The international environment

- *Growth in the United States and Japan was strong in the first quarter, but latest data suggest that activity in both countries slowed in the second quarter.*
- *By contrast, activity in Germany and France strengthened from the moderate growth seen in the first quarter. Activity in Italy is more subdued, though there are signs of a gradual recovery. The smaller EU countries continue to grow strongly.*
- *Real broad money growth in the major six overseas (M6) economies rose further in the second quarter and is consistent with increasing activity. Rising equity markets should also help to strengthen demand, particularly in the United States, where consumer confidence is already strong.*
- *Producer prices remain subdued in all the M6 economies; consumer price inflation is currently very low, with little evidence of emerging wage pressures, even in the United States.*
- *In the absence of price pressures, M6 short-term interest rates were broadly stable in the second quarter. Financial markets do not expect significant rises in short-term interest rates during the remainder of the year.*
- *Long-term interest rates fell in Japan and the European Union (despite uncertainties about EMU) and were stable in the United States.*

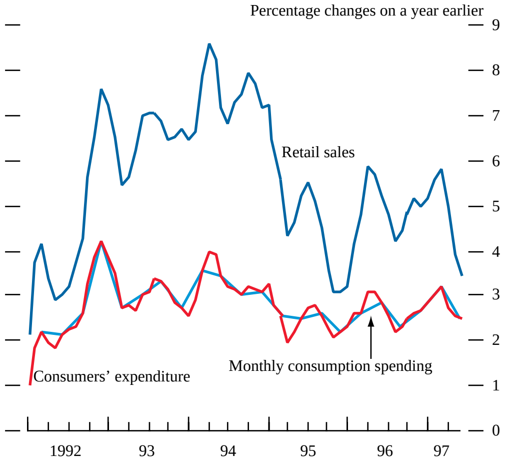
Table A
Contributions to US GDP growth(a)

Percentage points

	1996		1997	
	Year	Q4	Q1	Q2
Domestic demand	**3.0**	**0.6**	**1.5**	**0.8**
Consumption	1.8	0.6	0.9	0.1
Investment	1.2	0.1	0.6	0.5
Stocks	0.0	-0.1	0.4	0.0
Government	0.0	0.1	0.0	0.2
Net trade	**-0.2**	**0.5**	**-0.3**	**-0.3**
GDP growth	**2.8**	**1.1**	**1.2**	**0.5**

(a) Contributions may not sum because of rounding.

Chart 1
US consumer activity



Latest data suggest that activity in the United States and Japan may have slowed from the strong first quarter.

US GDP rose by 0.5% in the second quarter, following a 1.2% rise in the first quarter. In both quarters, the increases in GDP were driven by domestic demand, with net trade making a negative contribution (see Table A). Consumption, which accounted for three quarters of the first quarter rise in GDP, rose by just 0.2% in the second quarter. That recent weakness in consumption is reflected in the latest retail sales data (see Chart 1). But consumer confidence remains strong, probably due to strong growth in employment and income (real disposable income grew by 1.1% and 0.8% in the first and second quarters, respectively).

A key question is whether the 0.2% increase in consumption in the second quarter represents a permanent slowdown in consumer activity towards more sustainable growth rates, or whether it is simply temporary, like the slowdown in the third quarter of 1996. Consumer confidence continues to improve, owing to high levels of job creation (and perhaps wealth effects from a rising equity market), suggesting that the recent slowdown may be temporary. Employment growth has continued: the average monthly increase in non-farm payrolls was 239,000 in Q2, up from 229,000 in Q1, suggesting a rise in income from employment.

By contrast with the slowdown in retail sales, industrial activity has remained more buoyant (see Chart 2). Industrial production rose by 1.1% in the second quarter. The National Association of

Chart 2
US industrial activity

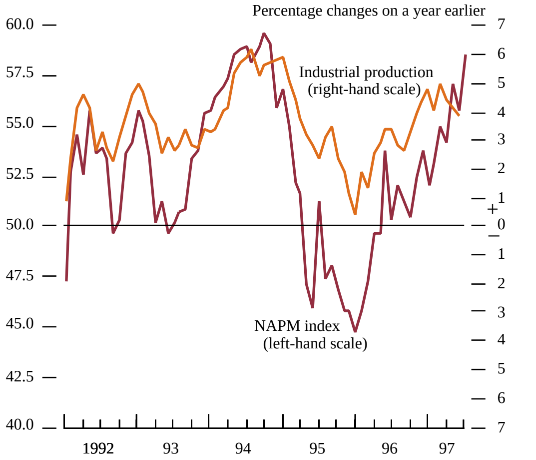


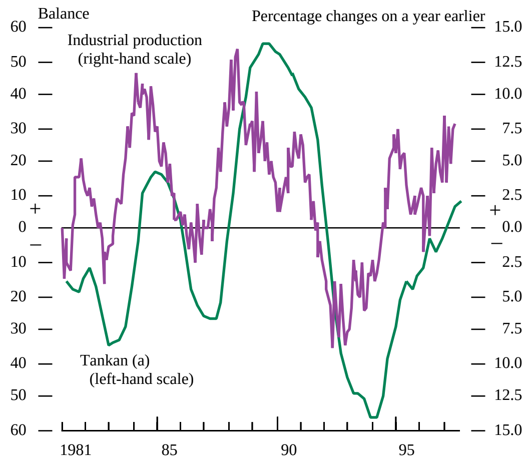
Table B
Contributions to Japanese GDP growth(a)

Percentage points

	1996 Year	Q3	Q4	1997 Q1
Domestic demand	**4.4**	**0.1**	**0.5**	**1.5**
Consumption	1.7	-0.1	0.7	2.7
Investment	2.6	0.1	-0.1	-1.2
Stocks	-0.1	0.0	-0.1	0.0
Government	0.2	0.1	0.1	0.0
Net trade	**-0.9**	**0.2**	**0.4**	**0.1**
GDP growth	**3.6**	**0.3**	**0.9**	**1.6**

(a) Contributions may not sum because of rounding.

Chart 3
Japan: Tankan Survey and industrial production



(a) Major manufacturers' view of business conditions.

Table C
Contributions to German GDP growth(a)

Percentage points

	1996 Year	Q3	Q4	1997 Q1
Domestic demand	**0.8**	**-0.1**	**0.3**	**0.3**
Consumption	0.7	0.1	-0.2	0.1
Investment	-0.2	0.2	0.0	-0.6
Stocks	-0.3	-0.5	0.6	0.3
Government	0.5	0.2	-0.2	0.6
Net trade	**0.6**	**0.8**	**-0.2**	**0.1**
GDP growth	**1.4**	**0.7**	**0.1**	**0.4**

(a) Contributions may not sum because of rounding.

Purchasing Managers' (NAPM) index which averaged 55.7 in Q2 (compared with 53.4 in Q1), rose to 58.6 in July, consistent with further increases in industrial output. And in the second quarter the index of new orders was 61.4, its highest quarterly level since the third quarter of 1994, suggesting that further increases in output are likely over the next few months.

Japanese GDP rose by 1.6% in the first quarter, largely because of increased consumption (see Table B). Net external trade contributed only 0.1 percentage points, despite the depreciating yen (the nominal effective exchange rate fell by 9.3% during 1996). Investment was weak despite the low cost of capital, reflecting subdued industrial confidence, particularly in smaller firms.

The Japanese recovery has been erratic, but the underlying trend is gradual expansion. Analysts have attributed much of the first-quarter strength in consumption to advance purchasing prior to April's indirect tax increase (consumption tax rose from 3% to 5%). So consumption growth is likely to be weaker in the second quarter. And with little evidence of any improvement in the labour market (the unemployment rate was 3.5% in May), consumer sentiment is likely to remain weak. The sluggish nature of the industrial recovery was reflected in the June Tankan Survey (see Chart 3). Though industrial sentiment improved, this continued to be skewed towards larger export firms, with the response from smaller domestically orientated firms still quite muted.

Activity in the larger continental European economies was slow in the first quarter, though more recent data show continuing recovery in Germany and France. Economic performance in Italy remains weak. By contrast, activity in the peripheral European countries has been more buoyant.

In Germany, GDP grew by 0.4% in the first quarter, largely driven by government expenditure (see Table C). In line with the pattern in the previous two quarters, consumer demand and investment remained subdued. French GDP grew by 0.2% in the first quarter: growth was entirely export-led, with weak consumption and investment (see Table D).

More recent data indicate some revival in industrial activity in both countries, which seems to be largely export-driven. Industrialists in both countries continue to report strong export orders, but domestic orders are less buoyant. In Germany, the increase in exports has been sufficient to stimulate business confidence: the IFO balance of manufacturing sentiment was +4.6 in the second quarter, up from -1.4 for the first quarter (see Chart 4). French industrial production has also picked up: increasing export orders more than offset weak domestic demand, leading to an increase in business confidence.

Italian GDP fell by 0.2% in the first quarter, reflecting a negative contribution from net external trade (see Table E). Unlike its two larger European neighbours, Italy has not benefited from any stimulus from external demand since the third quarter of 1996. Domestic demand rose by 0.2% in the first quarter, but that was largely because of consumption growth (up 0.5% on the quarter), reflecting an incentive scheme that encouraged the demand for cars. The underlying picture of activity is more subdued.

Table D
Contributions to French GDP growth(a)

Percentage points

	1996 Year	Q3	Q4	1997 Q1
Domestic demand	**0.9**	**0.6**	**0.0**	**-0.3**
Consumption	1.3	0.5	-0.3	0.2
Investment	-0.1	0.3	0.0	-0.3
Stocks	-0.5	-0.3	0.2	-0.3
Government	0.2	0.1	0.1	0.1
Net trade	**0.6**	**0.2**	**0.2**	**0.5**
GDP growth	**1.5**	**0.8**	**0.2**	**0.2**

(a) Contributions may not sum because of rounding.

Chart 4
Industrial confidence

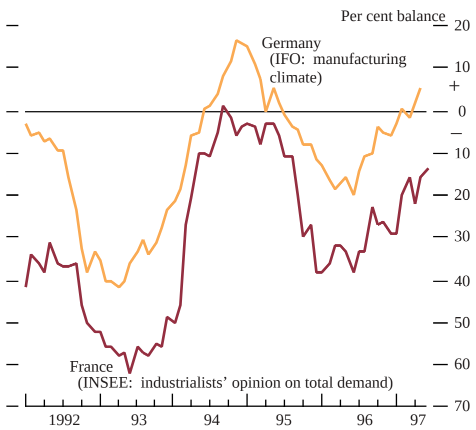


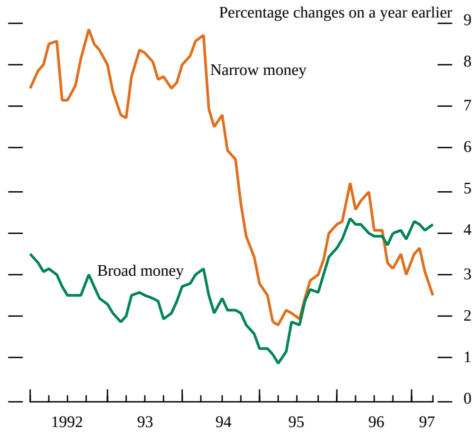
Table E
Contributions to Italian GDP growth(a)

Percentage points

	1996 Year	Q3	Q4	1997 Q1
Domestic demand	**0.2**	**0.6**	**0.4**	**0.2**
Consumption	0.5	0.2	0.2	0.3
Investment	0.2	-0.1	-0.1	0.0
Stocks	-0.5	0.4	0.3	-0.1
Government	0.1	0.1	0.0	0.0
Net trade	**0.5**	**0.1**	**-0.9**	**-0.4**
GDP growth	**0.7**	**0.7**	**-0.5**	**-0.2**

(a) Contributions may not sum because of rounding.

Chart 5
Average narrow and broad money growth in the M6 economies



In all three countries, underlying consumer activity is weaker than industrial output, reflecting the weak labour market conditions that currently prevail. But it might also partly reflect uncertainty about the tightness of fiscal policy in the run-up to EMU. There have been signs more recently of a slight pick-up in consumer confidence, but it still remains low.

Overall, total GDP in the M6 economies (aggregated using UK export weights) rose by 0.7% in the first quarter, compared with 0.3% in the final quarter of 1996. Much of this increase reflects the strong growth in the United States and Japan. Latest data suggest that second-quarter growth in both countries will be lower, though this effect should be partly offset by stronger growth in Germany and France.

Activity in the smaller EU countries has been more buoyant than in their larger continental European neighbours. In Spain, GDP rose by 0.9% in the first quarter, driven by consumption and investment, as private demand replaced net exports as the main force behind the recovery. In the Netherlands, GDP fell by 0.6%, though that was largely because of a smaller number of working days in the first quarter of 1997. The underlying picture in the Netherlands is of broad-based growth: industrial production rose by 0.4% in the first quarter and latest industrial surveys suggest continued improvement in order books.

In the M6 economies, recent trends in narrow and broad money growth have continued. The annual growth rate of GDP-weighted broad money has picked up, and the annual increase in narrow money has contracted slightly.

Broad money growth has increased in the M6 economies: the annual increase averaged 4.2% in April and May, the highest rate since the first quarter of 1992. This mainly reflects a smaller annual decrease in French money supply and a rise in the annual rate of increase in Italian M2, from 7.4% in the first quarter to 9.4% in the second. The annual increase in US M2 has remained stable, averaging 4.8% in the second quarter, slightly below the upper edge of its 1%–5% target band. German broad money growth, as measured by M3, fell from 7.7% in Q1 to 6.5% in Q2.

By contrast, the decline in M6 GDP-weighted narrow money growth has continued in 1997. The annual increase in M6 narrow money averaged 2.6% in April and May, compared with 3.4% in the first quarter. This reflects lower rates of increase in narrow money across the G3. In the United States, narrow money contracted by 4.9% in Q2 from a year earlier, following a contraction of 3.9% in Q1. In Japan, the annual increase was 8.7% in Q2, down from 9.7% in Q1. The German narrow money growth rate fell by a similar amount, down from 10.3% in Q1 to an average annual rate of 9.3% in April and May.

Equity market performance in the M6 economies has also been buoyant.

All major equity market indices rose in Q2. The Dow Jones and Nikkei Dow were up 13.8% and 15.4% respectively, while in Europe, the German DAX and Paris CAC 40 rose by 10.4% and 7.6% (see Chart 6).

Chart 6
Equity indices in domestic currencies

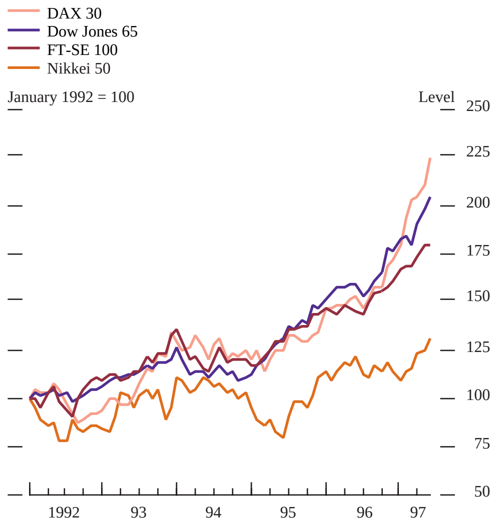


Chart 7
US producer price inflation

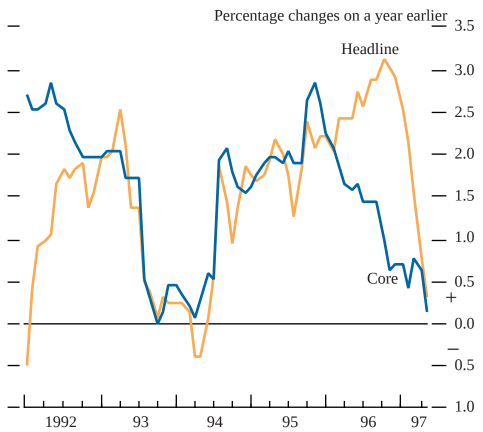
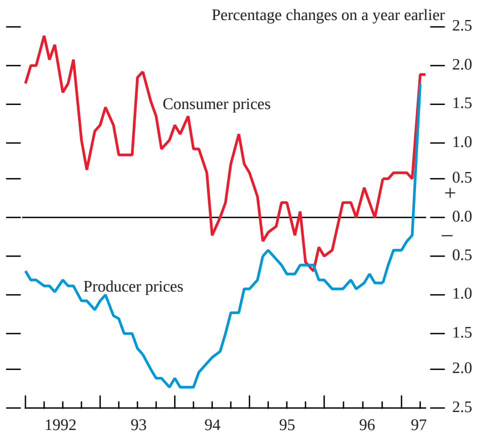


Chart 8
Japanese inflation



But despite strengthening activity, broad money growth and rising asset prices, inflation in the M6 economies has been quite low.

In the United States, there is little evidence of inflationary pressure either from the labour market or from within the supply chain. The unemployment rate was 4.9% in the second quarter the lowest for 23 years. But there is little evidence that the reduction in the unemployment rate since 1992 Q3 (when it was 7.6%) is feeding through to a significant increase in wage pressures. Wage inflation did pick up slightly in the first quarter (to 3.9%), but fell back (to 3.6%) in the second quarter.

US producer price inflation of both crude materials and finished goods has fallen sharply over the past few months. This largely reflects the effects of lower oil prices, reversing the rises in 1996 (see Chart 7). But it might also reflect the effects of lower import prices as a result of the dollar appreciation. The low producer price inflation is reflected in consumer price data. The headline rate of consumer price inflation has fallen sharply over the past three months and, at 2.3% in June, is at its lowest since 1986.

Despite rising import prices, Japanese producer price inflation remains low. In contrast with the United States, Japanese import prices have risen sharply: the annual inflation rate was 10% in the second quarter. The level of producer prices fell throughout 1996, but has levelled out since January 1997. This could reflect rising import price pressures; in addition, producers may have attempted to widen margins in response to the revival in domestic demand. As well as this underlying pick-up in producer prices, there was also a step increase in prices in April (up 1.9% on the month), reflecting the effects of the increase in the consumption tax rate. Nonetheless, producer price pressures remain muted.

Japanese consumer price inflation has also been low (see Chart 8). Historically high levels of unemployment may partly explain low levels of consumer confidence, which in turn is restraining private demand and creating a competitive pricing environment. As with producer prices, the sharp increase in consumer prices since April reflects the increase in consumption tax. This effect will drop out of the index in April 1998.

European consumer price inflation remains subdued despite the contrast in the pace of activity between the core and peripheral countries.

As in Japan, rising import prices in Germany and France have not yet led to a significant rise in producer price inflation (see the box on page 269). In Germany and France, where the nominal effective exchange rates depreciated by 4.1% and 2.1% respectively during 1996, annual import price inflation has risen quite sharply since mid 1996, reaching 2.7% in Germany and 1.5% in France in the first quarter. These pressures may be reflected in producer prices, which have been rising in both countries since the start of the year. But the annual inflation rates remain quite low.

Italy, by contrast, has benefited from lower import prices owing to the appreciation of the lira prior to its entry to the ERM in November 1996. As a result, Italian producer price inflation has been modest, remaining slightly below 1% during the past twelve months.

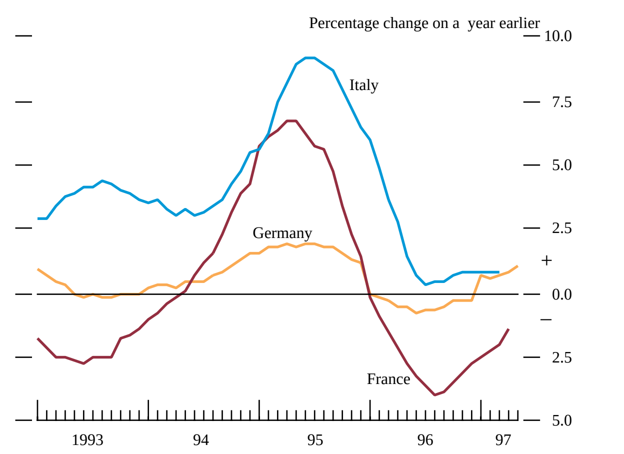
Trends in European producer price inflation

This box assesses recent producer price inflation[1] across the European Union. The main finding is that trends in producer prices have been similar, despite differing rates of activity between the larger and smaller economies. And though there has been a modest pick-up in producer price inflation over the past year as the European economies recover, these rising producer prices are so far putting little pressure on consumer prices.

Larger economies

Despite differences in the absolute rate of producer price inflation, the trend since 1993 has been similar in Germany, France and Italy (see Chart A). In all three countries producer price inflation rose in 1993, and picked up sharply during 1994 in response to the global rise in commodity prices.

Chart A
Larger EU: producer price inflation



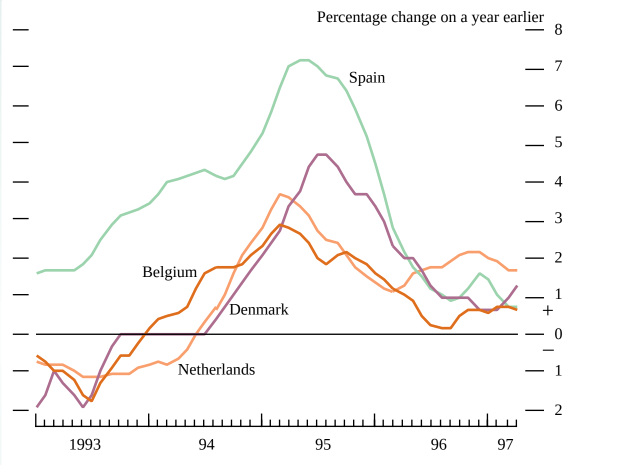
In all three countries producer price inflation peaked in early 1995 but then fell, in line with the fall in commodity prices. This reduction continued until mid 1996, when there was producer price deflation in Germany and France; in Italy, prices were slightly higher than a year earlier.

Since mid 1996, producer prices have picked up slightly. In Germany and Italy, producer price inflation is now mildly positive. And though French producer prices are below their level of a year earlier, the price index has been rising over the past few months: in May 1997, the index was 0.5 percentage points above its level at the end of 1996.

Smaller economies

The trend in producer price inflation in the smaller European economies has been similar to that in the larger economies (see Chart B). Producer price inflation increased in 1993 and 1994, reflecting rising commodity prices. During that period, inflation rates in Belgium, Denmark and the Netherlands were similar, peaking at around 4% in early 1995. Inflation in Spain was higher, reaching 7%. Producer price inflation fell sharply during 1995, though it remained positive during 1996. (In the Netherlands, it increased during 1996.)

Chart B
Smaller EU: producer price inflation



Implications for EU consumer prices

One explanation why producer price pressures in 1996 may have been slightly stronger in the smaller countries (excluding Belgium) than in the larger ones could be the relative cyclical position. Real GDP growth in 1996 was 2.7% in the Netherlands, 2.2% in Spain and 2.4% in Denmark. This compares with 1.4% in Germany, 1.5% in France, 1.3% in Belgium and 0.7% in Italy. The contrast in activity could explain why in the Netherlands and Spain producer prices increased in 1996, while there was producer price deflation in Germany and France.

But more recently, producer price inflation has also picked up slightly in countries where activity has been more subdued. This might reflect rising prices of imported commodities priced in dollars because of exchange rate depreciation against the US dollar. It could also reflect demand-led pressures as these economies recover. Nonetheless, producer price inflation across the European Union remains low and, as yet, is putting little pressure on consumer prices.

(1) This refers to an aggregate measure of manufacturers' output prices (though the precise definition of these series differs between countries).

Chart 9
Consumer price inflation in Germany, France and Italy

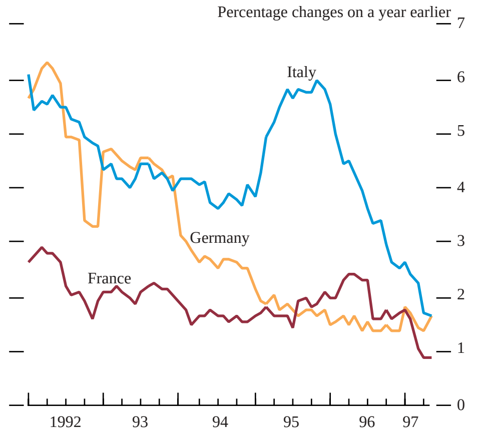


Chart 10
Consumer price inflation in the smaller economies

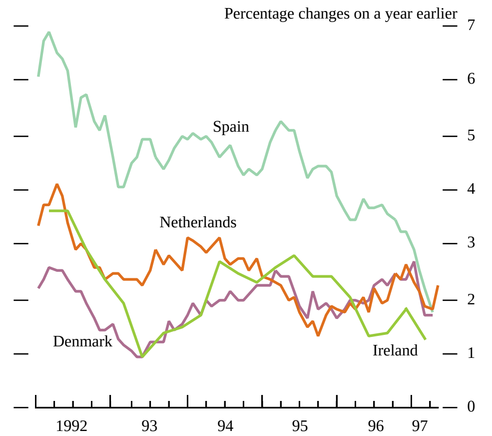
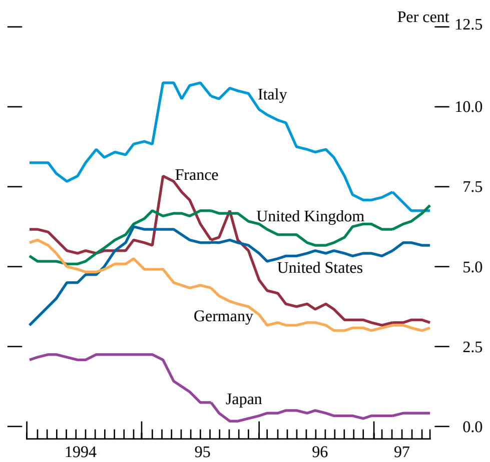


Chart 11
Short-term interest rates



But in these three economies, weak demand seems to have offset any cost pressures, leaving consumer price inflation either very low or falling further (see Chart 9). In Germany, inflation averaged 1.6% in Q2, compared with 1.7% in the first quarter and 1.5% for 1996 as a whole. In France, consumer price inflation continued to fall, averaging 0.9% in Q2, down from 1.5% in the first quarter and 2.0% in 1996. Italy's recent inflation performance has been even more striking, with annual inflation of 1.6% in Q2, down from rates above 6% at the end of 1995.

Consumer price inflation (measured on a national basis) also remains relatively low in those smaller European economies where activity has been more robust (see Chart 10). In the Netherlands, where GDP growth was 2.7% in 1996, inflation was 1.9% in Q2, compared with 2.1% in 1996. In Denmark, inflation averaged 1.9% in April and May, compared with 2.0% in 1996.

Policy interest rates were unchanged in most of the major economies in the second quarter and, as a result, short-term market interest rates remained stable during this period.

US three-month market interest rates averaged 5.7% in Q2, compared with an average of 5.45% for each of the previous four quarters, reflecting the 25 basis points rise in the federal funds rate in March (see Chart 11). But market expectations of future short-term rates have fallen during the past three months. This followed a combination of weaker activity data in Q2 (most notably retail sales) and further falls in inflation. Short-term rates (as implied by the December 1997 futures contract) are now expected to remain around 5.75% by the year end, almost 75 basis points lower than at the time of the May *Inflation Report*.

Financial markets are now not expecting Japanese short-term rates to rise by as much as they were three months ago, despite strong Q1 GDP data and improved industrial sentiment described in the Tankan Survey. Three-month interest rates, which averaged 0.4% in Q2 (compared with 0.3% in the first quarter), are expected to rise to around 0.7% by the year end (40 basis points lower than implied three months ago).

Short-term rates in Germany and France were stable during Q2, averaging 3.1% and 3.3% respectively. There has been little change in interest rate expectations implied by the futures markets: three-month rates are expected to rise by about 50 basis points by the year end, reflecting the benign inflationary outlook for 1997. The Banca d'Italia cut its discount rate by 50 basis points to 6.25% on 27 June 1997, but short-term rates had already fallen during Q2, in response to the reduction in consumer price inflation. And the weakness of the current Italian expansion, together with a limited inflationary risk, means that financial markets expect further reductions in interest rates. The December 1997 futures contract implies three-month interest rates of 6.30% by the year end, little changed from expectations three months ago.

Long-term rates have picked up marginally in the United States, but continue to converge in Europe, despite uncertainty over progress towards EMU.

In the United States, long-term interest rates averaged 6.7% in Q2, 15 basis points above their Q1 average. But after rising sharply at the beginning of Q2, long-term rates fell during the following three

Chart 12
Long-term interest rates

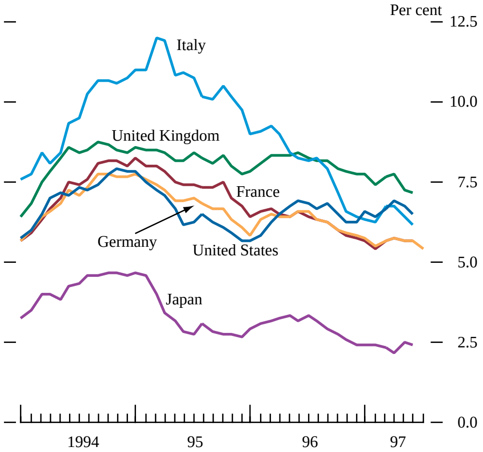


Table F
Harmonised indices of consumer prices

Annual inflation rates (per cent)

	1996		1997	
	Aug.	Nov.	Feb.	May
United Kingdom	n.a.	n.a.	2.0	1.6
Austria	1.9	2.2	1.5	1.5
Belgium	1.2	2.1	2.0	1.5
Denmark	2.2	2.1	2.0	1.9
Finland	1.0	1.2	0.6	0.9
France	1.7	1.6	1.7	0.9
Germany	1.2	1.3	1.6	1.4
Greece	7.7	7.4	6.5	5.3
Ireland	2.0	2.1	1.7	1.4
Italy	3.5	2.9	2.3	1.7
Luxembourg	1.3	1.3	1.5	1.1
Netherlands	1.3	1.7	1.6	1.7
Portugal	3.5	2.9	2.4	1.9
Spain	3.7	3.3	2.5	1.3
Sweden	0.6	0.2	1.1	1.2
EU 15 average	**2.2**	**2.2**	**2.0**	**1.5**

n.a. = not available.

Table G
Forecasts of 1997 fiscal deficits

Percentage of GDP

	EC	OECD	IMF
Belgium	-2.7	-2.8	-2.9
Denmark	0.3	0.0	-0.1
Germany	-3.0	-3.2	-3.3
Greece	-4.9	-5.2	-5.1
Spain	-3.0	-3.0	-3.2
France	-3.0	-3.2	-3.3
Ireland	-1.0	-1.2	-1.6
Italy	-3.2	-3.2	-3.3
Luxembourg	1.1	n.a.	-0.1
Netherlands	-2.3	-2.3	-2.2
Austria	-3.0	-3.0	-2.5
Portugal	-3.0	-2.9	-2.9
Finland	-1.9	-2.0	-1.9
Sweden	-2.6	-2.1	-0.8
United Kingdom	-2.9	-2.8	-3.1

n.a. = not available.

months (see Chart 12). By contrast, Japanese long-term rates were little changed, averaging 2.4% in both Q1 and Q2.

European long-term rates converged further during Q2 and satisfy most interpretations of the Maastricht interest rate criterion, despite recent uncertainty surrounding progress towards EMU.

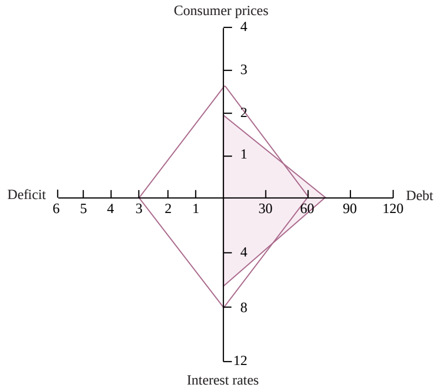
Since the inflation and interest rate criteria are quite likely to be satisfied by prospective members, the main hurdle for EMU is the fiscal criteria.

There has also been further convergence in inflation measured on a harmonised basis. Table F outlines the EU harmonised CPI data. In May, the differential between the highest and lowest inflation rates (excluding Greece) was 1.0 percentage points, compared with a 1.9 percentage points differential in February, indicating that the convergence in EU inflation rates under way since mid 1995 has continued into 1997. The inflation criterion in the Maastricht Treaty applies to the inflation rate for 1997 as a whole, and so will depend on relative inflation trends over the course of the year. Nonetheless, on the basis of the recent convergence, it seems unlikely that the inflation criterion will be the main problem for prospective members.

It is less clear how many countries will satisfy the fiscal criteria. Table G shows the latest EC, IMF and OECD deficit forecasts, and indicates that a small amount of overshoot is expected by both the IMF and the OECD. The box on page 272 outlines an appraisal of the extent of convergence in 1997 based on OECD projections for the deficit and debt ratios, together with data on the nominal variables for the first half of the year. This analysis underlines that it is the fiscal, rather than the inflation or interest rate, criteria on which the decision about EMU entry will need to be made.

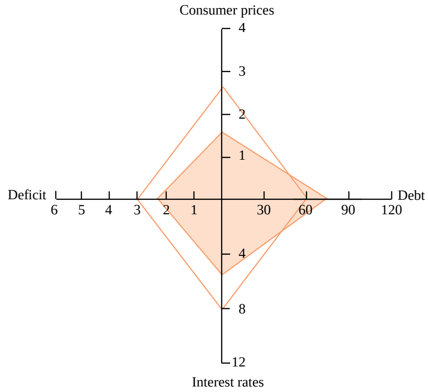
Performance relative to Maastricht convergence criteria in 1997

Denmark

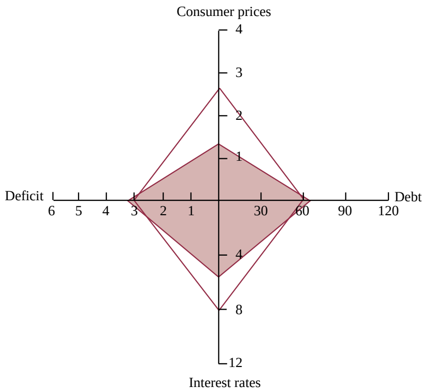


Note: The EC has ruled that Denmark does not have an excessive debt.

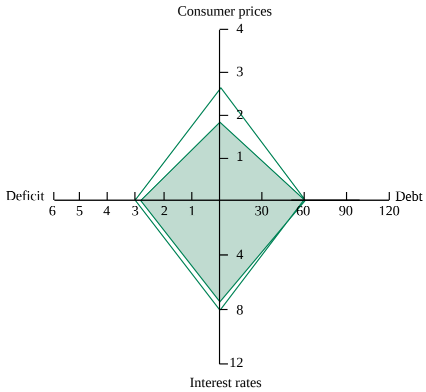
The Netherlands



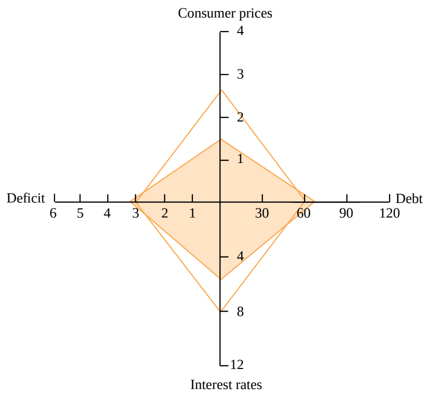
France



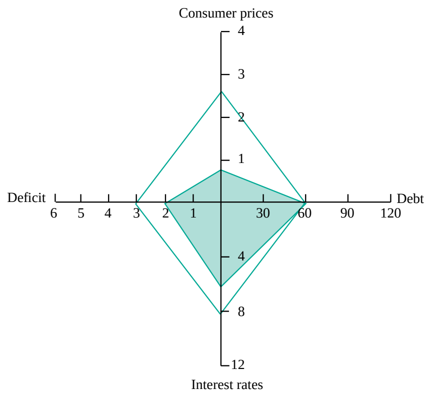
United Kingdom



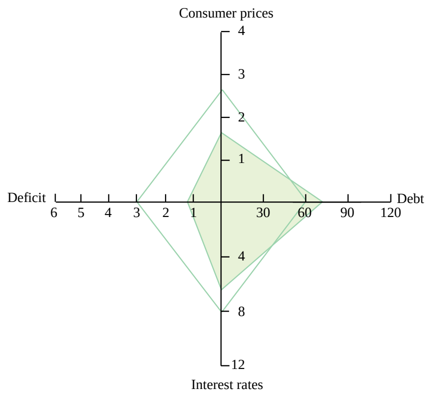
Germany



Finland

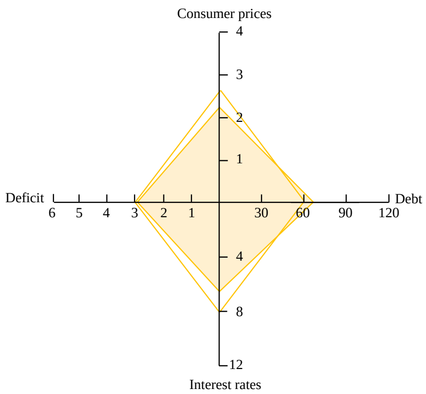


Ireland

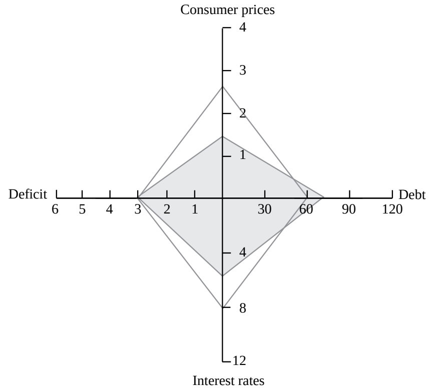


Note: The EC has ruled that Ireland does not have an excessive debt.

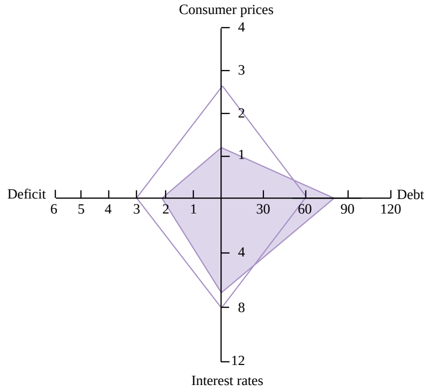
Portugal



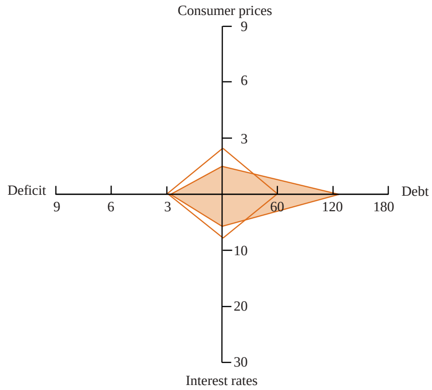
Austria



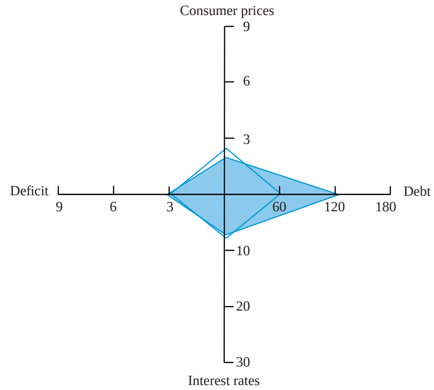
Sweden



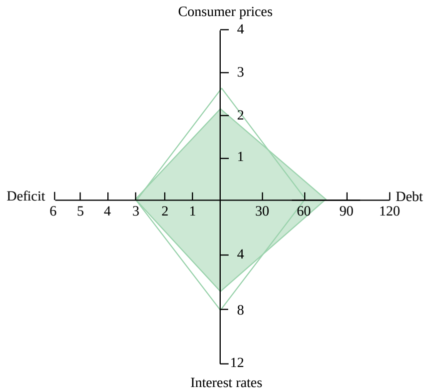
Belgium(a)



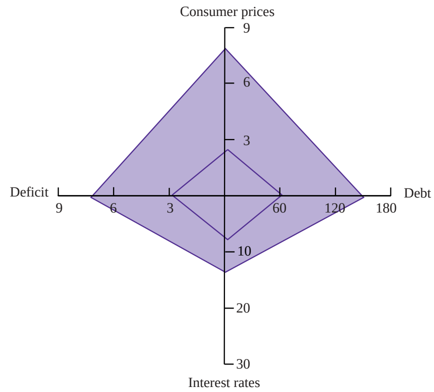
Italy(a)



Spain



Greece(a)



Source: Eurostat data and OECD.

(a) A different scale is used for these three countries.

The diagrams show the recent performance of EU countries against the convergence criteria for inflation and long-term interest rates as well as OECD forecasts of their fiscal debt and deficit positions in 1997. The shaded 'kite' shows the country's performance, while the other 'kite' shows the reference points for each criterion.

- The measure of inflation is the harmonised measure of consumer prices. The diagrams show the average annual increase in the indices in the first five months of 1997. The reference value for the convergence criterion is 1.5 percentage points above the three best-performing countries.

- The interest data are average long-term (ten-year) government bond yields for the first six months of 1997. The reference value is 2 percentage points above the three best-performing countries in terms of inflation.

- The deficit and debt, expressed as a percentage of GDP, are OECD forecasts for 1997, and are in line with Maastricht Treaty definitions. The reference values are 3% of GDP for the deficit and 60% of GDP for the debt.