The international environment

The main news since the previous Quarterly Bulletin *is:*

- *Activity in the United Kingdom's major export markets has firmed a little since the start of the year, but big differences remain among the major economies.*
- *Activity in Germany, France and Italy was very weak around the year end. There were some signs of a moderate improvement by March, largely in the export sector. Domestic demand remained weak. Activity has been more buoyant in many of the smaller EU countries.*
- *The recovery in Japan continues to be uneven, with large manufacturing companies faring better than non-manufacturing and smaller companies.*
- *In the United States, the Federal Reserve Board raised the target federal funds rate by 25 basis points in March, as the US economy continued to grow strongly in the first quarter of 1997.*
- *Interest rates were also increased in the Netherlands in February and March, but were cut in Portugal and Spain. Interest rates remained unchanged in Germany and Japan.*
- *Inflation remained low in the United States, despite a pick-up in earnings growth. Considerable spare capacity remains in the labour markets in Japan and continental Europe; wage pressures have been subdued. Within the European Union, inflation rates continue to converge; new harmonised measures of consumer prices were published for the first time in February.*
- *Long-term bond yields in the G7 fell at the start of 1997 but rose sharply towards the end of the first quarter, except in Japan where they continued to fall.*
- *The US dollar, sterling and the Canadian dollar appreciated on an effective basis during the first quarter of 1997 (up 5.6%, 3.2% and 1% respectively); the yen, lira, Deutsche Mark and French franc depreciated over the same period (by 3.3%, 2.8% , 1.5% and 1% respectively).*

Table A
Contributions to US GDP growth(a)

Percentage points

	1996					1997
	Q1	Q2	Q3	Q4	Year	Q1
Domestic demand	**0.8**	**1.3**	**0.9**	**0.4**	**1.5**	**1.9**
Stockbuilding	-0.3	0.2	0.4	-0.2	-0.3	0.4
Investment	0.4	0.3	0.4	0.1	1.0	0.4
Government	0.1	0.3	0.0	-0.1	0.1	0.0
Consumption	0.6	0.6	0.1	0.6	0.7	1.1
Net trade	**-0.3**	**-0.1**	**-0.3**	**0.5**	**1.6**	**-0.5**
GDP	**0.5**	**1.2**	**0.5**	**0.9**	**3.1**	**1.4**

(a) Contributions may not sum because of rounding.

Activity has remained strong in the United States

The US economy has entered its seventh year of expansion. US GDP grew by 0.9% in the final quarter of 1996 to a level 3.1% higher than a year earlier. Activity was broadly based but, as Table A shows, consumption and net trade contributed most to growth. GDP growth was even stronger in the first quarter of 1997, at 1.4% quarter on quarter, the highest quarterly rate of growth in the current expansion. Consumption remained very strong, but net trade made a negative contribution. Employment continued to grow strongly (non-farm payrolls rose by an average of 240,000 a month in the first quarter of 1997—well above the long-run monthly average increase of 160,000) and unemployment fell to 5.2% in March, below most estimates of full employment. (Most estimates fall in the range 5.4%–6%.) A strong recovery is under way in the construction and housing sectors, helped by the decline in long-term interest rates in the latter half of last year;

Table B
Contributions to German GDP growth(a)

Percentage points

	1996 Q1	Q2	Q3	Q4	Year
Domestic demand	**-0.4**	**1.2**	**-0.2**	**0.4**	**0.8**
Stockbuilding	0.3	-0.9	-0.5	0.6	-0.2
Investment	-1.2	1.5	0.1	0.2	-0.2
Government	0.1	0.2	0.2	-0.1	0.5
Consumption	0.4	0.3	0.1	-0.2	0.6
Net trade	**0.0**	**0.3**	**0.8**	**-0.2**	**0.6**
GDP	**-0.4**	**1.5**	**0.7**	**0.1**	**1.4**

(a) Contributions may not sum because of rounding.

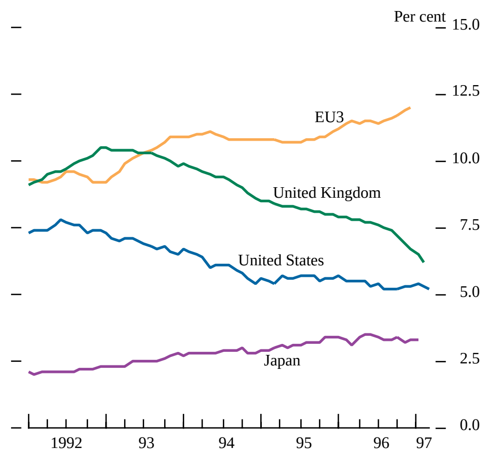
Table C
Contributions to French GDP growth(a)

Percentage points

	1996 Q1	Q2	Q3	Q4	Year
Domestic demand	**0.7**	**0.1**	**0.5**	**0.2**	**0.8**
Stockbuilding	-0.8	0.9	-0.3	0.3	-0.6
Investment	-0.1	-0.3	0.3	0.1	-0.1
Government	0.1	0.1	0.1	0.1	0.2
Consumption	1.5	-0.6	0.4	-0.3	1.3
Net trade	**0.7**	**-0.3**	**0.3**	**0.0**	**0.6**
GDP	**1.3**	**-0.2**	**0.8**	**0.2**	**1.5**

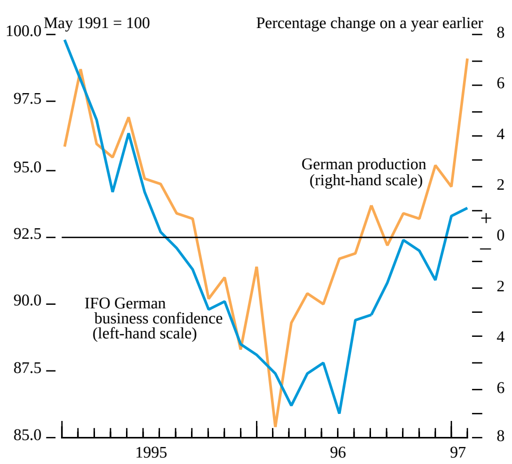
(a) Contributions may not sum because of rounding.

Chart 1
Unemployment rate(a)



(a) National definition (not ILO).

Chart 2
Germany: Industrial confidence and production



construction spending in February was more than 10% higher than a year previously. Home sales also rose strongly.

The National Association of Purchasing Managers Survey showed rises in the first quarter in production, new orders and employment. Consumer and business confidence were high and stock levels were low. Production should therefore continue to rise in the near term. Indeed the question now is how much spare productive capacity remains in the United States.

In contrast with the rapid growth in the United States, activity in the major countries of continental Europe was far more subdued during the year. GDP barely grew in the final quarter of 1996 in Germany and France (see Tables B and C) and fell fractionally in Italy. Exports were in general more buoyant than domestic demand, helped by improved exchange rate competitiveness.

GDP growth in the first quarter of 1997 was probably only a little higher. Construction activity fell sharply in Germany in January in part owing to harsh weather; employment data and fiscal outturns in the first two months of the year were also weak. Unemployment, largely but not solely structural, remains the major economic problem for these countries (see Chart 1). In March it stood at 11.2% seasonally adjusted in Germany, and 12.8% in France. Unemployment in Germany, France and Italy combined has reached almost ten million. Although some of the recent rise in unemployment was probably owing to temporary factors, such as the unusually harsh winter and a change in the way of recording unemployment among construction workers in Germany, labour market conditions remain extremely weak. Unemployment is not expected to fall much during 1997.

Data available for 1997 point to a rebound in activity, albeit a moderate one, since the start of the year. Industrial production in Germany rose by 1.9% on the month in February, up 7.1% on a year earlier, with manufacturing output particularly strong. Production of intermediate and capital goods was stronger than production of consumer goods, supporting the notion of an export-led recovery. As Chart 2 shows, business sentiment in Germany, as measured by the IFO Survey, improved sharply in January and slightly further in February. It fell back in March, but was nonetheless higher in the first quarter of 1997 than in the last quarter of 1996. (See the box opposite for a fuller discussion of survey data on industrial production in France and Germany.) But business sentiment in eastern Germany deteriorated sharply. The INSEE survey of industrial confidence in France also showed an improvement, again largely related to export orders. The key issue is how far export growth stimulates domestic demand during the course of the year. In this respect, the growth in fixed investment in Germany in the fourth quarter may be an encouraging sign.

There is less evidence of a pick-up in consumer spending (see Chart 3). Retail sales in Germany were some 6% lower in February than a year before. Household consumption in France rose 2.7% in January, but fell back in February and was flat in March.

The weakness of investment in Germany and France in the current cycle is a puzzle. As Tables B and C show, investment fell in Germany and France in 1996. Several explanations have been

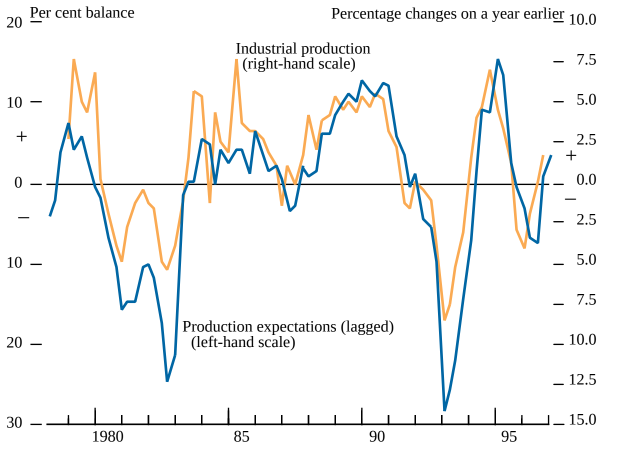
German and French industrial surveys

An important source of information on the current international conjuncture is survey data. Given the uncertainty surrounding the recoveries currently underway in the core European economies, this box considers survey evidence relating to short-term industrial prospects in France and Germany.

In Germany, the IFO industrial Survey has a well-established track record. The most widely quoted index is the business confidence measure, which has a strong contemporaneous correlation with both industrial production and GDP growth.

But this survey may also contain more forward-looking information. IFO question industrialists about prospects for production over the next four months. Intuitively, the *one quarter lag* of that series should be highly correlated with quarterly production growth. But, as shown in Chart A, it actually exhibits a high correlation with annual growth in German industrial output. (Many German industrialists base their responses on year-on-year comparisons. A similar finding applies to UK data.)

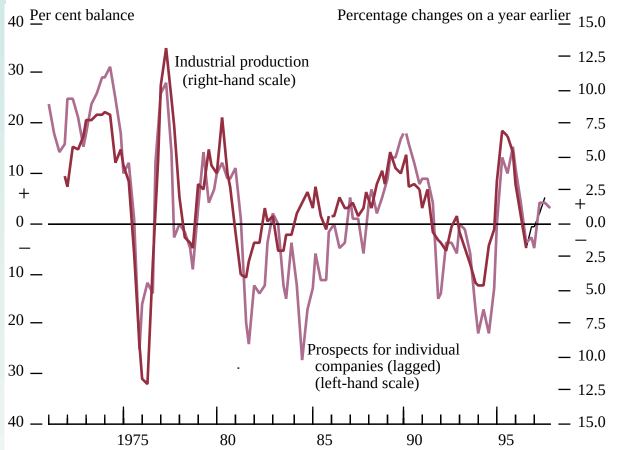
Chart A
German industrial activity



For most of the sample period, this relationship suggests that the survey balances may be an accurate predictor of future production. But since reunification, turning points in industrial production have occurred before the lagged survey balance, suggesting that the predictive power may have deteriorated slightly.

The French Statistical Agency INSEE also publishes a balance of business confidence which has a contemporaneous correlation with industrial production. But the *one quarter lag* of the balance of industrialists' assessment of prospects for their own companies (Chart B) also has a reasonable correlation with annual production growth (with the exception of the early eighties). This suggests it may also hold some forward-looking information.

Chart B
French industrial activity



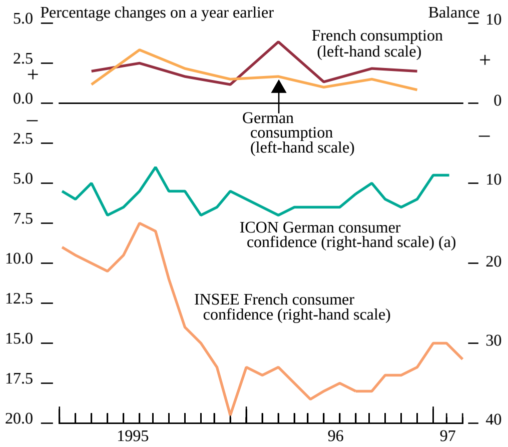
These relationships suggest that, in addition to information relating to current developments, surveys can provide an indication about the short-term outlook. In both countries, industrial activity picked up in the middle of 1996 (in France, this partly reflected the effects of an incentive scheme for new cars) following weakness over the 1995/96 winter. This expansion faltered at the end of 1996.

The industrial surveys suggest that these recoveries could continue throughout 1997. In Germany, the balance of firms expecting to increase output was +3.6% in 1996 Q4, rising to +6.5% in 1997 Q1, compared with an average balance of -7.2% in 1996 H1. Coupled with the continuing weakness in the Deutsche Mark and sharp rises in exports orders, the evidence from the IFO Survey suggests that annual German industrial production growth should strengthen sharply over the first half of 1997, following annual growth of 1.7% in 1996 Q4.

In France, the balance of industrialists expecting an improvement in company prospects has also strengthened over the past year, particularly so in recent months: the balance was +8.3% in 1997 Q1, compared with +3.3% in 1996 Q4. This suggests that, alongside Germany, a competitive exchange rate and rising export orders, coupled with modest improvements in consumer confidence may now be in place for a sustained recovery in French industrial production over 1997.

Overall, the survey data for the French and German industry suggest that expectations of future output have increased. That suggests that the modest recoveries currently under way in these core European economies should continue over 1997.

Chart 3
Consumer confidence and consumption



(a) This index is mean-adjusted.

suggested. In Germany, the reunification boom in investment at the start of the 1990s was such that capacity utilisation remains moderate. Capacity utilisation is not unduly high in France. And a considerable volume of investment has flowed abroad, for example to neighbouring Eastern European countries where wage costs are much lower. Inward direct investment in Germany has been extremely low (though higher in France). Uncertainty, particularly over the outlook for domestic demand, the stance of fiscal policy and the composition of the euro area, may have resulted in investment decisions being postponed.

In some respects, the investment environment is favourable. Real interest rates are low, corporate profitability is high and equity markets have risen strongly. At the end of March, the German DAX index was 42% higher than at the start of 1996 and the French CAC index was up by 32%.

Overall, domestic demand did not appear to strengthen at the start of 1997 in the three largest continental European economies. Though exports are firming and there is some evidence of improving business confidence, record unemployment and the tighter fiscal stance in 1997 are likely to hold down consumer spending, and may lead to a further deferral of investment plans. Structural rigidities in European labour and product markets further impede a strong recovery.

Several smaller EU economies are growing faster

Growth in the other EU countries has been higher. These eleven EU economies between them account for about 30% of UK exports—equal to the combined proportion exported to Germany, France and Italy. Estimated GDP growth in Ireland, the Netherlands, Finland, Greece, Portugal and Luxembourg was more than 2.5% in 1996, in contrast to 1.5% or less in the three largest continental European economies.

The weakness of investment noted in the larger continental European economies has not been evident in Sweden, Finland and Spain. These countries also experienced strong export growth, but economic recovery since the 1995 slowdown has been more broadly based. Domestic demand was sustained by strong consumer spending in Denmark, the Netherlands and Portugal. Investment has made an important contribution to growth in Belgium and Austria. Growth in Ireland moderated to around 7% in 1996, from more than 10% in 1995.

Table D
Contributions to Japan GDP growth(a)

Percentage points

	1996				
	Q1	Q2	Q3	Q4	Year
Domestic demand	**2.4**	**0.1**	**0.1**	**0.6**	**4.4**
Stockbuilding	0.1	-0.2	0.0	0.0	-0.1
Investment	1.0	0.7	0.1	-0.2	2.6
Government	0.1	0.0	0.1	0.1	0.2
Consumption	1.2	-0.6	-0.1	0.7	1.7
Net trade	**-0.3**	**-0.2**	**0.2**	**0.4**	**-0.9**
GDP	**2.0**	**-0.3**	**0.3**	**1.0**	**3.6**

(a) Contributions may not sum because of rounding.

The manufacturing sector leads the Japanese recovery

GDP growth in Japan in 1996 was 3.6%, the highest among the G7 countries. This masks an uneven picture during the year and between different sectors of the economy. GDP grew very strongly in the first quarter of 1996, reflecting significant public expenditure (see Table D). Over the middle two quarters, GDP was broadly flat, before rising by 1% during the fourth quarter. The key question for the Japanese economy is: is the recovery firmly under way and, in particular, what will be the effects of the fiscal tightening (equivalent to about 1.5% of GDP) introduced in April?

As in the major continental European economies, exports provided an important stimulus to growth in Japan in the second half of 1996 (see Table D). But domestic demand was also robust, particularly in the fourth quarter. Several special factors may have boosted demand, including incentives on residential investment, and the prospect of the increase in consumption tax from 3% to 5% in April 1997, which may have led to some consumption being brought forward. These factors are however unlikely to account for all of the increase in domestic demand.

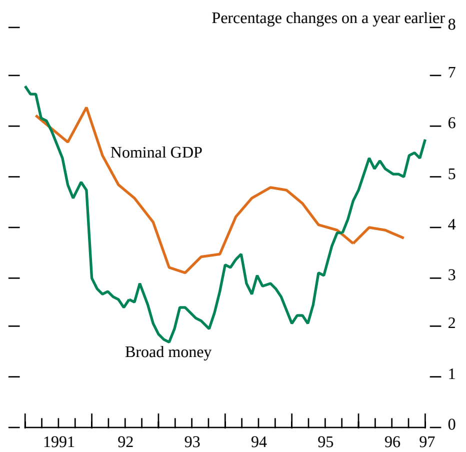
Exports continued to rise strongly in January and February. The March 1997 Tankan Survey of corporate sentiment confirmed the unevenness of the recovery. In the survey, manufacturing companies, particularly large ones, expressed most optimism. Non-manufacturers were less optimistic, suggesting that the stimulus from exports had yet to feed through to the rest of the economy and/or that the slowdown in the real estate and construction sectors may have accelerated. Non-manufacturers, mainly those in construction and real estate, also reported more difficulty in obtaining credit, reflecting the continued weakness in these two sectors. As in Germany, investment intentions remained weak.

Growth in the other advanced Asian economies slowed around the middle of last year, in part owing to a slump in the electronics market that reduced exports, and as a result of monetary tightening to prevent overheating.

The Mexican economy—an important export market for the United States—is estimated to have grown by more than 5% in 1996, after a 6% fall in GDP in 1995. Output in the transition economies of Eastern Europe as a whole also began to recover during 1996, although their growth was probably affected by weak export demand in some EU countries.

It is notable that many industrialised countries are relying on net exports to stimulate output growth. For this to happen, net imports by other countries such as the United States, the advanced Asian economies and emerging markets, will have to increase commensurately. Current account imbalances may therefore widen over the next year or so. A key issue is how different countries may react to these imbalances, and whether the necessary financing will be available.

Chart 4
Average broad money and nominal GDP growth in the G7



Money

In January, the weighted average of broad money growth in the G7 economies rose to 5.7%, the highest growth rate since 1991. Broad money growth in the G7 has now been rising almost continuously for two years (see Chart 4), but this has so far not been clearly reflected in a strengthening of nominal GDP growth: broad money velocity has fallen.

The strength in broad money has been accompanied by strong growth in private sector credit and may partly be owing to wealth effects arising from higher equity prices. The increased wealth and broad money holdings have not, however, had any clear and significant effects on spending in the G7. But the rise in broad money growth may presage stronger activity later this year. Narrow money also rose strongly in January (except in the United States, where it has been falling since 1995, probably as a result of the increased use of sweep accounts).

Chart 5
United States consumer prices and average weekly earnings

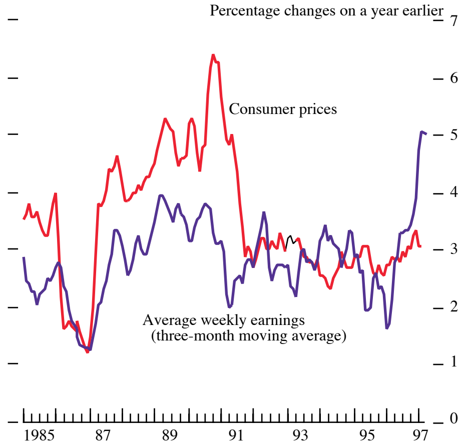


Chart 6
Consumer price inflation

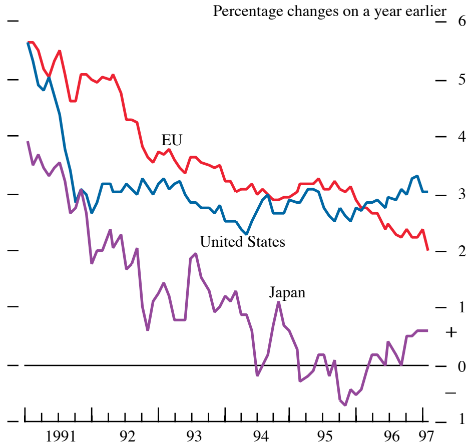
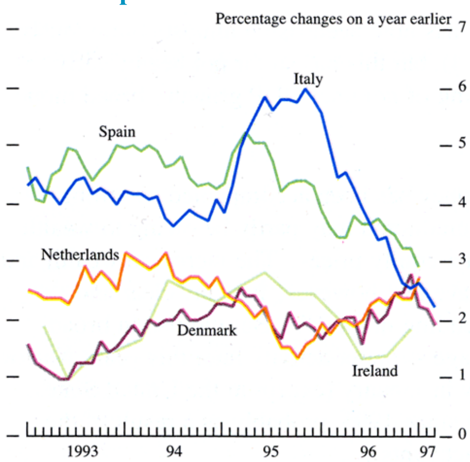


Chart 7
Consumer price inflation



Inflation remains low

Inflation remained low in the advanced overseas economies in 1996, and declined further in Asia and most developing countries. Strong growth and doubts about remaining spare capacity in the United States and some of the smaller EU economies suggest that there may be some inflation risks further ahead.

The main potential source of inflationary pressure in the United States is the labour market. Unemployment fell to 5.2% by the end of the first quarter, and average hourly earnings were 4% higher than a year earlier—the fastest rate of increase during the current seven-year expansion. The lack of strong wage pressures over the past few years, despite near-full employment, has been a feature of the US economy. Slow growth in non-wage costs (particularly health insurance costs), job insecurity and increased competition between firms have been cited as possible explanations. The first two factors may have become less important in recent months. (For example, the number of people voluntarily leaving employment—the 'quit rate'—increased in the first quarter, and the year-on-year increase in health care costs to employers remained constant at around 2% per annum during 1996, after falling in 1995.) And as Chart 5 shows, wage inflation has been rising since early 1996. The concern is that it might be difficult to reverse this trend.

Outside the labour market there are few signs of inflationary pressure. The twelve-month increase in consumer prices has been around 3% for the last two or three years (see Charts 5 and 6). Core inflation, which excludes food and energy, remained at 2.5% in March. The strong dollar has put downward pressure on imported goods prices.

In Japan, measured consumer price inflation has been negligible for the past four years or so. The depreciation of the yen by 12% in real terms since the start of 1996 has brought an end to twelve-month falls in the consumer price index, but there is little sign of inflationary pressure. In the March Tankan Survey more companies said they were reducing their prices than increasing them, even in the manufacturing sector. Retailers are unlikely to increase their prices by the full amount of the increase in consumption tax.

Within the European Union, convergence among inflation rates has increased, as inflation has fallen further in Italy and Spain and picked up in Ireland, Denmark and the Netherlands (see Chart 7). In the European Union as a whole, the twelve-month rate of increase in prices declined gradually during 1996 from 3% in January to 2.4% in December. It has since fallen further to 2% in February, a record low. In March, annual consumer price inflation fell to 1.5% in Germany and 1.1% in France. The process of disinflation is likely to continue as lower energy prices and administered prices (especially in France and Spain) feed through.

A more accurate comparison of inflation rates in individual EU countries is now possible, following publication by Eurostat of harmonised indices of consumer prices. These measure prices on a common basis. They differ from national CPIs in coverage (particularly in the treatment of housing costs) and in how data are aggregated. The harmonised indices use geometric rather than arithmetic means. The Office for National Statistics estimate that

Table E
Annual rates of inflation for January 1997

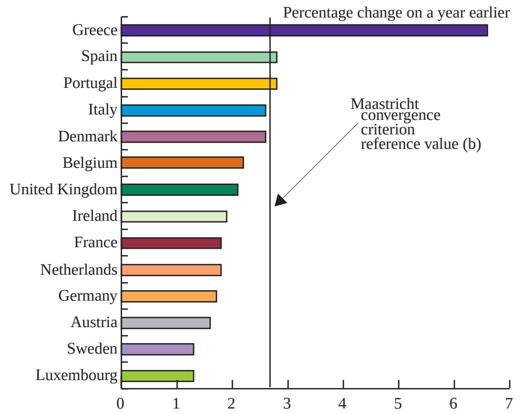
Per cent

	HICP	National index
Finland	0.9	0.6
Sweden	1.3	-0.1
Luxembourg	1.3	1.3
Austria	1.6	1.9
Germany	1.7	1.8
Netherlands	1.8	2.3
France	1.8	1.8
Ireland	1.9	n.a.
United Kingdom	**2.1**	**2.8** (a)
Belgium	2.2	2.3
Denmark	2.6	2.7
Italy	2.6	2.7
Spain	2.8	2.9
Portugal	2.8	3.3
Greece	6.6	6.8
EICP	2.2	n.a.

n.a. = not available.

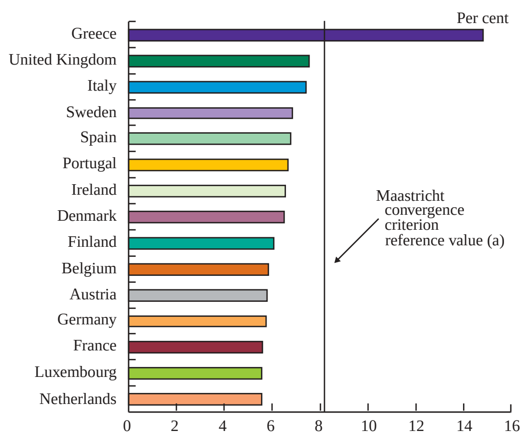
(a) RPIX.

Chart 8
EU consumer price inflation(a)



(a) Data calculated using the harmonised consumer price indices (January 1997).
(b) Criterion equals 1.5 percentage points above three best-performing countries.

Chart 9
Long-term interest rates, January 1997



Source: National data (series proposed by the central banks for the purpose of the Maastricht criteria).

(a) Criterion equals 2 percentage points above three best-performing countries in terms of inflation.

this latter effect accounts for about half of the difference between UK inflation as measured by the harmonised measure and the RPIX measure. National measures may be preferable for assessing inflation in an individual country—for example, RPIX has a wider coverage than the harmonised measure—but the harmonised measures are useful for cross-country comparisons.

Table E shows harmonised and national measures of inflation in EU countries in January 1997. A striking point is the reduced disparity between countries' inflation rates when measured by the harmonised indices. Apart from Greece, all EU countries had inflation rates within two percentage points of each other, whereas on national definitions the differential was nearly 3.5 percentage points. Countries with the lowest rates of inflation on national measures—notably Sweden and Finland—had higher rates of inflation on the harmonised measure. Greece, Portugal and the United Kingdom, with higher-than-average inflation on national definitions, had lower inflation on the harmonised measure.

The convergence of inflation rates among EU countries at the start of 1997 masks some divergent trends among countries with different cyclical positions. Inflation in Belgium, the Netherlands and Denmark increased a little over 1996, and there are signs of further inflationary pressure in these countries and in Ireland. In both Denmark and the Netherlands, house price inflation was more than 10% per annum at the start of 1997; house prices have also been rising sharply in Ireland. Mortgage lending rose by around 18% in the Netherlands in 1996, and private sector credit was up about 11.5%. In Ireland, too, broad money growth was 16% in 1996, but the appreciation of the currency in 1996 helped offset inflationary pressures.

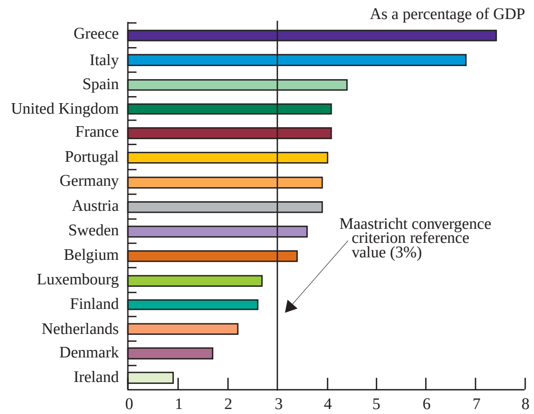
So there is evidence of some modest inflationary pressure in some of the smaller EU countries, but for the European Union as a whole inflation is likely to fall further, reflecting subdued wholesale prices, the absence of capacity constraints and the moderation in oil prices.

EMU

The harmonised measures of consumer prices will be among the variables used to assess convergence against the criteria set out in the Maastricht Treaty for the EMU process. Charts 8–11 show the position at the start of 1997. Convergence of inflation and interest rates has generally been more substantial than fiscal convergence. In 1996, according to latest national estimates, only 5 of the 15 countries had deficit/GDP ratios below the 3% reference value (Chart 10). In eight other countries the ratio was between 3% and 4.5%. Italy and Greece had deficit ratios of more than 6.5%.

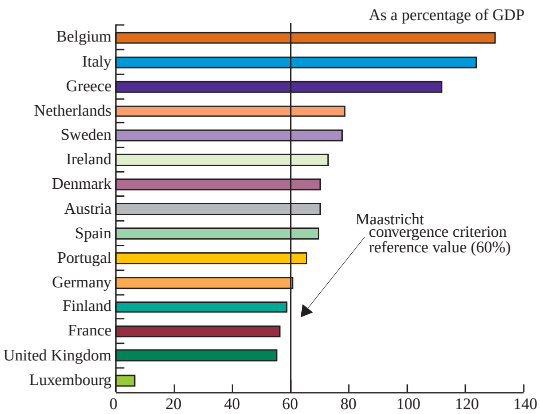
These figures provide only a snapshot of the fiscal position in Europe. In assessing the fiscal stance it is necessary to look at the underlying position and at the issue of sustainability. There is evidence of fiscal consolidation in the EU as a whole in the past two years: the aggregate fiscal deficit fell from 5.4% of GDP in 1994 to an estimated 4.3% in 1996. But the aggregate deficit was no smaller in 1996 than in 1991. And some of the improvements are due to one-off measures that improve the budgetary position in one or a limited number of years only. Moreover the snapshot figures give no indication of the effect of cyclical influences on the

Chart 10
EU general government deficits, 1996



Source: National government March 1997 estimates.

Chart 11
EU gross general government debt, 1996



Source: National government March 1997 estimates.

Table F
G7 ten-year forward rates

	Basis point change				Level
	1996		1997	18 Feb.–	27 Mar.
	Q3	Q4	Q1	27 Mar.	1997
United Kingdom	-12	-75	-4	+42	8.02
United States	-3	-35	+27	+47	7.37
Germany	-29	-35	-13	+82	7.89
France	-49	-54	-8	+47	7.06
Italy	-83	-64	+5	+90 (a)	9.05
Canada	-21	-67	-11	+22	7.82
Japan	-35	-65	-44	-20	3.89

(a) Change from 24 February 1997, as rates started to rise later in Italy.

deficit. Above-trend growth usually results in increased government revenue and lower welfare payments; this is quite different from structural fiscal consolidation.

The fiscal ratios for 1996 also ignore demographic trends; in the European Union as a whole, the proportion of elderly people in the population is rising, so future pension and health care costs will be greater. What is important, from the point of view of economic convergence and the success of EMU, is that fiscal consolidation should be sustainable over the medium to longer term.

The Maastricht reference level for the ratio of general government debt to GDP is 60%. In 1996 Luxembourg, the United Kingdom and France had debt ratios below 60%; Germany's was marginally above. All other countries had debt levels above 60%: in Greece, Italy and Belgium, debt/GDP ratios were around double the reference value (see Chart 11). The ratio of general government debt to GDP for the EU as a whole has risen dramatically over the past twenty years or so. In 1980 the ratio was less than 40%; in 1990 it reached 55%, and by 1996, an estimated 74%.

France, Austria, the United Kingdom and Germany expect the ratio of their general government debt to GDP to rise in 1997 (though not above 60% in France and the United Kingdom). All other countries (except Luxembourg) expect the debt ratio to fall, but not below 60% and at varying speeds depending on, among other things, the size of the primary surplus.

Interest rates

Two issues dominated international futures and bond market developments in 1997 Q1; higher expected and actual official interest rates in the United States and market uncertainty over the EMU timetable.

The US federal funds target rate was raised by 25 basis points to 5.5% on 25 March. There was only a limited reaction from financial markets (the dollar effective index rose by 0.3%, and stock prices fell slightly on the day), suggesting that the move had been widely expected. Expectations about future short-term interest rates were also revised upward during the quarter. In mid-April, US futures contracts were discounting a rate rise of over 80 basis points by the end of the year.

The Netherlands Central Bank responded to signs of inflationary pressure by increasing interest rates by 20 basis points in each of February and March. Official interest rates in Spain and Portugal were cut by 25 basis points in March; Italy and France reduced their interest rates earlier in the quarter.

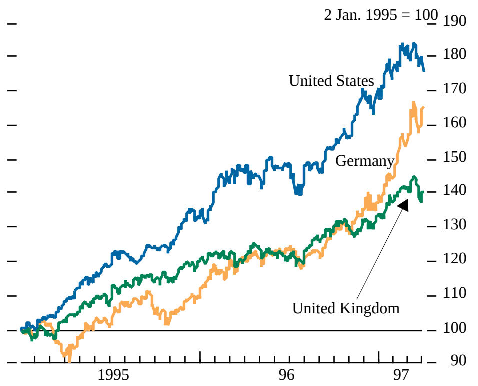
At the beginning of the year, ten-year bond yields fell in most European countries and the United States but increased sharply after the middle of February, in many cases more than offsetting the initial decline. The largest increases have been in Swedish, US, Italian and Spanish yields; yields fell in France and Austria.

The sharp rise in long-term international interest rates since mid-February may in part be explained by expected policy tightening worldwide. But the sharp rise in German and Italian rates (see Table F) may also reflect EMU factors.

Forward rates—ie the future short-term interest rates implicit in the current yield curve—enable us to distinguish between movements at different time horizons. Ten-year yields reflect the average short-term interest rate expected to prevail over the next ten years (and not just in ten years time), and so, unlike ten-year forward rates (ie the short-term interest rates ten years in the future that are implicit in the current yield curve), will be influenced by a combination of short and long-term conditions.

Ten-year forward rates in the United States rose by 47 basis points in the second half of the first quarter, but two-year forward rates (not presented in the table) rose by considerably more (up 74 basis points). This suggests that a large proportion of the rise in US yields is caused by short to medium-term cyclical factors. In contrast, ten-year forward rates in Germany rose by 82 basis points between the middle of February and the end of March, compared with an increase in two-year forward rates of 29 basis points over the same period. Increasing uncertainty among market participants over the feasibility of the EMU timetable, and fears that Germany may not meet the Maastricht fiscal criteria and about the possibility of a 'soft' euro may have raised the risk premium on bonds of prospective EMU Member States or increased long-term inflation expectations.

Chart 12
Common currency (sterling) equity price indices



Equity markets

International equities, as shown in market indices of leading shares, performed well (see Chart 12). Over the quarter as a whole, though markets fell back a little after the rise in US official interest rates, the FT-SE 100 was up 6.3%, the Dow Jones 4.6%, the Frankfurt DAX 20.4% and the Paris CAC -40 by 17.7%. The Nikkei fell by 6% over the same period.