The international environment

- *This article reports on developments in the major overseas economies since the August 1996* Quarterly Bulletin. *However, since UK exports to the G7 account for slightly less than 50% of UK exports, it is also important to consider developments beyond those economies (see box on page 382).*

- *In Germany, the pause in growth, which started in the middle of 1995, now appears to be over. There is less sign of a revival in activity in France and Italy. Output and employment have continued to grow rapidly in the United States. The recovery in the Japanese economy that started around the end of last year has continued, albeit at a moderate pace.*

- *Inflation in the major overseas economies has been low in recent years. There are some signs of a slight pick-up in the United States, but the evidence is mixed. Inflation has fallen further in most European countries and remains negligible in Japan. Producer price inflation is very low in almost all the industrialised countries.*

- *Interest rates were trimmed in Germany and other European countries in September, continuing the recent shift in policy mix towards tighter fiscal and looser monetary policy. Official interest rates were left unchanged in the United States and Japan.*

- *Growth in Asia has moderated during 1996, but this has been broadly offset by strengthening activity in Mexico and Africa.*

Table A
Contributions to German GDP growth(a)

Quarter-on-quarter contributions

	1996 Q1	1996 Q2
GDP growth	-0.5	1.5
Consumption	0.3	0.5
Investment	-1.3	1.5
Government	0.1	0.3
Stocks	0.3	-1.5
Domestic demand	-0.5	0.8
Net trade	0.0	0.7

(a) Contributions may not sum due to rounding.

A recovery in German activity seems to be confirmed

At the end of the first quarter of 1996, German GDP was only 0.3% higher than a year earlier. But the picture in the first part of the year was distorted by the exceptionally severe winter, which depressed output, particularly in the construction sector. Some bounce-back was expected in the second quarter, but the strength of second-quarter output—the largest quarterly rise in GDP since reunification—suggested that a more widespread recovery was under way. As Table A shows, investment, consumption and net external trade all contributed to GDP growth.

Data for the third quarter suggest that there has been further growth of activity. Industrial production, which increased very strongly in the second quarter, accelerated further in July and August. Orders were also up. And the IFO survey of business confidence showed sentiment in manufacturing improving sharply over the third quarter, although the level was still low.

But the growth rate in the second half of the year is unlikely to be as strong as in the second quarter. Consumer confidence is still low, (see Chart 1) and unemployment remains above 10%. These factors are likely to constrain domestic demand. And the pattern of investment by German companies, which has over the recent past been concentrated outside Germany, is unlikely to create as much employment as in previous recoveries.

Chart 1
Consumer confidence and consumption in France and Germany

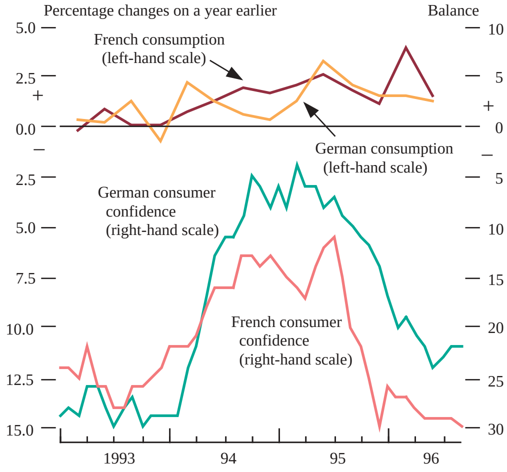


Chart 2
European GDP growth

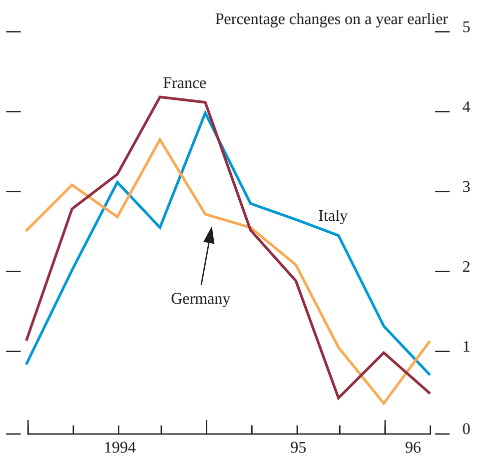


Table B
Contributions to French GDP growth(a)

Quarter-on-quarter contributions

	1996 Q1	1996 Q2
GDP growth	1.1	-0.4
Consumption	1.5	-0.5
Investment	-0.1	-0.1
Government	0.1	0.1
Stocks	-1.0	0.5
Domestic demand	0.5	0.0
Net trade	0.6	-0.4

(a) Contributions may not sum due to rounding.

While German GDP fell in the first quarter and rose sharply in the second, the opposite occurred in France. Taking the first half of the year as a whole, growth was very similar in both countries (see Chart 2). GDP growth in France in the first quarter was boosted by a number of special factors, as noted in the August *Quarterly Bulletin*. Second quarter data were weak, even after allowing for the unwinding of these factors, reflecting a fall in most of the main components of demand (see Table B). Consumption may have been held back this year, as fiscal and social levies have been increased. (See section below on fiscal policy.) The saving ratio is still high, possibly because unemployment remains a serious problem; the unemployment rate rose further to a record 12.6% in August. Business confidence picked up in August and September after reaching a trough in July, but consumer confidence deteriorated further in September (see Charts 1 and 3).

In the second half of the year, production may be boosted by stockbuilding; stocks were at extremely low levels by mid-year. Household spending rose in the third quarter, but this was almost all due to purchases of cars as consumers took advantage of a government incentive scheme. This scheme finished at end-September, so consumption in the fourth quarter is likely to be weaker.

The German and French governments have both revised up their forecasts for GDP growth in 1996 to a little over 1%. In Italy, on the other hand, forecasts have been revised down in the light of a weaker-than-expected first half year. Fiscal and particularly monetary policy have been comparatively tight in Italy over the past couple of years. Exports have been the main source of growth since mid-1994, but they slowed sharply this year, reflecting the stronger lira and weaknesses of some export markets. Imports have slowed even more sharply, reflecting the weakness of domestic demand, with the result that the trade surplus—particularly with non-EU countries—widened in the first part of the year. Investment slowed as temporary tax incentives were withdrawn. Unemployment has remained stable at slightly over 12% in 1996.

Growth in the European Union as a whole has been rather better than in the major three continental economies, which perhaps, in part explains the relatively good UK export performance in the first half of the year. The Irish and Dutch economies, both important export markets for the United Kingdom, grew robustly in the first half of the year. Both these economies have implemented structural reforms in the labour market with some success. About 100,000 new jobs are expected to be created in the Netherlands this year.

Unemployment has also fallen in Denmark (see Chart 4), where domestic demand has remained robust. Growth in Sweden and Finland was stronger than forecast in the first half of the year, led by exports and investment. Consumer spending was more subdued, but may have picked up in the third quarter. Fiscal tightening over the remainder of 1996 and during 1997, and a poor employment situation, are likely to constrain consumer spending, however. The picture in Norway is brighter; GDP growth should be over 4% this year, according to official estimates.

Switzerland, Austria and Belgium have experienced weak growth in 1996 as a result of falling exports to the European Union, and weak domestic demand, but should benefit from a recovery in Germany.

Chart 3
Industrial output growth and business confidence

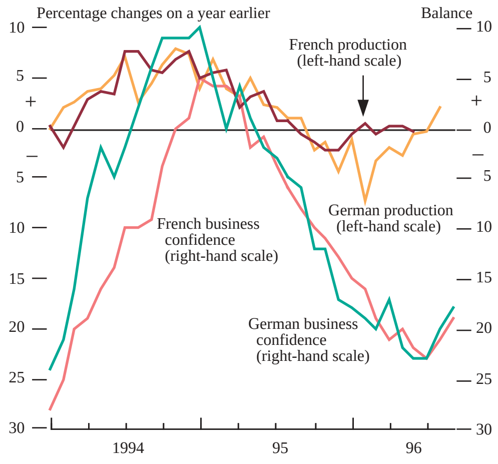


Chart 4
European unemployment

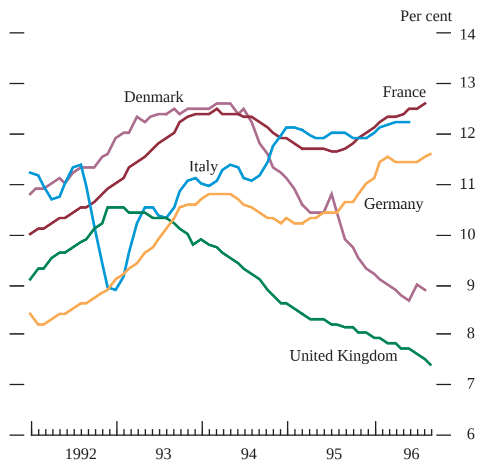


Table C
Contributions to US GDP growth(a)

Quarter-on-quarter contributions

	1996 Q1	1996 Q2
GDP growth	0.5	1.2
Consumption	0.6	0.6
Investment	0.4	0.3
Government	0.1	0.4
Stocks	-0.3	0.2
Domestic demand	0.8	1.5
Net trade	-0.2	-0.2

(a) Contributions may not sum due to rounding.

Table D
Contributions to Japanese GDP growth(a)

Quarter-on-quarter contributions

	1996 Q1	1996 Q2
GDP growth	2.9	-0.7
Consumption	1.4	-0.8
Investment	1.4	0.6
Government	0.3	-0.1
Stocks	0.1	-0.2
Domestic demand	3.2	-0.5
Net trade	-0.3	-0.2

(a) Contributions may not sum due to rounding.

Growth in Spain and Portugal has been stronger than in several other European countries, although it has slowed since 1995.

The US economy remains very buoyant

In the United States, GDP growth in the first quarter of 1996—at 0.5%—was stronger than most commentators had expected at the turn of the year. Second quarter growth was stronger still, at 1.2%. As Table C shows, consumption was the main source of growth, although investment and government spending were also important. Employment growth in the first half of the year was above trend.

The key issue since mid-year has been whether the economy would slow to a sustainable growth rate without the need for a tightening of monetary policy. A slowdown was expected because of higher long-term interest rates and slower income growth. Early data for the third quarter showed little sign of a slowdown except in durable goods orders. Chain store sales and housing starts were firm in July. Industrial production which barely rose in July, rose quite strongly in August. Later data suggested a slowdown was underway. Housing starts fell in August and September. The National Association of Purchasing Managers' index of manufacturing activity slipped back a little in September, but that still left the average for the third quarter higher than in the second consistent with the 1.1% quarterly rise in industrial production in the third quarter. After above trend growth in July and August, employment fell in September, reflecting lower government and manufacturing employment.

A moderate recovery continued in Japan

There were signs in the fourth quarter of 1995 that the Japanese economy was recovering after four years of stagnation. Growth in the first quarter of 1996 was exceptionally strong, distorted by a number of special factors. As in France, an unwinding of these factors resulted in a fall in GDP in the second quarter (see Table D). Nonetheless, the underlying picture is one of moderate recovery.

The recovery in Japan has been stimulated by large fiscal packages and very low interest rates. A main concern has been the extent to which private sector activity can sustain the momentum of recovery once the effects of the fiscal policy stimuli fade. There remain a number of macroeconomic problems, including the continuing fragility in parts of the banking system, still-falling land prices and high unemployment. Nonetheless, the strength of GDP growth in the first half—over 6% at an annualised rate—has led most forecasters to revise up their projections for growth for the year to around $3^1/_4$%–4%.

Evidence for activity in the third quarter has been mixed. Annual growth in department store sales fell in July, but rebounded in August. Consumer spending was affected by an unseasonally cool summer, and a food poisoning scare. Industrial production was volatile: it rose strongly in July but fell in August.

The September Tankan survey was weak—indeed the unexpected fall in business confidence was the first in a recovery cycle for 25 years—suggesting that production in a number of basic industries had faltered as stocks had piled up to high levels. In general, small and medium-sized companies appear to be facing

Developments outside the largest overseas economies

The main part of the international environment article focuses on developments in the major overseas economies. Those provide an indication of prospects for UK export growth. However, UK exports to the G7—the United States, Canada, Japan, Germany, France and Italy—account for less than 50% of total UK exports. That suggests that the rest of the G7 countries do not give a complete indication of demand for UK exports. Several countries outside the G7, notably the Netherlands and Belgium, account for a higher proportion of UK exports than either Canada or Japan. Other European countries, particularly Ireland and the transitional economies of eastern Europe are growing markedly faster than Germany, France and Italy (EU3). South East Asia is becoming increasingly important to UK exporters, though its share of UK exports is still small.

EU growth

The fastest growing economy in the European Union at the moment is Ireland which has been largely unaffected by the recent EU downturn. This is partly because of its close trading links to the United States and the United Kingdom, where growth has been relatively strong during this period, and partly due to its success at attracting inward investment throughout the last decade.

The Netherlands is the United Kingdom's fourth largest export partner (although its share might be overstated because of re-routed exports through Rotterdam). In common with the EU3, it experienced a slowdown in 1995 H2. However, GDP grew by 1% in 1996 H1, and confidence is strengthening, suggesting that growth is recovering sooner than in the EU3.

The other European G10 countries—Sweden, Switzerland and Belgium—seem more in step with the rest of the European Union (Sweden slightly stronger, Switzerland slightly weaker). So, developments in the EU3 appear to be a reasonably proxy for this group at the moment.

Per cent	UK export weight (a)	Average growth 1991–95	Forecast GDP growth (b) 1996	1997
EU3	29.1	1.6	1.3	2.4
Netherlands	7.5	1.9	2.2	2.5
Belgium	5.6	1.3	1.4	2.4
Switzerland	1.9	0.2	0.0	1.5
Sweden	2.5	0.0	1.6	2.0
Ireland	5.1	4.7	7.0	5.5
Central and eastern Europe (c)	1.5	-2.0	4.2	4.7
South East Asia	8.8	8.4	8.0	7.5

(a) 1991–95 average.
(b) Source: IMF.
(c) Excluding the ex-Soviet Union.

According to the IMF, the outlook for the other EU countries is markedly stronger than the EU3 countries in 1996.

Growth elsewhere in the world

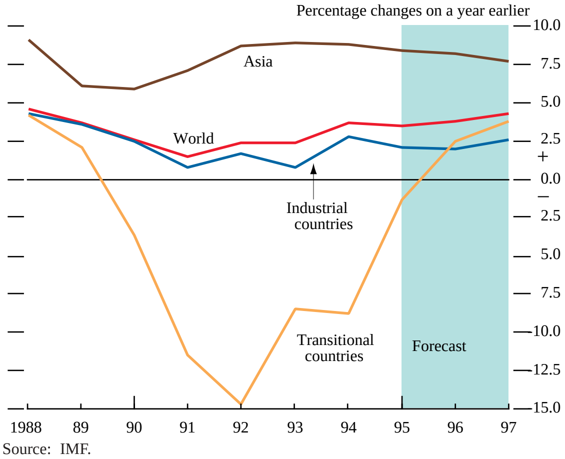
The emerging market economies in South East Asia have roughly doubled their share of UK exports since 1980. This is partly because the United Kingdom has gained a higher share of South East Asian imports, but also because their economies have been growing much faster than those in the industrialised world. In 1995, they accounted for 5.8% of UK exports, more than Italy, and well over twice as much as Japan.

Growth in the emerging market economies is not closely correlated with that of the major industrialised economies. Japan, which had the closest correlation with them, now serves as an extremely poor proxy for their growth. That reflects a number of developments, including the growing importance of China in Asian growth, the increasing outward investment by Japanese firms in South East Asia, and greater access to global capital markets by South East Asian firms.

Another area where economic growth has been very fast recently is the transitional economies in eastern Europe and the ex-Soviet Union. Those economies contracted sharply following the move towards capitalism, but have since strengthened to the point where collectively they are likely to grow more quickly than the rest of the industrialised world in the next few years.

The chart shows that the industrialised countries grew by a very similar rate to that of the global economy in the late 1980s, but that the growth rates have diverged recently. This gap is likely to increase: in the very near term, because EU growth is expected to be significantly stronger than that in the EU3; and in the longer term, as the faster growing areas assume greater importance to the United Kingdom. In conclusion, growth in the rest of the G7, which used to be a close proxy for UK export markets as a whole, is likely to increasingly underestimate world growth, and hence prospects for UK exports.

World GDP growth



Source: IMF.

Chart 5
Consumer price inflation

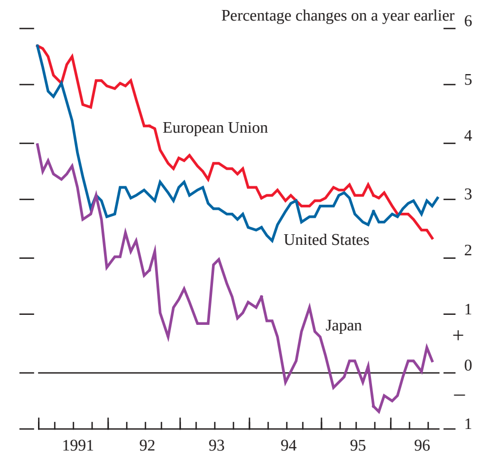


Chart 6
Producer price inflation

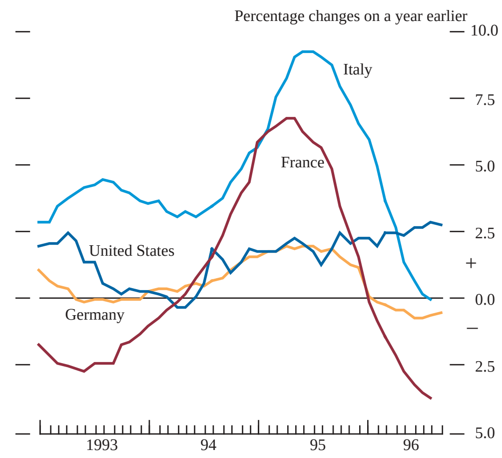
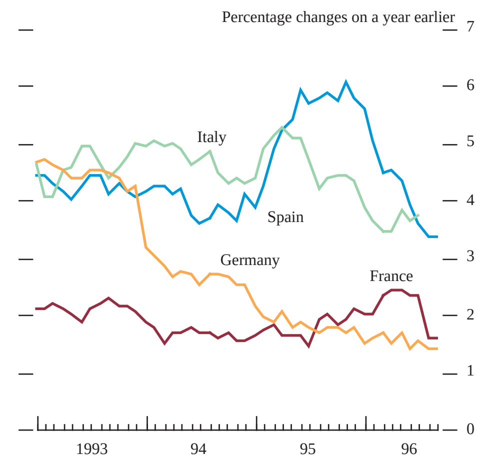


Chart 7
EU consumer price inflation



more difficulties than the large manufacturers. The evidence of a moderate and patchy recovery raises questions for fiscal policy (see below). The authorities have to judge whether a recovery in private sector demand will be able to offset the contractionary effects of fiscal consolidation due for 1997.

Growth in the emerging market economies

The European Union, North America and Japan together account for about 50% of world GDP, but 75% of UK exports. But, as the box on page 382 discusses, Asia and central and eastern Europe are rapidly growing markets.

Growth in industrialised countries in recent years has been helped by exports to the fast growing emerging market countries. In the course of 1996 there was some moderation of growth in Asia, but this was broadly offset by a pick-up in Mexico and Africa.

Central and eastern European economies, which are important export markets for Germany and others, are expected to show robust growth over the next year or so.

Inflation remains low in the industrialised countries

With the possible exception of the United States, there is little sign of inflationary pressure in the industrialised economies. Indeed, annual consumer price inflation for the European Union as a whole was 2.6% in July, continuing the downward trend seen over the 1990s (see Chart 5). Convergence of inflation rates among individual countries has also continued; eleven of the 15 EU countries had inflation rates of under 3% in July/August; among the other four, inflation in Spain, Italy and Portugal was below 4% and falling. The outlier was Greece, with an inflation rate of around 8½%.

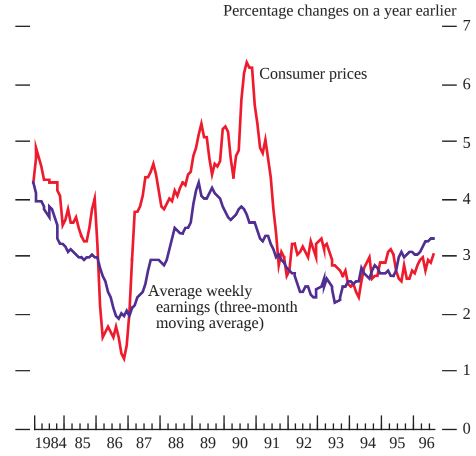
Producer prices in Europe were even more subdued (see Chart 6). Weak domestic demand has meant that in Germany—and more particularly France—prices are lower than a year ago, while the year-on-year rate of producer price inflation in Italy fell by around nine percentage points in the year to July.

Special factors, some of them country specific, have contributed to the general fall in inflation since the beginning of the year. Increases in VAT in 1995 pushed up measured inflation in Italy, Spain and France. These price rises dropped out of the year-on-year comparisons, producing a step fall in the inflation rate: in the first quarter for Spain and Italy, and in August for France (see Chart 7). Lower prices of public sector goods have also contributed to lower inflation in France and Italy.

The relative weakness of domestic demand and the fall in producer prices suggest that inflation may fall further in Europe over the second half of 1996. The main upside risk, which is not confined to Europe, is the rise in oil prices over the summer months. That was partly offset by weaker copper and food prices, however.

Japan has a longer recent history of price deflation and weak activity. Measured consumer price inflation has turned mildly positive this year and was around ¼% year-on-year in August, as strengthening domestic demand and yen depreciation underpinned prices.

Chart 8
US price inflation and wage growth



In the United States, a feature of the current conjuncture has been that above-trend growth has not been accompanied by a clear increase in inflation. Consumer price inflation has remained remarkably steady over the past three years at around 3%. The main threat to low inflation is widely perceived to come from the labour market. Unemployment was 5.2% in September; below most estimates of the 'natural' rate, or the rate below which inflation begins to accelerate. One possibility is that structural changes in the labour market have reduced the natural rate. A related argument is that job insecurity has reduced the extent of wages pressure associated with a given level of unemployment.

There is, in fact, some evidence of a pick-up in average earnings growth, which historically has had a fairly close relationship with consumer price inflation (see Chart 8). In September, annual average earnings growth was 3.5%, up from 3.2% in the second quarter and 3.0% in the first quarter. A possible explanation for the lack of any direct feedthrough from earnings to prices is that reductions in the cost to employers of health care provision have offset the increase in earnings so that total labour costs have not risen. More fundamentally, it is not clear whether wage setters take account of past price increases, or prices setters take account of past wage increases in the United States. In the former case, a pick-up in earnings has no particular implications for inflation.

Official interest rates were reduced in Europe, but left unchanged in Japan and the United States

Low inflation, slowing M3 growth, and international considerations were the reasons cited by the German Bundesbank for the 30 basis point cut in the repo rate on 22 August. That was the first cut in the repo rate since February 1996. The Lombard and Discount rates were left unchanged. After the German cut, the Bank of France reduced its intervention rate by 20 basis points, and by a further
10 basis points in September to 3.25%. Belgium, Denmark, Finland, Holland and Portugal also cut their interest rates. The Special Advances Rate in the Netherlands is now 2.5%, and interest rates at all maturities are lower than in Germany. Interest rates were also cut in Sweden and Spain, and have since been cut again. In mid-October, the Bank of Italy cut interest rates by 75 basis points, taking the official discount rate to 7.5% and the Lombard rate to 9.0%. The Bank of Italy cited the decline in inflation and inflation expectations as the reason for the cut.

Interest rate expectations for the G3 economies were volatile in the third quarter. At the end of June, market expectations were for an increase in short-term interest rates in each country by the end of the year. German interest rate expectations were revised down as money supply data and inflation outturns improved. But, at the end of September, the March 1997 contract implied an increase in German short-term interest rates in the first quarter of 1997.

US interest rate expectations were more or less unchanged over the quarter as a whole (although they were very volatile during the quarter as the market speculated whether the Federal Reserve Board would tighten policy at each successive Federal Open Market Committee—FOMC—meeting).

With the exception of the United States, ten-year bond yields in the major industrialised economies fell in the third quarter. In the United States, nominal forward rates rose across all maturities and in Germany nominal forward rates fell across all maturities. The UK/German yield differential widened in the third quarter of 1996 to 177 basis points.

Comparing current bond yields with those prevailing at the start of the year, German, UK and the US rates are all higher, whereas French and Italian rates, which both fell over the quarter, are lower.

Money supply

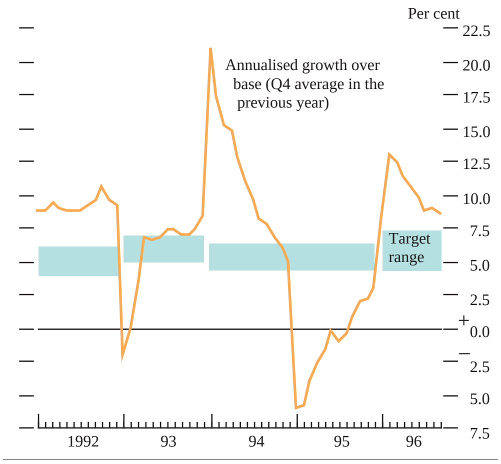
The weighted averages of both narrow and broad money growth in the G7 economies fell slightly in the twelve months to July to 4.4% and 5.1% respectively. That ended a period of accelerating monetary expansion in the G7 which started in April last year.

Narrow money

Japan continued to show the highest narrow money growth rate among the major industrialised countries in the second quarter. M1 accelerated again in the second quarter before falling in August. The strong growth may be related to very low interest rates which give agents little incentive to hold their savings in bank time deposits.

Growth of currency in circulation in the United States slowed down in the second quarter, but has since returned to rates more in line with those observed earlier this year. Compared with the second quarter of 1994, however, the growth rate of US currency has decreased considerably. This may be related to the declining use of US dollars as a vehicle currency relative to Deutsche Marks.

Chart 9
German M3 growth



Broad money

Broad money growth in the United States was above the upper limit of the monitoring range in the first half of the year. That may be related to the easing of monetary policy earlier this year. The FOMC provisionally left the monitoring ranges for M2 and M3 for 1997 unchanged at 1%–5% and 2%–6%, respectively.

As noted earlier, the cut in the German repo rate to 3% on 22 August was partly motivated by the slowdown in M3 growth (see Chart 9) and the expectations that monetary growth would continue to fall into this year's target range of 4%–7%. In August, however, broad money accelerated again slightly to an annualised rate of growth of 8.7% relative to the fourth quarter of 1995, largely due to an increase in sight and savings deposits.

Fiscal policy

Fiscal policy in Europe has increasingly been dominated by the Maastricht convergence criteria, which will be applied to data for 1997. Japan's fiscal position has deteriorated rapidly in the 1990s, and, in common with continental Europe, Japan faces medium-term problems associated with an ageing population.

Fiscal consolidation can have indirect as well as direct effects on economic activity. If markets view the longer-term fiscal position as more credible as a result of current fiscal measures, long-term interest rates should fall, so offsetting, at least to some extent, the contractionary effect of fiscal policy. The other main indirect effect is on consumption. The extent to which consumers adjust spending patterns when the fiscal stance changes depends on whether changes such as tax increases are seen as temporary or permanent.

All twelve of the 15 EU countries which have announced their 1997 budgets (since the August *Quarterly Bulletin*) have a target deficit/GDP ratio of 3% or less for 1997 (see Table E). The United Kingdom, Greece and Ireland have not yet announced their 1997 budgets.

Table E
Deficit/GDP ratios in the European Union

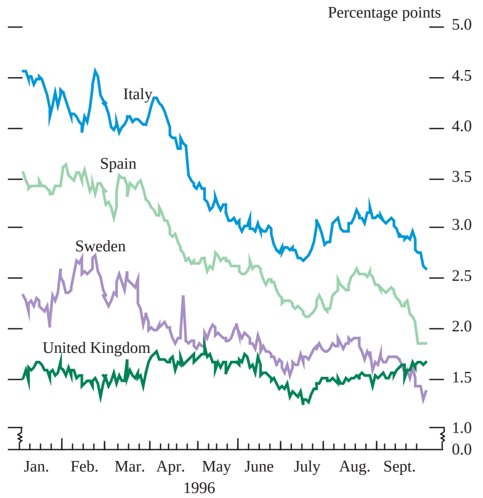
		Forecasts	
	1995	1996	1997
Germany	3.6	3.6	2.5
France	5.0	4.0	3.0
Italy	7.2	6.1	3.0
Spain	5.8	4.4	3.0
Holland	4.0	2.6	2.2
Belgium	4.5	3.3	2.9
Sweden	8.1	4.0	2.6
Denmark	1.5	1.6	0.5
Finland	5.6	2.9	1.4
Austria	5.9	4.5	3.0
Portugal	5.1	4.2	2.9

The 1995 data are provisional and may be subject to revisions.

In Germany, several of the measures announced in the DM 70 billion April savings package have become law, chiefly relating to spending on pensions and health. Final resolution of the 1997 budget is not expected before December. Waigel, the Finance Minister, has indicated that further savings may be needed at Federal level. Meeting the Maastricht criteria will also need considerable savings at länder and local level, yet to be agreed.

The French budget projected a deficit of 3% of GDP next year. The central government deficit will be reduced by only FFr 4 billion in 1997. Cuts in other public spending, including a reduction in the number of civil service jobs, amounting to FFr 60 billion were announced. Partly offsetting this, income taxes are to be cut by FFr 25 billion. Almost half of the deficit cut projected in 1997, which amounts to 1% of GDP, comes from exceptional receipts, notably a FFr 38 billion receipt from the privatised France Telecom in exchange for the assumption by the Government of France Telecom's pension liabilities.

Chart 10
Ten-year bond yield (spread over Germany)



The Italian budget reduced the 1997 target for the fiscal deficit from 4.5% of GDP to 3%. Savings worth Lit 62.5 trillion are planned, including Lit 25 billion in expenditure cuts, with further measures to be announced later this year. There is also a one-off 'tax increase for Europe', in the form of a temporary increase in income tax. Tax evasion measures are expected to increase revenue, along with as yet unspecified 'treasury operations'.

In Spain, a fall in the deficit/GDP ratio of 1.4 percentage points is envisaged between 1996 and 1997, partly as a result of higher GDP growth—the official forecast is for 3% in 1997—but mainly via spending cuts of Pta 800 billion (1% of GDP), together with tax increases on insurance premiums. Public sector wages, which account for 50% of government spending, are to be frozen, and public sector employment will be reduced by natural wastage. That is budgeted to save Pta 200 billion. A further Pta 250 billion worth of cuts are to be made in public investment and subsidies to firms. Social expenditure has largely been protected, however, contrary to earlier indications.

The yields on Italian and Spanish government bonds fell after the announcement of the budget proposals, in Italy's case to about $2^1/_2$ percentage points over German government bonds, compared with around $3^1/_4$ percentage points a month earlier (see Chart 10).