in unemployment in the first quarter. But investment in machinery

Chart 3
European real exchange rates

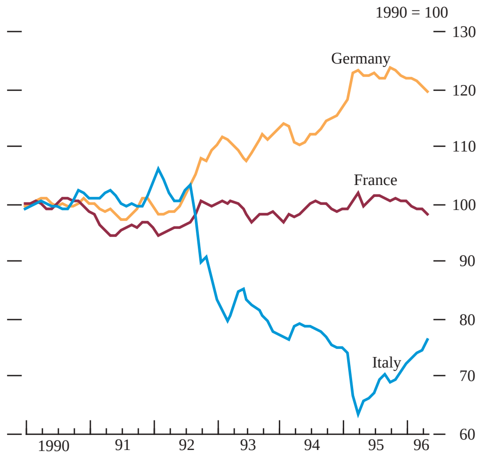


Chart 4
European GDP

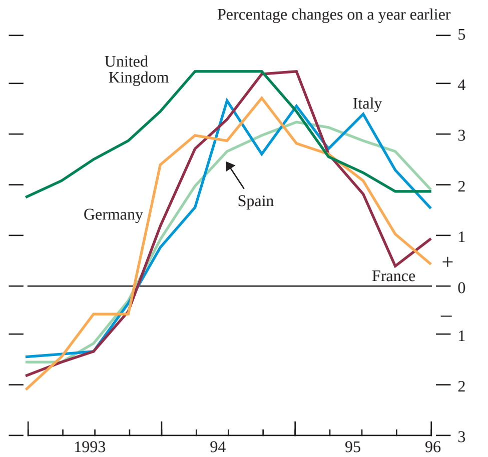
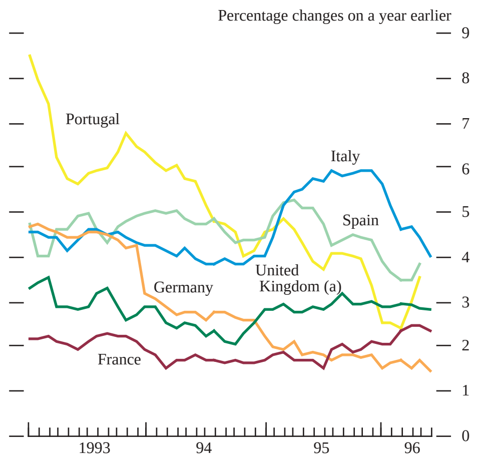


Chart 5
European consumer price inflation



(a) Calculated using RPIX.

and equipment, which normally features prominently in German economy upturns, was mediocre (see Chart 2). Export growth was also weak, reflecting competitive pressures and weak external demand for Germany's traditional exports.

The data available so far for the second quarter suggest a rebound in activity—particularly in the construction sector. But there were some signs that, in addition to the bounce back, a cyclical recovery was underway. Industrial production rose in both April and May, and manufacturing and export orders improved. Retail sales were less buoyant than production, but nonetheless rose for three consecutive months before falling in May. Retailers' confidence also picked up in the quarter. The labour market remained weak; headline (unadjusted) unemployment fell slightly to 9.9% in June, but the improvement was entirely due to seasonal factors, according to the official statistics office. The seasonally adjusted rate of unemployment was unchanged at 10.31%.

Looking at the components of demand, consumption may be constrained by high unemployment, but the fiscal stance in 1996 is expansionary. Exports were weak in the first quarter, but both foreign and domestic orders rose in the second. As Chart 3 shows, the real exchange rate depreciated by 1.8% in the second quarter, but remained high in historic terms. The prospects for exports will be an influence on investment spending which has so far made no contribution to growth since the trough of the last recession.

Among the other European economies, first quarter GDP growth was weak in Italy and Spain. In Italy, the expected bounce back from the fourth quarter fall in GDP was weaker than expected. Reported activity grew by only 0.5%, despite a beneficial leap year effect, in part because the appreciation of the lira and weak external demand hit exports. In Spain, industrial production was weak, despite a weather-related boost to energy output. The slowdown in these economies has been less pronounced, however, than in Germany and France (see Chart 4). Performance was mixed in the Benelux countries, which together account for about 13% of UK exports of goods (a similar proportion to Germany, our largest export market). In the Netherlands, a less cyclical economy than the others, and a larger market for UK exports than either Italy or Spain, GDP grew by 1.1% quarter on quarter; the gradual slowdown in economic growth seen in 1995 did not persist into 1996. In Belgium, by contrast, GDP growth in the first quarter was only 0.2%. All European economies continued to be outstripped by the Irish economy, where real GDP grew by $7\frac{1}{2}$% last year.

Inflation

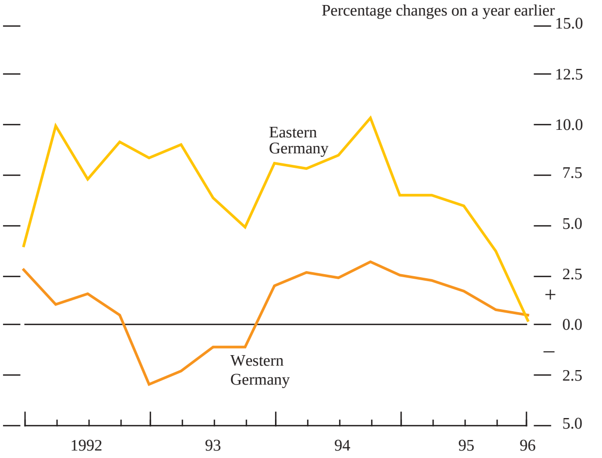
Average consumer price inflation in the major economies has remained at around 2%–$2\frac{1}{4}$% for more than two years

Inflation differences between areas persist, but are less stark than five or ten years ago. In the European Union as a whole, average inflation was about $2\frac{3}{4}$% a year in April, down from 3.1% in December 1995, reflecting sharp falls in inflation in Italy, Spain and Portugal in the first four months of 1996 (see Chart 5). Further falls in EU inflation are possible in the near term as the effects of lower commodity prices and lower producer input price inflation feed through. In Germany, whole economy unit labour costs should

Eastern Germany six years on

Since German reunification, the output of the eastern Länder has increased rapidly—by 7.5% per year on average since 1991 (see Chart A). However, last year, growth in the eastern Länder slowed sharply, raising questions about the conditions necessary for continued convergence of eastern and western German *per capita*

Chart A
GDP in eastern and western Germany



output. In this box, reasons for the current slowdown are examined and the implications for the German reunification process are considered. It suggests that living standards in eastern Germany will be dependent on transfers from the west until eastern Germany is capable of self sustained growth. This requires investment sufficient to create jobs and support the living standards currently enjoyed by eastern and western Germans. The eastern Länder remain a long way from this point, as costs in the region, along with less buoyant economic conditions in western Germany, have deterred direct investment, despite generous subsidy provisions.

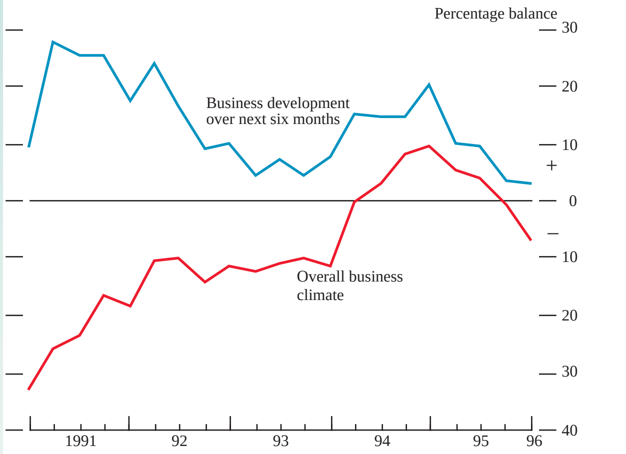
Investment

At the end of 1994, fixed capital formation as a share of total output was running three times faster in the eastern Länder than in western Germany. Since then, investment growth has declined in both regions of Germany following the sharp fall in business profitability and confidence (Chart B). As a high level of investment in the eastern Länder is likely to be a pre-requisite of the convergence process, a recovery of business confidence and investment is particularly important if eastern German living standards are to continue rising.(1)

Construction

In the new Länder, construction investment has been a mainstay of economic growth since reunification,

Chart B
Eastern German business confidence



supported by western German public transfers and by subsidies (see Table 1). Total real construction investment increased almost two and a half times between 1991 and 1995, while employment in the construction industry rose from about 630,000 in 1990 to more than 1,000,000 five years later. By creating many new jobs, the construction sector acted as an important counterweight to job losses in other sectors, particularly manufacturing industry. From the second quarter of last year, construction orders decreased, housing construction fell, and confidence in the construction sector weakened sharply. This is in part due to the cyclical slowdown in western Germany, in part due to tight public sector budget constraints, but is also a consequence of the dynamic growth of previous five years, which saw around 30% of commercial buildings renewed and costs rising very quickly—by 1995, the basic pay of eastern German construction workers had risen to 92% of the western German level. Given these developments, demand for construction is unlikely to be as dynamic as in previous years.(2)

Table 1 also illustrates the similarity between the production structures of west Germany in 1965 and east Germany in 1989, and illustrates changes in production structures since these dates.

Table 1
Structure of output in the eastern and western German economies

Percentage of output	FRG 1965	GDR 1989	West 1994	East 1994
Agriculture	10.1	9.5	1.2	3.0
Production	61.3	60.4	38.6	40.7
Construction	17.1	16.9	10.6	26.1
Manufacturing	44.2	43.5	28.0	14.6
Trade/transport	11.8	12.7	14.3	14.2
Services	8.4	7.1	32.6	23.6
Government and other	8.4	10.3	13.3	18.8

(1) See IFO Institute Schnelldienst (5/1995), 'Investment in the New Bundesländer, and 17–18/1995—Investment: High dynamism underpins adjustment process'.
(2) See 'The trend and current state of the German construction industry', *Deutsche Bundesbank*, June 1996 Monthly report.

Private consumption and the welfare state

By 1994, private consumption *per capita* in eastern Germany had risen to 67.2% of the western German level (compared with 49.9% in 1991). However, GDP *per capita* only increased from 31.3% to 48.7% of western German levels during this period. Private consumption growth has been buoyant largely because of official transfers. Table 2 shows how these transfers have developed over the last five years. Payments to the east have continued to increase, primarily due to the link between benefits and average earnings: as average earnings rise in the east to western levels, unemployment benefits also increase *pro rata*. In addition, eastern pension rates are steadily converging on those in the west. Indeed, average pensioner incomes in the east now exceed those in the west due to longer periods of insurance, a higher participation rate of women in the labour force and vested rights provisions. Although the uptake of investment subsidies has also been substantial, about 60% of financial transfers to the east have financed consumption rather than investment and have therefore had a relatively minor direct effect on the adjustment process.

Table 2
Public sector payments to eastern Germany

	1991	1992	1993	1994	1995
Payments to eastern Germany					
Federal budget	75	88	114	128	151
Transfers from western Länder Governments and authorities	5	5	10	14	14
German unity fund	31	24	15	5	—
EC budget	4	5	5	6	7
Federal labour office	24	25	15	14	14
Statutory pensions	—	5	9	14	14
Gross payments, total	139	152	168	181	200
Revenues in EG					
Tax revenue	31	35	37	40	43
Administrative revenue	2	2	2	2	2
Revenue, total	33	37	39	42	45
Net payments, total	106	115	129	139	155
as percentage of GDP	3.7	3.7	4.1	4.2	4.5

Source: Deutsche Bundesbank.

Labour market

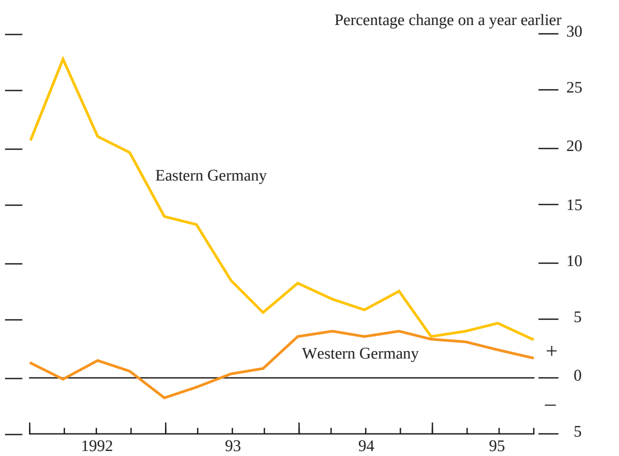
Tight regulation of the German labour market has, in large part, determined the effect of the recent economic downturn on the level of unemployment. Since the beginning of 1995, the unemployment rate has increased from 13.7% to 15.5% in eastern Germany, and from 8.2% to 9.0% in the west. Although job protection, social welfare, and product market regulation are broadly the same in both German regions, and wage and non-wage labour costs are somewhat lower in the eastern Länder, unit labour costs are considerably higher than in western Germany because high wage settlements have not been matched by productivity improvements (see Table 3). As a result, the incentives for eastern German firms to create jobs in anything but very high value-added, capital intensive, activities are much reduced.(3) The recent fall in investment growth has been accompanied by reduced productivity growth in the eastern Länder (Chart C), putting further upward pressure on unit labour costs and unemployment.

Table 3
Unit wage costs in eastern and western Germany

Eastern as a percentage of western	1991	1992	1993	1994	1995
GDP	7.8	8.3	9.0	9.5	9.9
Wage rates	51.3	60.6	69.3	70.4	73.1
Productivity	33.2	38.0	43.1	43.4	44.0
Unit wage costs	154.5	159.6	160.8	162.3	164.7

Source: Deutsche Bundesbank.

Chart C
Productivity growth



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Van Fürstenburg, G M (1995), 'Overstaffing as an endgame and prelude to the employment collapse in eastern Germany', *Communist economies and economic transformation*, Vol 7, No 3, September.

(3) See De Nederlandishe Bank reprint 409, 'Can Eastern Germany Catch-up? A brief look at Neo-Classical and Modern Growth and Trade Theories', S. Brakman and H Garretsen.

Chart 6
US price inflation

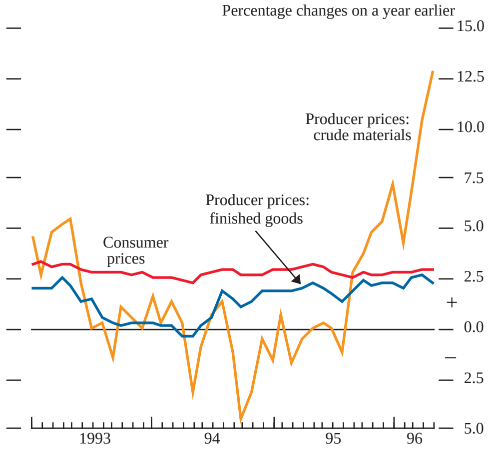


Chart 7
US interest rates and inflation

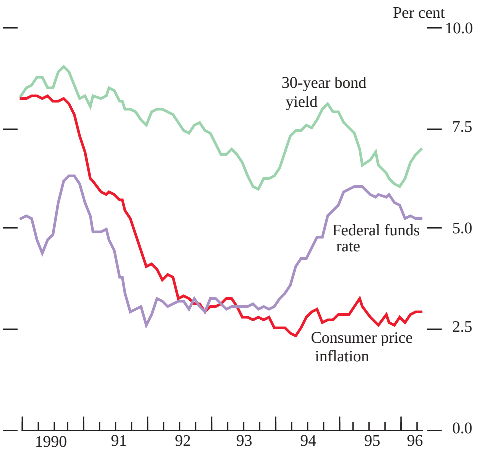


Table C
Three-month interest rates(a) expected in September 1996

Percent

	1995	1996	
	29 December	29 March	28 June
US dollar	5.01	5.04	5.73
Deutsche Mark	3.45	3.33	3.42
Yen	0.15	0.44	0.74
Sterling	6.05	6.27	5.75

(a) Expected rates as implied by futures contracts.

rise by less than 1% in 1996; wage settlements in the first half averaged under 2%—well under last year's 3.5%.

Eleven of the 15 EU countries recorded inflation rates between 1% and 3% in April 1996, the latest month for which national data are available, with only Greece, Italy and Spain above 3% and Finland below 1%.

In the United States, by contrast, there is growing evidence that inflation has ticked up somewhat in recent months. Consumer prices in May were 3% up on a year earlier, compared with 2.7% in February. On the three-month annualised measure, moreover, consumer price inflation was 4.5% in May. The three-month annualised increases in producer prices and average earnings in the United States in May were also higher than the six-month annualised and twelve-month changes. Against that, productivity gains and reductions in the costs of health care plans meant that unit labour cost increases remained moderate.

There is a marked divergence between inflation rates at different stages of the supply chain. Chart 6 shows that annual inflation in crude goods was above 12% in May. But this has not, so far, translated into higher inflation in final goods prices. Indeed, the rate of increase in prices of finished producer goods remains below consumer price inflation, suggesting little upward pressure on consumer prices.

Perhaps the more serious upside risk to inflation comes from the possibility that growth will continue above trend during 1996, resulting in wage pressures as the labour market tightens. By mid-1996, employment had been growing at a rate of about 2% for a year or so; and unemployment fell to 5.3% in June, its lowest for six years. An increase in hours worked was further evidence of a tightening labour market. This potential inflation risk may be one reason for the recent rise in bond yields (see Chart 7).

In Japan, the combination of robust growth in the first quarter and a lower exchange rate than in 1995 seems to have reduced the likelihood of continued price deflation. In April, the core measure of consumer prices, which excludes food, was 0.2% higher than a year earlier, though this measure probably overestimates prices.

Interest rates remained on hold in the G3 countries

With activity if anything strengthening and the inflation outlook reasonably benign, official interest rates in the G3 countries at the time of going to press had not been changed since publication of the May *Quarterly Bulletin*. The round of easing in Europe continued over the period under review, however, with France, Denmark, the United Kingdom, Spain and Sweden all trimming interest rates over the period. The Bank of Italy cut its discount rate from 9.0% to 8.25% in July, amid indications that core inflation was below 4%.

For the G3 economies, market expectations at the end of June were that the next movement in interest rates would be upwards (see Table C). Implied forward short-term interest rates for the United States increased sharply in June, although interest rate expectations have been creeping up gradually throughout 1996. In Germany, the level of interest rates expected in September 1996 fell during the first quarter, only to rise again in the second. In Japan, the

Chart 8
Ten-year government bond yields

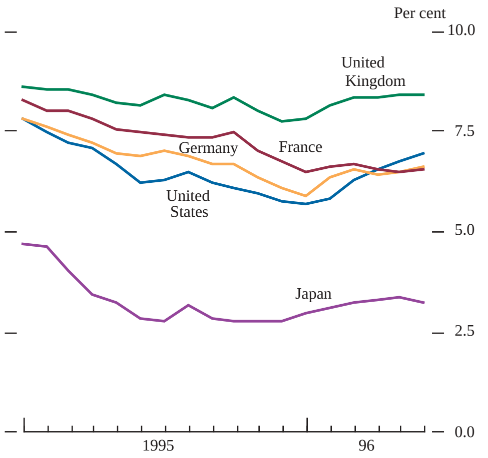
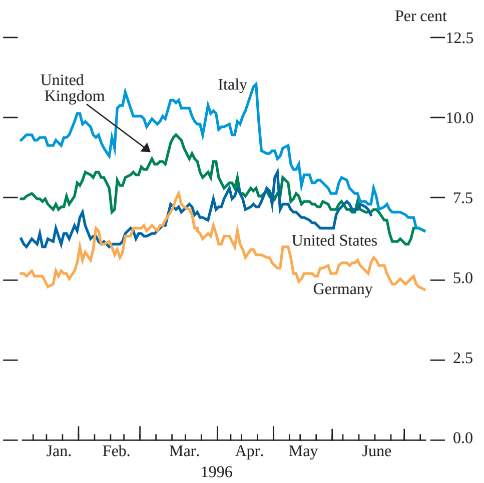
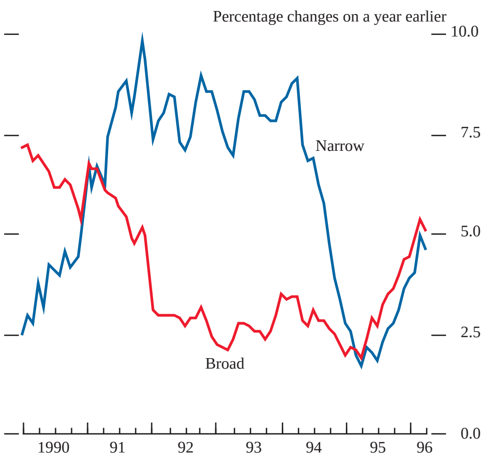


Chart 9
Implied bond market volatility(a)



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

Chart 10
Average money growth in the M6



December 1996 and March 1997 interest rate futures contracts at end June suggested market expectations of a tightening of monetary policy at end-1996/early 1997.

Long-bond yields in the United States and Japan have risen since the start of the year (see Chart 8); bond yields in France and Germany have also increased slightly since May but in these two countries there was a more pronounced rise in interest rates at the short end of the yield curve. Ten-year bond yields in Italy, by contrast, fell by more than 125 basis points from the beginning of the year, reflecting falling inflation and confidence in the new government. Yields on UK bonds also fell relative to yields in the G3.

Part of the explanation for the changes in bond yields may be changes in uncertainty. As Chart 9 shows, in Italy, implied bond market volatility fell sharply in the second quarter, suggesting that uncertainty had decreased; this may have been a factor in yields falling.

In France and Germany, long and medium-term bond yields converged in May, following a progressive narrowing of the differential during the year. The spread over German bonds of most other EU countries also fell noticeably in the first half of 1996, possibly reflecting growing confidence in financial markets that EMU will proceed on track. But the pattern of implied ten-year forward nominal short-term interest rates is rather different: on this comparison the UK/German differential was only about 40 basis points at end-June compared with around 150 basis points on the bond yield comparison. The narrower differential reflects the fact that bond yields are heavily influenced by interest rates in the near future, which are likely to be higher in the United Kingdom than in Germany for cyclical reasons. Differentials in implied ten-year forward nominal short-term interest rates between Italy, France and Germany are also low. By contrast, there is no evidence of expected future interest rate convergence between Germany and either the United States or Japan.

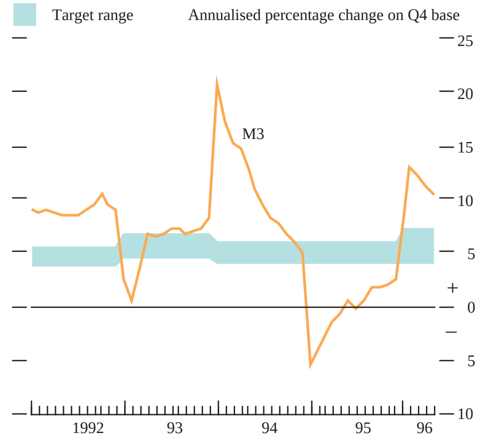
Money in the M6 economies

Broad money

Average broad money growth in the M6 economies accelerated in the first five months of the year, which may presage stronger GDP growth. The increase over a year earlier was 4.8% in May, compared with 4.3% in December 1995, thus continuing the sharp upward trend that began in April 1995 (see Chart 10). A considerable part of the increase in broad money since the start of 1995 has been driven by credit expansion, with consumer credit being particularly strong in the United States. As noted in previous *Quarterly Bulletins*, broad money velocity has fallen in most G7 countries over the past two years.

In the United States, both M2 and M3 growth remained strong, with the former increasing by 5.3% a year in May—above its monitoring range of 1%–5%. German M3 was also well above its target range in the first five months of the year after a year of slow growth
(see Chart 11), but the Bundesbank attributed much of this to flows into 'special savings' products such as new savings schemes with

Chart 11
German M3 growth



escalating rates of interest, which are included in the definition of M3. Monetary capital formation, which is outside M3, has been fairly volatile over the period, languishing in the first quarter, but picking up after the cut in official rates in April. Consequently M3 growth slowed in May.

In Japan, the annual growth rate of broad money (M2 plus CDs) picked up slightly in May, but at 3.3% remained moderate. The rise in May possibly reflected the effect of slightly higher interest rates on CDs. Broad money growth in Italy also picked up in May, to 3.8%; as in Japan a slight increase in deposit rates may have been the underlying reason. In France the annual rate of growth of M3 fell sharply from 5.1% in Q4 1995 to only 1.8% in May.

Narrow money

Narrow money growth in the G7 countries has also been accelerating since its trough in April 1995. Within the M6, Japan continued to have the highest annual rate of growth of narrow money at 15.4% in May, but growth rates in Germany and Canada also accelerated in the first five months of the year.

Following a similar pattern to 1995 Q4, currency in circulation continued to slow down in Canada and the United States. The increased use by US banks of sweep accounts to reduce their reserve requirements may explain the negative growth rate of M1. Without these sweep accounts, M1 would have increased by 1% in 1995.

In Germany, currency in circulation accelerated to an annual growth rate of 6.1% in May, while M1 grew at an annual rate of 10.4%. The strength of narrow money may signal a recovery in activity later this year, and is also consistent with Bundesbank forecasts of a continued increase in Deutsche Mark circulation in eastern Europe.

In Japan, M1 continued to accelerate quickly to an annual rate of 15.4% in May, compared with 12.9% in 1995 Q4. The strength of M1 reflects Japanese monetary policy; since September last year the Bank of Japan has held the official discount rate at 0.5% in order to prevent a deflationary spiral and to stimulate economic recovery led by private demand.

In Italy, narrow money contracted and continued the slowdown recorded since early 1994. An increasing interest differential between Treasury bills and current account deposits, and subdued activity were two factors behind the recent slowdown.

Fiscal policy

The weakness in activity in Europe at the start of the year led to a deterioration of the fiscal positions in France and Germany, relative to budget plans. In May, the German Council of Experts forecast that tax revenues in 1996 would be DM 21.7 billion less than originally assumed in the 1996 Tax Law and Budget. About half of the shortfall was attributed to weaker output, and half to higher than expected uptake of tax reliefs in eastern Germany. In response, the Finance Ministry announced savings which should be sufficient to cover the projected DM 11.8 billion shortfall in the Federal government sector this year.

There is more uncertainty about whether the Länder government and social security deficits can be held to target this year and next. The 1997 proposed budget package envisages some DM 70 billion of expenditure cuts; DM 25 billion in each of the Federal government and Länder sectors, and DM 20 billion on the social security fund. These proposals have yet to be agreed, and it has not yet been determined where savings outside the Federal government sector will be made. The Bundesbank monthly report for June said that ‘the overall public sector deficit might expand this year to approximately 4% of GDP. The deficit ratio would therefore overshoot the ceiling laid down in the Maastricht Treaty even more than it did last year, and the maximum debt level (60% of GDP) is likely to be exceeded slightly’.

In France, figures published for the first quarter of 1996 showed a sharp deterioration in the government deficit, as expenditure rose while revenues fell. The 1997 draft state budget, announced in May, proposed holding government expenditure in 1997 to 1996 levels in cash terms, implying a cut of 2% in real terms. This is considerably tougher than the 1996 budget, which envisaged a freeze in real terms between 1996 and 1999. The 1997 draft budget also assumes that the social security deficit returns to balance in 1997.

In June, a month after its formation, the new government in Italy announced a mini budget to bring 1996 public finances back on track, as the growth forecast of 3.0% for 1996, on which the original budget was made, had come to look too optimistic. (By mid-year, most forecasters were predicting growth of around 1.2% for 1996.) The mini budget contained measures to achieve savings of 16 trillion lire (0.8% of GDP). The reduction in long-term Italian interest rates noted earlier will also have a beneficial effect on public finances.