The international environment

The main news[1] *since the previous* Quarterly Bulletin *is:*

- *US GDP continued to grow strongly in the second quarter of 1997, but GDP fell sharply in Japan.*
- *Output growth in the major European countries has strengthened, but in Italy it remains significantly weaker than elsewhere in Europe. Growth in Japan, France and Germany is being driven by net exports. In sharp contrast with the United States, the unemployment rate in Germany, France and Italy remains well above 10% of the labour force.*
- *Narrow money growth in the major industrialised economies has continued to increase, but broad money growth has remained stable.*
- *Equity prices in general continued to grow strongly, though in Japan they have continued to fall.*
- *Measured inflation remains low throughout the major six overseas economies. In Europe, consumer price inflation rates have largely converged at slightly above 1.5%.*
- *The Bundesbank increased its repo rate in October, leading to increases in several other European policy interest rates. But in the United States and Japan, official interest rates were unchanged.*

GDP grew in the major six overseas economies (M6)[2] *by 0.8% in the second quarter, up from 0.5% in the first quarter. US growth remained strong, but activity in Japan has slowed sharply since the end of the first quarter. Continental European growth is picking up, led by net exports, but domestic demand remains weak.*

US GDP grew by 0.8% in the second quarter, to a level 3.4% higher than a year earlier, well above the trend rate of growth for the US economy. This followed growth of 1.2% in the first quarter of 1997 and 1.1% in the fourth quarter of 1996. In the second quarter, unlike the first, private consumption grew slowly, as Table A shows. Business investment continued to grow strongly, but net exports once again fell, by the equivalent of 0.3% of GDP. This was the fifth fall in the past six quarters, reflecting continued appreciation in the dollar effective exchange rate and markedly stronger domestic demand than in most of the United States' major trading partners.

Table A
Contributions to US GDP growth[(a)(b)]

Percentage points

	1996		1997	
	Q3	Q4	Q1	Q2
Private consumption	0.1	0.6	0.9	0.2
Investment	0.6	0.1	0.6	0.7
Government consumption	0.1	0.0	0.0	0.1
Stockbuilding	0.2	-0.1	0.4	0.2
Domestic demand	**0.6**	**0.6**	**1.5**	**1.0**
Net trade	**-0.4**	**0.5**	**-0.3**	**-0.1**
GDP	**0.3**	**1.1**	**1.2**	**0.8**

(a) The table shows the increase in each demand component expressed as a percentage of GDP.
(b) Contributions may not sum because of rounding.

Data released so far for the third quarter suggest that the slowdown in private consumption in the second quarter may have been temporary. Private consumption grew by 0.8% in July and by 0.2% in August, so that the average level in those months was 1.2% higher than the average level in the second quarter. Consumer confidence remains higher than at any time since the late 1960s, partly reflecting the continued growth of employment and the associated low levels of unemployment. Non-farm payrolls, the key employment indicator in the United States, increased by an

(1) Up to 24 October 1997.
(2) UK trade-weighted. M6 comprises the G7 countries minus the United Kingdom, ie the United States, Japan, Germany, France, Italy and Canada.

Chart 1
US National Association of Purchasing Managers' Survey and industrial production growth

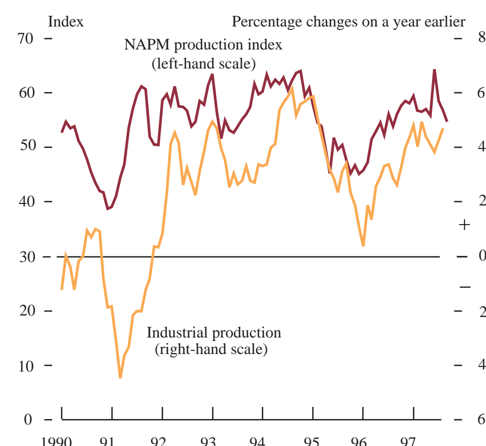


Chart 2
Japanese GDP growth

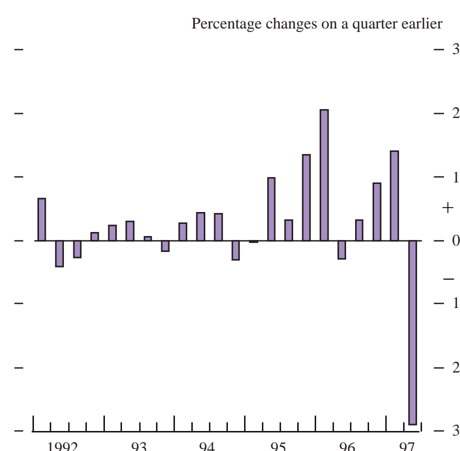


Table B
Contributions to Japanese GDP growth(a)(b)

Percentage points

	1996		1997	
	Q3	Q4	Q1	Q2
Private consumption	-0.1	0.7	2.6	-3.5
Government consumption	0.1	0.1	0.0	-0.1
Investment	-0.2	-0.7	-1.1	0.3
Stockbuilding	0.0	-0.1	-0.1	0.2
Domestic demand	**0.1**	**0.5**	**1.4**	**-4.0**
Net trade	**0.2**	**0.4**	**0.0**	**1.0**
GDP	**0.3**	**0.9**	**1.4**	**-2.9**

(a) The table shows the increase in each demand component expressed as a percentage of GDP.
(b) Contributions may not sum because of rounding.

average of more than 210,000 per month in the third quarter, compared with the 25-year average monthly increase of slightly more than 160,000. This was the eighth consecutive quarter of above-trend employment growth, but employment growth slowed towards the end of the third quarter, especially when the upward bias produced by the end of the United Postal Service strike was taken into account (people on strike are treated in the statistics as being out of work). The unemployment rate was 4.9% of the labour force in September, below most estimates of its natural rate, which are typically close to 5.5%.

Industrial production in the United States also remained strong—it was 4.7% higher in August than a year before. And survey evidence points to continued buoyant output. The Federal Reserve's Beige Book for August suggested widespread increases in demand for non-defence goods, and the National Association of Purchasing Managers' index of business confidence was 54.2 in September (see Chart 1). A reading of more than 50 indicates expected business expansion.

By contrast with the United States, the Japanese recovery has been weak and erratic (see Chart 2 and Table B). The average quarterly GDP growth rate since the trough in 1993 Q3 has been 0.3%, compared with 0.7% in the United States. And the standard deviation of quarterly GDP growth since 1990 in Japan is nearly double that in the United States, though that could be partly because of seasonal adjustment problems. GDP fell by 2.9% in the second quarter, following 1.4% growth in the first quarter and 3.6% growth in 1996, the strongest of any G7 country. Spending patterns were distorted by the increase in the consumption tax from 3% to 5% in April 1997, giving consumers an incentive to bring forward their purchases. Private consumption fell by 5.7% in the second quarter.

This distortion to spending, plus possible seasonal adjustment difficulties,[1] make it difficult to assess the Japanese economic position. But the underlying picture appears to be that growth has slowed, though perhaps not by as much as the GDP data might suggest. The Bank of Japan's quarterly Tankan Survey, released in early October, suggested that the retail and construction sectors remained very weak. Other aspects of the survey were more optimistic: spare production capacity and employment indices were broadly stable, and investment intentions were revised upwards. As with some of the EU economies (see below), net export growth has been very important to the Japanese recovery during the past two years, and a major issue therefore is whether the recent currency crisis in South East Asia represents a real or nominal shock. A real shock—for instance if trend growth in South East Asia has fallen—would be more serious for the Japanese economy because of its implications for Japanese trade. A nominal shock would have less serious implications.

Output growth in the large continental European economies has been picking up, led primarily by net exports. Developments in Germany and France have continued to be broadly similar. In both countries, GDP grew by 1% in the second quarter. Italian growth is recovering, but remains significantly weaker than elsewhere in Europe.

(1) The Economic Planning Agency change their seasonal adjustment of Japanese GDP statistics on the release of Q3 data. Historically, the changes in back data have been significant. The changes made in December 1996 resulted in an average absolute change to estimated quarterly growth of 0.5 percentage points, compared with average quarterly growth of 0.7%, in the seven quarters to the second quarter of 1996.

Table C
Contributions to German GDP growth[(a)(b)]

Percentage points

	1996		1997	
	Q3	Q4	Q1	Q2
Private consumption	0.1	-0.3	0.1	0.7
Government consumption	0.2	-0.4	0.2	0.1
Investment	0.1	0.0	-0.5	0.1
Stockbuilding	-0.7	1.0	0.4	-0.8
Domestic demand	**-0.1**	**0.4**	**0.2**	**0.1**
Net trade	**0.6**	**-0.2**	**0.1**	**0.9**
GDP	**0.5**	**0.2**	**0.3**	**1.0**

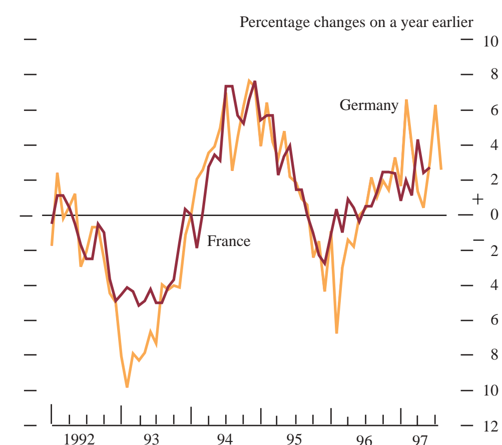
(a) The table shows the increase in each demand component expressed as a percentage of GDP.
(b) Contributions may not sum because of rounding.

Table D
Contributions to French GDP growth[(a)(b)]

	1996		1997	
	Q3	Q4	Q1	Q2
Private consumption	0.5	-0.3	0.1	0.0
Investment	0.3	0.0	-0.2	0.0
Government consumption	0.1	0.1	0.1	0.1
Stocks	-0.3	0.3	-0.4	0.4
Domestic demand	**0.6**	**0.1**	**-0.4**	**0.4**
Net trade	**0.2**	**0.2**	**0.6**	**0.6**
GDP	**0.8**	**0.2**	**0.3**	**1.0**

(a) The table shows the increase in each demand component expressed as a percentage of GDP.
(b) Contributions may not sum because of rounding.

Chart 3
French and German industrial production growth



The two sectors that contributed most to German GDP growth were net exports and private consumption, as Table C shows. But the strength in second-quarter growth in consumption is misleading: though it grew by 1.3% in the second quarter, consumption was only 1.4% higher than in the second quarter of 1996. Net exports were strengthened by the Deutsche Mark depreciation and by strong growth in several key export markets, most notably the United States. But investment remained weaker than is normal at this stage of a German recovery. Construction investment has been weak so far in 1997, following the end of the post-reunification boom and associated subsidies. Growth in machinery and equipment investment, which had been strong during the winter quarters, slowed to 0.3% in the second quarter. Given that German companies' profitability is high, share prices had risen by 42% from the beginning of 1997 to 24 October, and capacity utilisation is relatively high and rising, investment in plant and machinery might be expected to accelerate, so the weakness in the second quarter may prove to be temporary.

Unlike in the United States, the United Kingdom and Germany, French GDP data are not adjusted for the number of working days in each quarter. There were fewer in the first quarter, implying that growth of 0.2% on the previous quarter probably understated the underlying strength of the economy, and growth of 1% in the second quarter probably overstated it. As in Germany, net exports have been strong, helped by the depreciation of the franc (see Table D). The strength of net exports in both countries has been characterised by a combination of above-trend growth in both imports and exports. The average annual growth rate of French imports since 1970 measured on the national accounts basis is 4.6%, compared with growth in the year to 1997 Q2 of 7.4%. The corresponding figures for Germany are 4.2% and 6.4% respectively.

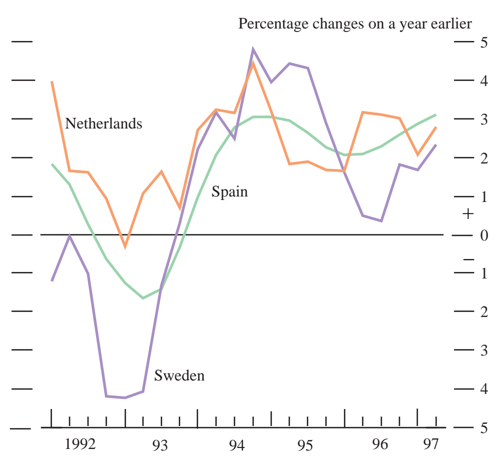
French imports are strong despite the weakness of private demand. French consumers' expenditure has been even weaker than in Germany: it only grew by 0.6% in the year to the second quarter. The primary reason for the weakness in both countries is the mirror image of the case in the United States: the employment situation. In France, the unemployment rate has not risen in the last year, as it has in Germany, but it remains very high (12.5% in August). The German unemployment rate reached 11.7% in September. Wage growth in both countries has been muted because of the high levels of unemployment, which have held back growth in disposable income: for example, the Information und Forschung (IFO) Institute estimate that the average net real wage in Germany will be 1% lower in 1997 than in 1996. In France an additional distortion is caused by the car incentive scheme that ended in September 1996. Because car purchases are a major investment for consumers, car sales may still have been affected this year by the ending of the scheme—they have remained well below the levels seen in 1995 and 1996. But INSEE, the French statistical office, expects car sales to return to more usual levels in the third quarter.

Monthly data released during the last quarter suggest that third-quarter growth in both Germany and France will be strong. German industrial production in July and August averaged 2.8% more than in the second quarter (see Chart 3). Business confidence is high, and external trade data are consistent with continued growth in net exports for both countries.

The situation in Italy is somewhat different from in Germany and France. GDP data, as in France, may be distorted by the absence of working-day adjustment, and by a car incentive scheme that started at the beginning of 1997. So though GDP grew by 1.6% in the second quarter, the underlying growth was much weaker—probably close to its quarterly trend rate of around 0.5%. In sharp contrast with Germany and France, net exports fell by the equivalent of 0.3% of GDP. This was largely because the depreciation of the Deutsche Mark and franc has not been matched by the lira: in the two years to August, the Deutsche Mark effective exchange rate depreciated by more than 8%, but the lira appreciated by more than 7%. In addition, underlying domestic demand in Italy is no stronger than in Germany and France.

Output elsewhere in Europe also strengthened in the second quarter (see Chart 4). The Spanish economy continued its strong growth, growing by 0.9% in the second quarter, the highest quarterly growth rate for two years, bringing annual GDP growth close to 3%. GDP in the Netherlands grew by 2.1% in the second quarter. This overstates the underlying rate of growth—the economy contracted in the first quarter—but with GDP 2.8% higher than a year before, activity continues to grow faster than trend. By contrast with Germany and France, growth in the other European economies is more broadly based, with strong domestic demand.

Chart 4
GDP growth in the Netherlands, Spain and Sweden

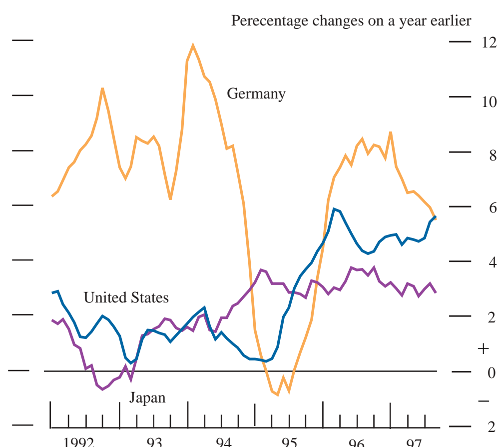


The OECD area as a whole is expected (by both the IMF and the OECD) to be a net exporter of goods and services in the next couple of years. In particular, Japan, Germany, France and Italy are expected to rely on net trade for GDP growth. This means that developing countries, notably in Asia and Eastern Europe, will need continued capital inflows to finance the resultant current account deficits. A key issue is the degree to which the currency crisis in Asia will hinder the cyclical recovery in the industrialised world. This could happen in several ways: lower demand for M6 exports; contagion for other developing economies, involving lower private capital flows; lower equity prices throughout the world; and moral hazard resulting from international 'bail-outs'. But calculations by the OECD suggest that the effects are likely to be limited. They estimated that if Asian growth was 1 percentage point lower in each of 1997 and 1998 than their baseline forecast, the cumulative effect would be to reduce GDP in Japan by 0.4%, and GDP in the European Union and the United States by 0.2%. The latest IMF forecast suggests that the effect of the currency crisis will be somewhat less than that.

Narrow money growth has continued to increase, but broad money growth has remained roughly constant in the last three months.

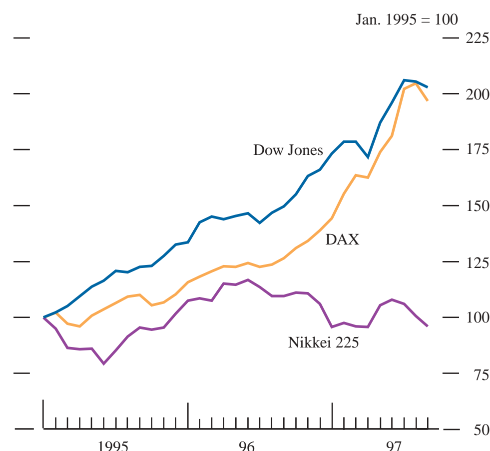
The GDP-weighted average of narrow money growth in the major six economies picked up slightly, to an annual rate of 3.3% in July. In real terms, average narrow money only grew at an annual rate of 0.6% in June (compared with 3.2% in March 1996). But the relative weakness in narrow money in the M6 was largely due to the decline in US M1 in the past two years, though its annual rate of decrease fell from 4.5% in March to 2.8% in August. Narrow money growth has increased in all M6 countries except Japan and the United States since the end of 1997 Q1. German M1 rose by 9.8% in July, mainly because of a strong increase in money held in current accounts.

Chart 5
Broad money(a) growth



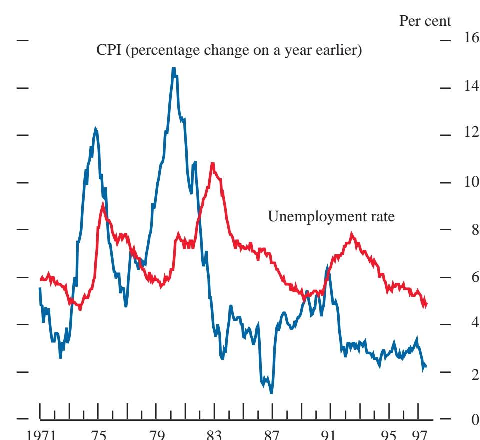
(a) M3 for Germany, M2 for the United States and M2 + CDs for Japan.

Chart 6
Equity prices(a)



(a) Measured in local currency.

Chart 7
US unemployment and CPI



Since 1996, the GDP-weighted averages of (nominal) broad money and nominal GDP in the M6 economies have been growing at similar rates of around 4% a year. Broad money growth in these countries reached a peak of 4.4% in July, the highest since 1992 Q1. US M2 picked up to an annual growth rate of 5.4% in August, exceeding its range (of 1%–5%) for the first time this year (see Chart 5). German M3 has weakened gradually this year and rose at an annual rate of 5.8% in August (relative to its average level in 1996 Q4—the base used by the Bundesbank for its M3 target). M3 growth has been within its target range of 3.5%–6.5% since June. Growth in Japanese broad money has been around 3% this year, and rose to 3.2% in August. Italian broad money has been increasing more quickly since March 1996, and increased by 11% in July. French broad money has been contracting for about a year now, but rose by 0.3% in the month to the end of July.

Equity prices increased strongly in most of the large industrialised countries in July, but fell somewhat thereafter. Nevertheless, they were considerably higher on 24 October than at the beginning of 1997. But Japanese equity prices have continued to fall.

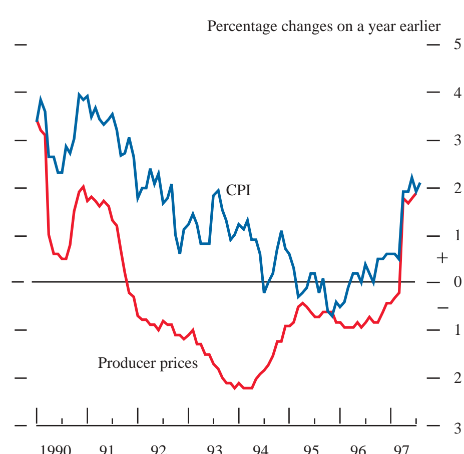
US equity prices rose sharply in July, following strong growth in May and June, but fell slightly in both August and September, and more sharply in October. On 24 October, the Dow Jones index was nearly 5% lower than three months previously, but still nearly 20% higher than at the start of 1997 (see Chart 6). Price:earnings ratios in the United States remain high, at around 23 compared with a 40-year average of 15, suggesting strong expected future profitability growth. A further reason, mentioned by Alan Greenspan, the Chairman of the Federal Reserve Board, in his testimony to the House of Representatives, might be that the amount of risk firms face has lessened, so that the risk premium in equity yields has fallen. German equity prices rose very quickly (the DAX index increased by more than 11%) in July, but have since fallen slightly. The position was very similar in France: the CAC 40 share index increased by more than 7% in July, but fell slightly thereafter. In contrast with the other G7 equity markets, Japanese equities continued to fall—by nearly 10% in July and August. Yen weakness boosted the share price of export-oriented industries. But continued weakness in financial sector companies, reflecting prolonged uncertainties about financial fragility, kept the Nikkei 225 depressed.

Despite the continued strengthening of activity, inflation remains low throughout the M6 and the European Union. Though EU inflation as a whole has picked up slightly, convergence of EU consumer price inflation has largely been achieved, at least temporarily.

Despite low unemployment, inflation has remained low in the United States, and, whether measured by the GDP deflator or consumer prices, was only 2.2% on the latest reading (see Chart 7). In the year to the second quarter, the employment costs index and unit labour costs, measured on the national accounts basis, both increased by less than 3%; the quarterly growth of unit labour costs was the lowest for three years. Prices throughout the supply chain have also remained subdued. Producer price inflation was zero in the year to September, with prices falling in the first seven months of 1997.

Some of the reasons for the small price rises seen recently may be temporary. Following their sharp rise in 1996, dollar oil prices fell quickly in the first quarter of 1997, placing downward pressure on producer prices. But oil prices rose in August and September. The dollar effective exchange rate appreciated by more than 10% in the year to August, lowering imported goods prices relative to what they would otherwise have been. But since the end of August, the dollar has depreciated slightly. Reforms of the US health care system allowed companies to limit increases in the benefit payments part of employment costs—benefits have grown by less than wages in the past two years, which is unusual (in the last ten years, annual benefits payment inflation has exceeded wages inflation on average by more than 1 percentage point). And computer prices fell by 22% in 1996, driven by sharp falls in semi-conductor prices. Given the strength of investment in information technology in the United States in the last two years, this has reduced the investment deflator and so the GDP deflator.

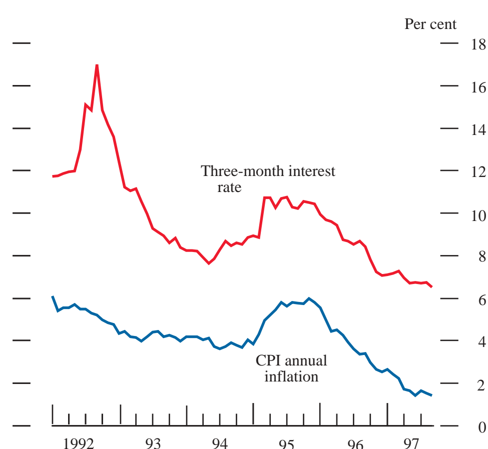
Chart 8
Japanese CPI and producer prices



Adjusting for the consumption tax rise in April, Japanese inflation remains negligible. Consumer and producer price inflation have remained close to 2% (see Chart 8), even though the consumption tax meant a step change in prices (other things being equal) of 1.9%. This reflects subdued domestic demand, which has constrained the degree to which producers and retailers are able to pass on the tax rises. Following the fall in retail sales and inventory build-up after April, margins have narrowed. Indeed, allowing for possible upward bias in the measurement of the CPI, it seems likely that the true cost of living is still falling.

In Germany, annual consumer price inflation increased to 2.1% in August from 1.6% in May, but fell back to 1.9% in September. Producer price inflation rose to 1.5% in August from 1.1% in May. But the size of these increases may be misleading. An important contributory factor was the depreciation of the Deutsche Mark, which led to annual import price inflation rising to 5.4% in August, its highest since 1989, from 2.8% in May. Administered prices were also influential, rising by 4.3% in the year to August. Excluding these, the inflation rate in August was 1.5%. The whole-economy inflation rate, as measured by the GDP deflator, was only 0.8% in the year to the second quarter.

Chart 9
Italian CPI inflation and three-month interest rates



Consumer price inflation has consistently been lower in France than in Germany since the beginning of 1997, and producer price inflation has been lower since the beginning of 1996, though this is partly because of differences in the national definitions of the producer prices series—the French series is intermediate goods prices, whereas the German series refers to output prices. As in Germany, consumer and producer price inflation have both increased in the last quarter, though the August consumer price inflation rate of 1.5% may be overstated because the pattern of discounting in the summer sales in 1997 was different from that in 1996. With annual producer price inflation at 0.3% and underlying consumer price inflation close to 1%, measured inflation remains extremely low in France.

In Italy, annual CPI inflation was only 1.4% in the year to September, maintaining the historically low rates of inflation seen in the summer (see Chart 9). Italian inflation has been restrained by a combination of tight monetary policy—real interest rates have

Table E
Harmonised index of consumer prices

Percentage changes on a year earlier

	1997 Feb.	May	Aug.
Austria	1.4	1.2	1.3
Belgium	2.0	1.3	1.7
Denmark	2.0	1.5	2.4
Finland	1.7	1.1	1.6
Germany	1.5	1.3	1.7
Greece	6.5	5.9	5.6
Ireland	1.7	1.3	0.6
Italy	2.3	2.2	1.6
Luxembourg	1.5	1.3	1.4
Netherlands	1.6	1.3	2.5
Portugal	2.4	2.3	1.6
Spain	2.5	2.2	1.7
Sweden	1.1	1.0	2.2
United Kingdom	2.0	1.8	2.0

Table F
Forecast of 1997 fiscal deficits(a)(b)

	EC	OECD	IMF
Austria	-3.0	-3.0	-2.5
Belgium	-2.7	-2.8	-2.8
Denmark	0.3	0.0	0.5
Finland	-1.9	-2.0	-1.9
France	-3.0	-3.2	-3.2
Germany	-3.0	-3.2	-3.1
Greece	-4.9	-5.2	-4.7
Ireland	-1.0	-1.2	-1.6
Italy	-3.2	-3.2	-3.1
Luxembourg	1.1	n.a.	-0.1
Netherlands	-2.3	-2.3	-2.1
Portugal	-3.0	-2.9	-2.9
Spain	-3.0	-3.0	-3.0
Sweden	-2.6	-2.1	-0.8
United Kingdom	-2.9	-2.8	-2.1

n.a. = not available.

(a) Percentage of GDP.
(b) General government (Maastricht definition).

remained well above those in Germany and France—and the associated strength of the lira. In all three countries, the weakness of domestic demand has meant that it has been difficult for retailers to pass on higher costs. And falling commodity prices in the last two years have limited inflation.

Inflation across the European Union is low and at similar rates. According to the harmonised price data for July, all countries other than Greece were within 1.5 percentage points of the countries with the three lowest inflation rates, whether using the mean, the highest or the lowest rate of the three countries (see Table E). The standard deviation of these 14 countries' inflation rates was only 0.4%. But in common with developments in the larger countries, EU-wide inflation increased in the three months to July. The average inflation rate (excluding Greece) increased to 1.6% from 1.3%.

The prospects for meeting the Maastricht fiscal deficit convergence criterion have improved, but most countries are still expected to fail to meet the debt criterion.

The German statistical office revised down their estimate of the German fiscal deficit for 1996 from 3.8% to 3.5%. The reasons for the change include the assimilation of new data, but also the adoption of the new European national accounting scheme (ESA 95). The biggest difference this makes to the German public sector deficit is that it classifies public sector hospitals as belonging to the corporate sector. This reduced the estimated German fiscal deficit by an average of nearly 0.2 percentage points in the three years to 1996. The deficit in the first half of 1997 was estimated to be DM 79.2 billion, DM 1.6 billion less than in 1996 (both numbers are calculated using the old scheme, and are therefore possibly overstated). The fall was due to an improvement in the social security account: the federal and Länder deficits increased, and the local authority deficit narrowed only very slightly. The German authorities agreed to reduce the solidarity surcharge—a tax intended to provide funds to assist the assimilation of eastern Germany—by 2 percentage points to 5.5% in January 1998. But they were unable to agree on more wide-ranging tax reforms. Discussion on these has been postponed for at least a year.

The French authorities announced both a supplementary budget for 1997 and their budget for 1998. The most important features were a 5 percentage point increase in the corporation tax rate to 41.6%, a reduction of the payroll tax (the RDS) by 4.75 percentage points and an increase in the CSG (a broad-based income tax that goes to the social security account) of 4.1 percentage points. With high corporate profits in France at present, and the CSG considered to have a higher marginal revenue rate than the RDS, both of these measures are likely to increase revenues.

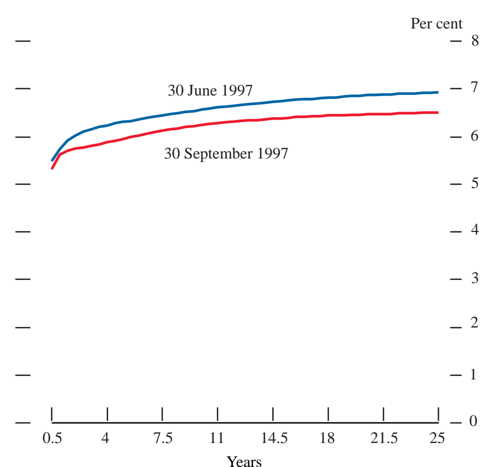
The prospect of EU countries meeting the fiscal reference values set out in the Maastricht criteria has improved. According to the latest IMF forecasts, eleven out of the fifteen countries will meet the 3% target for the fiscal deficit as a proportion of GDP, and three out of the other four are forecast to have deficits of 3.2% or less (see Table F). Since the previous *World Economic Outlook (WEO)*, nine countries' deficit forecasts have been revised down, and only one has been revised up (Sweden, which is still expected to meet the criterion comfortably). The EU autumn forecast was

even more upbeat, with only France and Greece missing the deficit criterion, France by just 0.1 percentage point.

The debt levels remain problematic. The IMF forecast that only four countries will have debt/GDP ratios of 60% or less, and since the previous *WEO* they have revised up their forecasts of the debt/GDP ratio for nine EU countries. The position is expected to improve in 1998. The IMF expect 13 EU countries to lessen their debt/GDP ratio, with only the ratios of Germany and Portugal forecast to increase. But in 1998, only France, Luxembourg and the United Kingdom are forecast to have a debt/GDP ratio under 60%. For Italy, Belgium and Greece, debt is expected to remain more than 100% of GDP.

Most industrialised countries' official interest rates remained stable, though the rise in Germany's repo rate in October led to similar moves elsewhere in Europe.

Chart 10
US yield curves



US official interest rates were left unchanged by the Federal Open Markets Committee during the past quarter, as the lack of clear indications of increasing inflationary pressures continued despite the strength of activity data. The long end of the US yield curve fell during the past three months but short-run rates were little changed, as Chart 10 shows, suggesting that concerns about rising inflationary pressure are limited. Japanese official interest rates also remained unchanged, at 0.5%. But, reflecting increasing pessimism about economic conditions and diminishing expectations of a near-term rise in short-term interest rates, the benchmark bond yield fell to 1.7%, the lowest in history for an industrialised country.

Following 14 months of stable short-term official rates, the Bundesbank increased its repo rate by 30 basis points to 3.3% on 9 October. The move was immediately followed by several other European countries, most notably France, where the Banque de France raised the intervention rate by 20 basis points, bringing it into line with the German repo rate. The Bundesbank stated that the move was to stem increasing inflationary pressures, as evidenced by rising consumer, producer and import price inflation. Before the move, German money-market rates rose in anticipation of the Bundesbank's rate rise. Between the end of June and the beginning of October, three-month Deutsche Mark euromarket rates increased by 30 basis points. By contrast, French short-term euromarket rates had only increased very slightly.

Italian official interest rates were unchanged during the quarter, but short-term market rates fell by roughly 30 basis points. At close to 6.5%, Italian short-term nominal interest rates are at historically low levels. But this is largely a function of the lower inflation rate in Italy. Real interest rates, as measured by the nominal interest rate minus the current level of CPI inflation, were slightly above 5% in September, compared with an average of 4.3% since 1977. A better measure of real interest rates uses forward-looking inflation expectations. Inflation expectations for the next three months are lower than in June—the market consensus (as measured by the poll published in the September issue of *Consensus Forecasts*) for quarter-on-quarter consumer price inflation in the fourth quarter was roughly 0.8%, compared with quarterly inflation of 0.2% in the third quarter. The fall in short-term nominal rates in Italy therefore understates the fall in real rates.

Spanish interest rates have continued to fall. The Spanish ten-day repo rate was lowered to 5% in early October, from 6.25% at the beginning of the year. Spanish activity is at least as strong as that of most of the northern European countries; these moves have reflected the relative strength of the peseta (though it has depreciated in real terms this year, it has appreciated by more than 1.5% against the Ecu), the rapid fall of Spanish consumer price inflation and fiscal tightening. The situation in Portugal has been similar. Dutch, Belgian and Austrian interest rates typically follow German rates closely; this has continued to be the case during the past three months.