The international environment

This article discusses developments in the international environment since the February 1998 Quarterly Bulletin. *The main news*[1] *is:*

- *The financial and economic situation in Asia now appears more stable.*[2] *Signs of contagion in other emerging markets have diminished.*
- *Growth in the United States slowed slightly in the final quarter of 1997.*
- *The Japanese economy has continued to slow, and Japanese output fell slightly.*
- *The recovery in Germany and France has continued, though growth slowed in Germany. Domestic demand continued to strengthen in France, but not in Germany.*
- *Equity prices in most major markets have continued to rise. After strengthening in January 1998, Japanese equity prices remained in a narrow range during February and March, but fell slightly in early April.*
- *Inflation has remained low throughout the major six (M6)*[3] *overseas economies.*
- *EU countries have released their fiscal debt and deficit figures for 1997. Based on these, the European Commission and European Monetary Institute recommended that eleven countries were eligible for membership of monetary union. The European Council decided to admit these countries to monetary union from 1 January 1999.*
- *Official interest rates have remained unchanged in most industrial countries. Bond yields remained at low levels.*

GDP in the M6 grew by 0.5% in the final quarter of 1997, down from 0.8% in Q3. US growth slowed, but remained strong. Activity in Japan continued to slow, and GDP fell slightly in Q4. In the European M6 countries, the pace of growth in Q4 was generally slower than in Q3.

US GDP grew by 0.9% in the fourth quarter of 1997 (see Table A), and was 3.7% higher than a year earlier. Growth was largely accounted for by private consumption and stockbuilding, with small contributions from net exports and investment. This contrasts with the earlier quarters of 1997, when investment made larger contributions and net exports made negative contributions to growth.

Table A
Quarterly contributions to US GDP growth[(a)]

Percentage points

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

(a) Contributions may not sum because of rounding.

The positive contribution of net exports in Q4 occurred despite the continuing strength of the dollar and of domestic demand in the United States relative to its main trading partners. But there are more recent signs that these factors may have begun to increase the

(1) Based on data up to 29 April 1998.
(2) Developments in Asia are discussed separately in the note on pages 133–35.
(3) The M6 comprises the G7 countries minus the United Kingdom, ie the United States, Japan, Germany, France, Italy and Canada.

Chart 1
US retail sales and industrial production

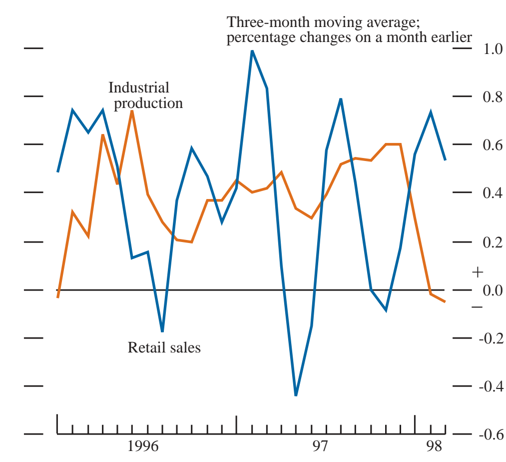


Chart 2
US non-farm payrolls and hourly earnings

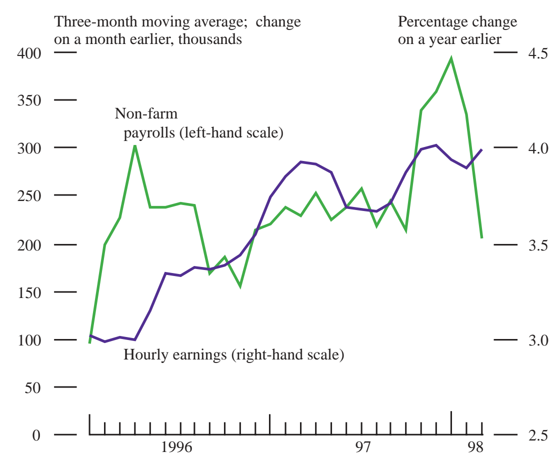


Table B
Quarterly contributions to Japanese GDP growth(a)

Percentage points

	1997 Q1	Q2	Q3	Q4
Domestic demand	**1.9**	**-3.8**	**0.9**	**-0.8**
Private consumption	2.3	-3.2	1.0	-0.5
Investment	-0.4	-0.8	-0.4	-0.2
Government consumption	-0.1	-0.1	0.1	0.1
Stockbuilding	0.0	0.3	0.0	-0.1
Net exports	**0.1**	**1.0**	**-0.1**	**0.6**
GDP	**2.0**	**-2.8**	**0.8**	**-0.2**

(a) Contributions may not sum because of rounding.

size of the trade deficit, which rose in January and February in contrast with its usual seasonal pattern. In February, it increased to $12.1 billion (from $11.6 billion in January) as a result of a sharp drop in exports, particularly to non-G7 countries. Though the bilateral trade figures are volatile and are not seasonally adjusted, figures for early 1998 show widening deficits with many Asian countries, compared with a year ago.

Retail sales rose by 1.8% in 1998 Q1, compared with average quarterly growth rates of 0.9% in 1997 and 1.2% in 1996. This suggests that consumption growth remained strong during the early months of 1998 (see Chart 1). Surveys indicate that consumer confidence also remained high during 1998 Q1.

Industrial production slowed. In the first quarter of 1998, it grew by only 0.2%, compared with 1.8% in the previous quarter. And in 1998 Q1, manufacturing output fell by 0.4%. But the production component of the National Association of Purchasing Managers (NAPM) index continues to suggest that manufacturing is expanding significantly, though at a slower rate than in 1997.

The US labour market continued to tighten in the early months of 1998; non-farm payrolls, the main employment measure, increased by a monthly average of 335,000 in the three months to February, compared with a monthly average of 267,000 in 1997, and 212,000 in 1996. But payrolls fell by 36,000 in March, the first monthly fall since January 1996 (see Chart 2). The US unemployment rate remained stable in 1998 Q1, at just under 4.7%, its lowest quarterly average since 1970 Q1. Rapid employment growth pushed up annual hourly earnings growth to 4% in 1998 Q1, from a monthly annual average of 3.8% in 1997 and 3.3% in 1996. The upward trend in labour costs is also seen in the Employment Cost Index, which provides a more comprehensive measure of labour costs. This rose by 0.9% in 1997 Q4, compared with 0.8% in the previous quarter, and was 3.4% higher than a year ago. The annual growth rate in employment costs in 1997 Q4 was the highest since 1993 Q4.

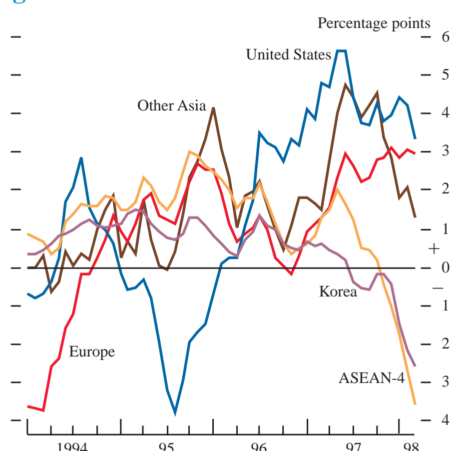
Recent developments in US consumer prices are discussed separately in the box on pages 128–29.

By contrast with the United States, the Japanese economy continued to slow. GDP fell by 0.2% in Q4, following growth of 0.8% in the third quarter, so that GDP was 0.2% lower than a year earlier. The fall was mainly accounted for by a reduction in private consumption, partly offset by a positive contribution from net trade (see Table B).

Private consumption declined by 0.9% during Q4, as real disposable incomes and consumer confidence fell. Reductions in overtime payments reflecting production cuts were the main reason for the fall in incomes. Non-residential investment slowed. Residential investment has continued to decline, as land prices have fallen further.

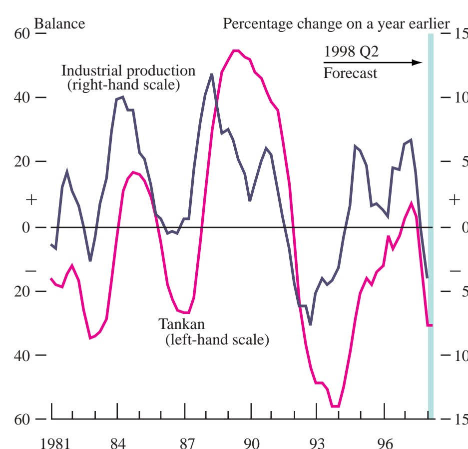
Imports on the customs-cleared basis in 1998 Q1 were 9.3% lower than a year earlier, following annual growth of 0.8% in 1997 Q4. This suggests that domestic demand remained weak in the first quarter of 1998. But the annual rate for 1998 Q1 may be biased downwards: imports were unusually strong in 1997 Q1, ahead of the consumption tax increase last April.

Chart 3
Japan: contributions to annual export growth(a)



(a) Current yen (not seasonally adjusted) three-month moving average.

Chart 4
Japan: Tankan(a) Survey and industrial production



(a) Major manufacturers' view of business conditions.

Table C
Quarterly contributions to German GDP growth(a)

Percentage points

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

(a) Contributions may not sum because of rounding.

The annual rate of export growth slowed further in 1998 Q1, to 3.9%, from 12.1% the previous quarter. And the signs of an effect from the Asian crisis became more clear: monthly average exports to the ASEAN-4[1] dropped to ¥350 billion, from ¥488 billion in 1997, though seasonal factors may account for part of this decline (see Chart 3).

The average level of industrial production in 1998 Q1 was 0.4% lower than in 1997 Q4, and 4% lower than in 1997 Q1 (see Chart 4). The Bank of Japan's March Tankan Survey indicated that business sentiment deteriorated in 1998 Q1, and that producers increasingly view their stock levels as excessive. This suggests that output in 1998 Q1 is likely to have fallen compared with 1997 Q4.

The impact of the fiscal package announced in March is difficult to assess. The proportion of new spending in the ¥16 trillion headline figure is unclear, as is the type of spending. The sharp falls in consumer confidence and the average propensity to consume, following several financial sector failures at the end of 1997, may also reduce the effectiveness of fiscal loosening.

Growth in the major continental European countries slowed slightly in Q4 compared with Q3. Slower growth in Germany reflected weakness in domestic demand. Quarterly growth also slowed in Italy, but this mainly reflected working-day effects. In France, Spain and the Netherlands, the pace of growth in Q4 was similar to that in Q3.

German GDP grew by 0.3% in the fourth quarter of 1997, and was 2.3% higher than a year earlier. Growth in Q4 was slower than that in the previous two quarters (see Table C). Private consumption made a small contribution, but remained weak: it was only 0.6% higher than a year earlier, and it remains below its 1996 Q3 peak. This weakness reflects slow growth in disposable income, and high and increasing unemployment during the quarter. Stockbuilding was the major contributor to domestic demand and accounted for two thirds of GDP growth in the year to 1997 Q4; how much of this was voluntary is unclear. As in Q3, government consumption fell significantly, possibly reflecting fiscal adjustments necessary to meet the Maastricht deficit criterion.

Net exports fell in Q4, after two quarters of strong growth, though their level remained high. The decline in net exports occurred because imports were 2.7% higher in Q4 than in Q3, while quarterly growth in exports fell to 1.3%, the lowest quarterly growth rate since 1996 Q2.

Data for the early months of 1998 suggest that the economy is recovering from its slowdown in the fourth quarter of 1997. Industrial production and orders (particularly of capital goods) were strong, pointing to increasing investment, and industrial confidence remained high (see Chart 5). Unemployment, one of the main factors thought to have been suppressing consumer spending, fell from 11.8% in December to 11.5% in March, though some of this fall may be the result of unseasonally warm weather. Consumer confidence improved in the final quarter of 1997, and strengthened sharply early in 1998, though it remains below the peak levels seen in 1990, when confidence was buoyed by prospects of

(1) Thailand, Indonesia, Malaysia, and the Philippines.

Chart 5
Industrial production

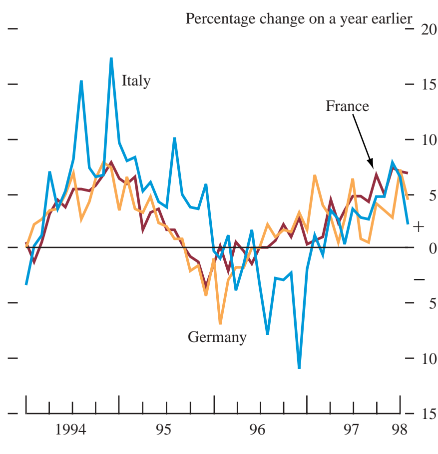


Chart 6
Retail sales

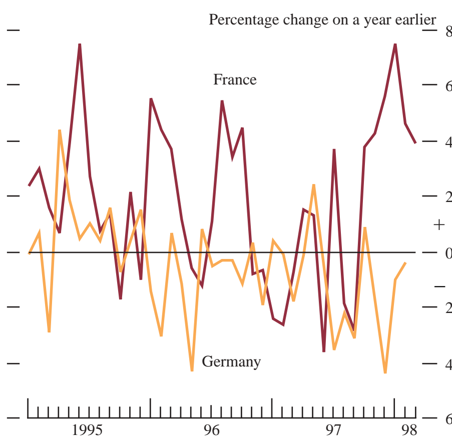


Table D
Quarterly contributions to French GDP growth(a)

Percentage points

	1997 Q1	Q2	Q3	Q4
Domestic demand	**-0.3**	**0.5**	**0.8**	**0.5**
Private consumption	0.2	0.1	0.7	0.6
Investment	-0.3	0.2	0.2	0.0
Government consumption	0.0	0.0	0.0	0.0
Stockbuilding	-0.2	0.2	-0.1	-0.1
Net exports	**0.5**	**0.6**	**0.0**	**0.3**
GDP	**0.3**	**1.1**	**0.9**	**0.8**

(a) Contributions may not sum because of rounding.

reunification. But despite these improvements, retail sales and confidence among retailers remain weak (see Chart 6).

French GDP increased by 0.8% in Q4 to a level 3.2% higher than a year earlier, slowing slightly compared with previous quarters (see Table D). Private consumption contributed significantly to growth, as employment and wage growth strengthened and consumer confidence improved. Investment fell slightly: growth in corporate investment slowed, and the level of household and public investment fell. However, the figures seem inconsistent with other Q4 investment data, such as capital goods imports, wholesale sales and production, and housing starts, all of which suggested continuing strength in investment during the quarter.

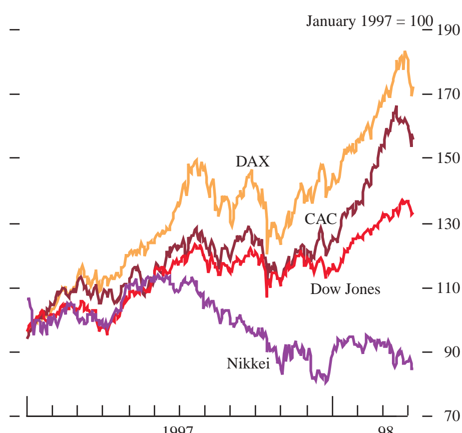
Net exports increased in Q4 from the previous quarter, and though their contribution was smaller than in the first half of the year, they accounted for just over half of growth during 1997 as a whole. The transport strike in November was one probable reason for the decline in net exports. But it appears that the lagged effects of the depreciation of the franc on export growth have also begun to wear off. The customs trade figures also appear to show an 'Asian effect': the French trade position with Asia shifted from a substantial surplus during 1997 Q3 into deficit in Q4, as a result of a fall in exports. The figures for January showed further growth of the bilateral deficit with Asia. But these shifts could be partly due to the lack of seasonal adjustment.

French business confidence remains strong, and according to the January investment survey, industrialists now plan to invest 10% more in nominal terms during 1998 than in 1997. In the previous survey, the planned increase in investment was only 3%. Fiscal incentives designed to encourage construction of apartments for rental should also encourage residential investment during 1998. Consumer confidence remains close to its peak of the late 1980s. Employment grew by 0.5% in the fourth quarter of 1997, and was 1.2% higher than a year earlier. Retail sales grew strongly in the early months of 1998 (see Chart 6).

GDP in Italy grew by 0.2% in 1997 Q4. This followed quarterly growth rates of 0.6% and 1.9% in Q3 and Q2 respectively, suggesting a slowdown. But this was because there were fewer working days in 1997 Q4 than in the earlier quarters of the year, and this is not taken into account in the GDP statistics. Annual growth has been increasing: between 1996 Q4 and 1997 Q4, which had the same number of working days, GDP grew by 2.8%, compared with annual growth rates of 1.9% and 2.2% in 1997 Q2 and Q3 respectively. And industrial production growth increased in Q4, to 1.2%, from 0.5% in Q3. Growth in Q4 was broad-based, suggesting that the government's car-purchase incentive scheme continued to support consumption, and that the Asian slowdown had yet to affect net export growth significantly.

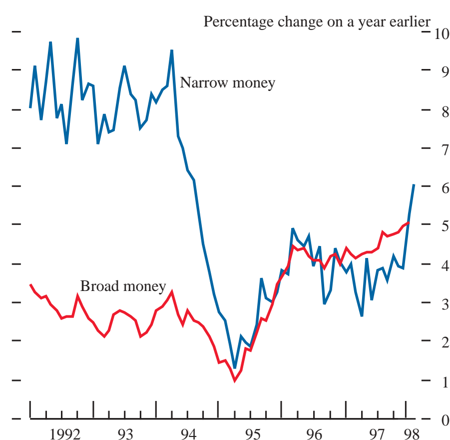
Output elsewhere in Europe grew strongly in 1997, picking up during the second half of the year. Spanish GDP was 3.4% higher in 1997 than in the preceding year, with quarterly growth stable in the 0.8%–0.9% range. GDP in the Netherlands grew by 3% in 1997, and the quarterly growth rate picked up to 1% in Q4. In Sweden, GDP grew by 1.8% in 1997, and was 3.3% higher in Q4 than a year earlier. Growth in these European economies has been broadly based, and domestic demand has been strong.

Chart 7
Equity markets(a)



(a) In local currencies.

Chart 8
Average narrow(a) and broad(b) money growth in the M6 economies



(a) M1.
(b) M4 for the United Kingdom.
M3 for France and Germany.
M2 and CDs for Japan.
M2+ for Canada.
M2 for the United States and Italy.

The buoyancy in most major equity markets last year continued in the opening months of 1998, with equity prices in most industrial countries reaching historic highs, though they have since fallen slightly. Japan was the exception; share prices there recovered only a little.

US equity prices increased sharply in the opening months of 1998, following a period of volatility during the latter part of 1997. At the end of April, equity prices in Germany and France were 19% and 24% respectively above their average levels in January (see Chart 7).

By contrast, Japanese equity prices recovered only moderately, and have remained within 15% of the lowest levels recorded during the 1990s. The fiscal package announced on 26 March contributed to a recovery of share prices, but these remained below ¥17,500, and fell when Moody's changed the outlook for Japanese government debt from 'stable' to 'negative' on 2 April, citing 'uncertainty about the ability of the authorities to achieve a policy consensus that would help promote a return to economic growth and fiscal balance'. Moody's announcement was also accompanied by a slight increase in long-term bond yields, though this has since unwound.

Narrow and broad money growth in the M6

The GDP-weighted average of annual growth in narrow and broad monetary aggregates in the major six economies rose modestly during 1997 (see Chart 8). In the final quarter, average broad money growth was 4.6%, compared with 4.5% in Q3, whereas average narrow money growth rose from an annual rate of 3.5% in Q3 to 3.8% in Q4. In real terms, average annual narrow money growth rose from 1.4% in September to 2.1% in November 1997. Real broad money growth in the M6 reached its highest level since March 1991 in November, when its annual rate reached 2.6%. In 1997, average inflation was below average real broad money growth in the M6. In the absence of velocity shifts, this suggests that nominal demand may rise slightly in the future.

Since the end of Q3, narrow money growth has risen in the United States and Japan, though annual US growth remained negative. Japanese M1 grew at an annual rate of 10.7% in February 1998, its highest rate since October 1996. This may reflect liquidity injections into the Japanese banking system by the Bank of Japan at the end of 1997. The record low deposit rates in Japan may also have encouraged increased narrow money holdings. Despite two 50 basis point rises in Canada's bank rate (in December 1997 and January 1998), M1 growth rose to 13.2% in February. By contrast, narrow money growth in Germany and Italy slowed in 1997 Q4.

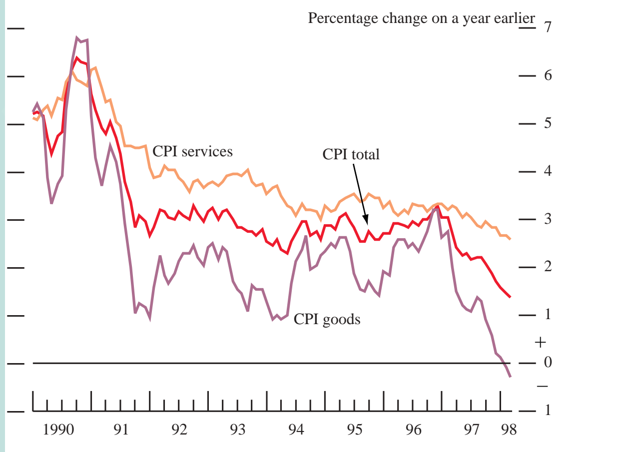
The United States and Japan also accounted for most of the increase in the growth rate of broad money in the M6. Broad money growth in Japan has picked up since October 1997, and rose by 4.8% in the year to February. US M2 growth has moved further away from the upper end of its range (of 1%–5%) since the end of Q3. In February, US M2 increased at an annual rate of 6.3%, the highest rate behind Italy within the M6. French broad money growth picked up strongly to 3.1% in January.

Broad money growth in Germany has fallen further since the previous *Quarterly Bulletin*. In February, M3 grew at an annualised rate of 2.8%, relative to its average level in 1997 Q4, which forms

US consumer prices

Consumer price inflation in the United States fell last year to an average of 2.3%, compared with 2.9% in 1996 (see Chart A). The easing of price pressures was particularly noticeable in the last quarter of the year, with the year-on-year inflation rate standing at just 1.7% in December 1997. This decline in the headline inflation rate was unexpected. In December 1996, the market consensus was that consumer price inflation in 1997 would remain at 2.9%; by June 1997, the consensus forecast had been revised downwards, but only to 2.7%. Any dissipation of inflationary pressures seemed unlikely at the time: the United States was in its seventh year of expansion, driven by particularly strong domestic demand growth (which averaged 4.1% annually in 1997), with the long upswing reflected in historical tightness in the labour market. But it is possible to explain recent US inflation performance in conventional terms, by considering separately the trends in goods and services inflation, and by discussing the role of commodity prices, the dollar, wage pressures and productivity.

Chart A
US consumer price inflation



The decline in US consumer goods inflation was evident in all parts of the price chain (see Chart B). Upstream input price (PPI crude goods) inflation averaged -2.3% in 1997, compared with 10.7% in 1996; output price (PPI finished goods) inflation fell to 0.4% in 1997, from 2.6% in 1996. Final retail price (CPI goods) inflation fell to 1.4%, from 2.5% in 1996. With goods accounting for 43% of the total CPI, the fall in retail price inflation was significant in moderating 1997 headline consumer price (goods and services) inflation in the United States.

Several factors lie behind these trends in goods prices. First, non-food commodities prices fell significantly on world markets for most of 1997, driven by both supply and demand factors (see Chart C). With commodities priced in US dollars on world markets, this was reflected in US input prices and passed through fairly directly to the 'energy' component of the CPI (comprising 4% of the CPI). Less directly, it also helped to depress inflation in the 'core

Chart B
US goods prices

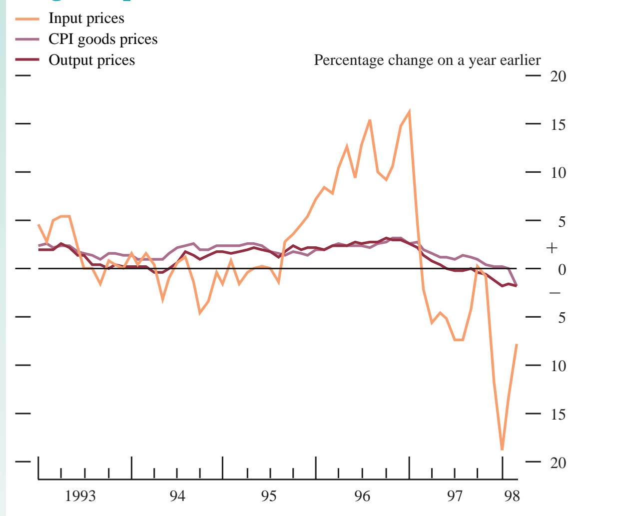
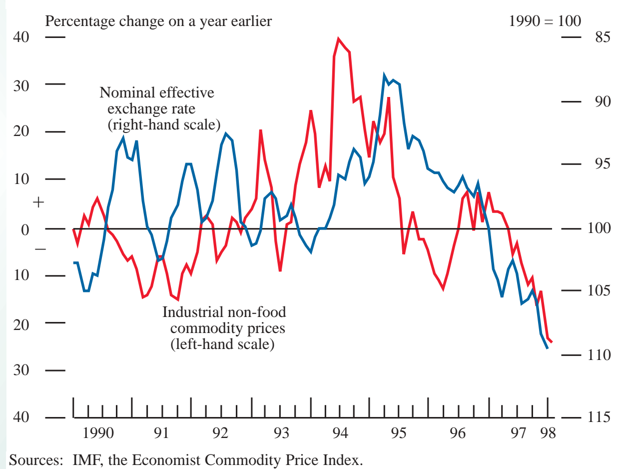


Chart C
Influences on US goods prices



Sources: IMF, the Economist Commodity Price Index.

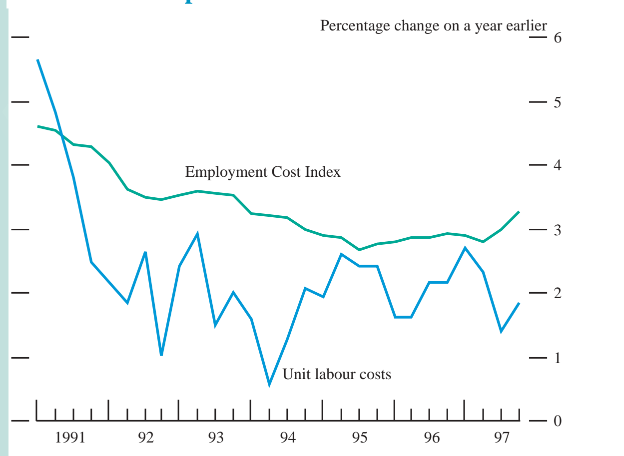
goods' component of CPI (goods excluding food and energy, comprising 23% of the CPI). The prices of these tradable core goods was also held down by significant dollar appreciation; the nominal effective exchange rate index rose by 5.5% during 1996 H2 and 1997 H1, when dollar movements might have been expected to affect 1997 retail goods prices. Finally, though world food commodity price inflation did not fall in 1997, US consumer food price inflation declined to 2.6% in 1997, from 3.3% in 1996, reflecting strong domestic harvests (and also muted labour cost pressure). With food comprising 16% of the overall CPI, this accounted for a significant component of the reduction in headline inflation in 1997.

Computer prices also made a small negative contribution to CPI growth during 1997. Though they account for only 0.2% of CPI goods, the US computers-at-home deflator fell by 33% in 1997. Other changes in CPI measurement by the US Bureau of Labour Statistics (BLS) have also contributed to the fall in CPI goods inflation (see below).

Service sector prices account for 57% of the US CPI.(1) The services included in CPI are broadly non-tradable, and therefore little affected by the dollar appreciation. Inflation in the services component of the CPI has been higher than consumer goods inflation in 1997, but has also fallen, from 3.4% in 1996 to 2.9% in 1997 (see Chart A). The behaviour of the cost of labour, the service sector's key input cost, is likely to have played a role in this decline.

Labour cost pressure as measured by the US Employment Cost Index (ECI) was moderate in 1997, considering the contemporaneous tightening of the US labour market. The ECI rose by 3% in 1997, little more than its 2.8% rise in 1996 (see Chart D). Signs of a pick-up in the ECI were visible in Q4, and as early as Q3 in the service sector. However, two factors may have limited the effect of this on consumer services price inflation. Anecdotal evidence suggests that the upturn in the 'services' ECI was largely due to rises in bonuses and benefits paid to workers in the producer-oriented (rather than household) service sector, such as in high-value financial services. More generally, wage pressure on overall consumer price inflation in the

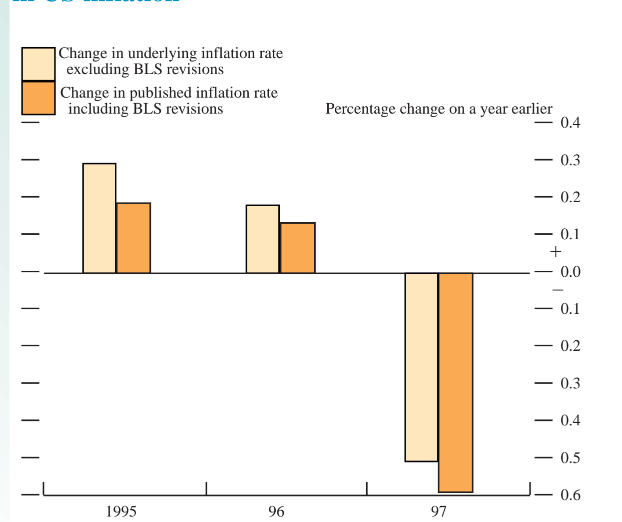
Chart D
US labour cost pressure



United States was mitigated by strong productivity growth in 1997 Q2 and Q3. As a consequence, US unit labour costs rose by only 2.1% on average in 1997. Also, US service sector inflation in 1997 was limited by special influences on the price behaviour of medical care services, which comprise 11% of CPI services (6% of total CPI). They continued to show declining inflation (to 2.9% in 1997, from 3.7% in 1996), reflecting the recent shift in the United States into cheaper 'managed-care' health insurance schemes.

One final factor in the analysis of US inflation is CPI measurement. There have been revisions to the calculation of the US CPI each year since 1995 to deal with potential sources of (upward) bias in the index. Official BLS estimates suggest that the full programme of revisions will reduce measured CPI inflation in total by 0.62 percentage points by 1999, and that the revisions introduced in 1997 accounted for 0.08 percentage points of the fall in the 1997 inflation rate (see Chart E). Details of the revisions show that they lowered inflation in both the goods and services components of the CPI in 1997.

Chart E
Role of CPI revisions in year-on-year changes in US inflation



The distinction between goods and services is helpful in considering the likely direction of US inflation in 1998. Certainly, there are expectations of continued declines in non-food commodity prices because of developments in Asia, Iraq and OPEC; the Economist Intelligence Unit now forecasts a 7% fall in world commodity prices in 1998. The dollar has also continued to appreciate in 1997 H2 and early 1998 (see Chart C). So these external factors should continue to limit goods price inflation in the near term. The headline CPI inflation rate should be further depressed, at least cosmetically, by the incremental BLS revisions to CPI measurement in 1998: these are expected to lower the measured inflation rate by a further 0.15 percentage points this year. These factors have led some commentators to discuss the possibility of deflation in the United States. But there are signs that the tightness of the labour market is finally being reflected in increasing labour cost pressures, and medical care costs are beginning to rise again as the effect of the institutional changes noted above begins to wane. These factors should put particular upward pressure on prices in the service sector, the main component in the CPI. So despite continued benign external influences on the 'goods' part of the CPI in 1998, growing domestic inflationary pressures on the majority of the CPI can be expected to dominate by the second half of the year.

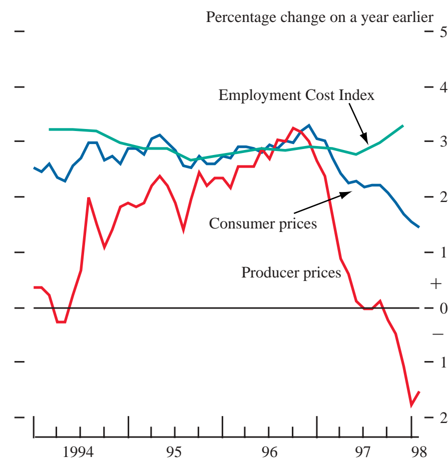
(1) The US CPI weights are split into 43% for goods and 57% for services. This is in marked contrast with the UK RPI index, where goods account for 56% of the index and services for only 35% (the balance being items not classified as either). In fact, these US weights understate the importance of 'service-type' components in US consumer prices, since one third of the US 'food' index (which accounts for 16% of CPI goods) is in the 'food away from home' category. This behaves much like the service sector in terms of its input cost base and price behaviour.

the baseline for the Bundesbank's target growth rate. M3 growth has been within its target range since June 1997. Canada was the only major country where broad money growth was negative, at an annual rate of -1.5% in January.

Despite continued strong activity in most of the M6, inflation fell. On the harmonised basis, inflation rates in the European Union remained low and within a narrow range.

Despite low unemployment and rapid output growth, consumer price inflation has remained low in the United States, edging down to 1.4% in March, from a peak of 2.2% last summer (see Chart 9).(1) Declining energy and commodity prices held down the headline inflation figure; core consumer prices, which exclude food and energy prices, were 2.3% higher in March than a year before. Producer prices fell by 1.8% in the year to March, and have fallen in each month since November, reflecting similar factors.

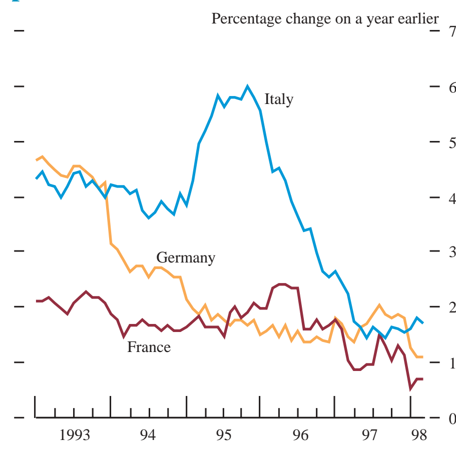
Chart 9
US inflation



By contrast, labour cost growth has increased slightly: after remaining below 3% from mid 1994, the annual rate of growth in the Employment Cost Index rose to 3.3% in 1997 Q4. However, increased productivity growth has moderated growth of unit labour costs to 1.8% in Q4, from a peak of 2.7% in Q1.

Adjusted for the effects of the consumption tax increase in Japan last April, the consumer price index has been stable, reflecting weak domestic demand. Consumer price inflation fell from 2.5% in October to 1.9% in January—a figure entirely accounted for by the impact of the consumption tax increase. Producer price inflation has fallen to below 1%, partly because of the stabilisation of the yen and lower import price inflation.

Chart 10
French, German and Italian consumer prices



German consumer price inflation continued to fall, from a peak annual rate of 2.1% in August 1997 to 1.1% in March 1998, as a result of several factors (see Chart 10). The slight appreciation of the Deutsche Mark, following its 6.9% depreciation in the year to August 1997, helped to reduce import price inflation, as did the fall in world commodity prices. And rent controls in eastern Germany were eliminated this year. These had previously led to sharp increases in rents each January; the absence of these increases reduced the annual inflation rate by 0.5 percentage points this year.

During the early months of 1998, consumer price inflation in France remained below that in Germany, as it has done since the beginning of 1997. But the margin between the annual rates narrowed significantly, partly as a result of the elimination of rent regulation in eastern Germany. From April, the German VAT increase is likely to lead to some divergence in headline annual inflation rates, though the lack of inflationary pressure in Germany suggests that this is unlikely to have second-round effects.

In Italy, annual CPI inflation edged up to 1.7% in the year to March, having fallen to 1.4% in September 1997, its lowest level since 1968. This increase was largely the result of further pass-through of last October's VAT increase, which has been slow, reflecting continuing tight monetary and fiscal policy. In addition, import price inflation in Italy was well below that in Germany

(1) US consumer prices are discussed in more detail in the box on pages 128–29.

during 1997: the lira effective exchange rate was stable during 1997, while the Deutsche Mark depreciated by around 3% in effective terms during the year, and by 4% during 1996.

Inflation across the European Union remains low and uniform. According to the harmonised data, the average inflation rate for EU countries (excluding Greece) increased slightly towards the end of 1997, but then fell back a little in January, reflecting unseasonally weak food prices and the decline in commodity and oil prices. These factors are likely to reverse to some extent in 1998. The standard deviation of inflation rates has increased marginally since the summer; the drop in average inflation since then has resulted from marked declines in inflation rates in Germany, France, Belgium and the Netherlands, partly offset by increases in Italy, Spain, Portugal and Ireland.

Most countries met the Maastricht criteria for inflation and bond yields, leading to the decision to admit eleven countries to monetary union from January 1999. The cyclical upturn in the second half of 1997 helped to bring the deficits of all EU members, apart from Greece, below the 3% limit. Only France, Finland, Luxembourg and the United Kingdom achieved debt ratios below 60%.

Table E shows performance against the Maastricht criteria in 1997. As was the case earlier in the year, inflation rates converged markedly, at low levels, across the European Union. This led to a high degree of yield convergence.

Achievement of the deficit targets was assisted by the strength of the cyclical upturns in many of the smaller European countries, and the low level of interest rates. In France and Italy, deficit reduction was also helped by strengthening domestic demand in the second half of 1997, together with additional fiscal consolidation measures, some of which will unwind in the next few years.

The reduction in deficit ratios and the increase in growth have helped to reduce debt to GDP ratios, though these have remained above 60% in most potential EMU Member States.

The EC and EMI reports were positive about these figures, and recommended, as the markets had been expecting, that eleven countries (the 'EU11') were eligible for membership of monetary union.[1] The European Council decided to admit these countries to monetary union from 1 January 1999. The EMI did, however, express 'ongoing concerns' about the pace of fiscal consolidation in Italy and Belgium, and in Greece, which aims to join EMU in 2001. And substantial real differences persist between the members of the monetary union (see Table F).

Official interest rates remained unchanged in most industrialised countries. Canada and Finland increased their base rates. Italy and Portugal cut official rates.

US official interest rates were left unchanged by the Federal Open Market Committee in 1998 Q1, as they have been since March 1997. During March, the US yield curve rose slightly at the short end. This change was sharply reversed on 3 April 1998,

(1) The EU Member States excluding Greece, Denmark, Sweden and the United Kingdom.

Table E
Maastricht criteria outturns

	Deficit/(surplus) as a percentage of GDP	Debt as a percentage of GDP	HICP (a)	Long-term government bond yields
Target	3.0%	60%	2.7%	8.0%
Austria	2.5	66.1	1.2	5.7
Belgium	2.1	122.2	1.5	5.7
Denmark (b)	(0.7)	64.1	2.0	6.2
Finland	0.9	55.8	1.2	5.9
France	3.0	58.0	1.3	5.6
Germany	2.7	61.3	1.5	5.6
Greece (b)	4.0	108.7	5.5	9.7
Ireland	(0.9)	67.0	1.2	6.3
Italy	2.7	121.6	1.9	6.6
Luxembourg	(1.7)	6.7	1.4	5.6
Netherlands	n.a. (c)	n.a. (c)	2.0	5.6
Portugal	2.5	62.0	1.9	6.2
Spain	2.6	68.3	1.9	6.2
Sweden (b)	n.a. (c)	n.a. (c)	1.9	6.6
United Kingdom (b)	1.9	53.4	1.9	6.9

(a) Harmonised index of consumer prices.
(b) Denmark, Greece, Sweden and the United Kingdom have no plans to participate in the first wave of EMU.
(c) n.a. = not available.

Table F
Selected economic indicators and forecasts for the EU11

	GDP growth (a)		Output gap forecast (a)		Unemployment level (b)	Productivity (c)
	1998	1999	1998	1999	1998	1994
Germany	2.7	2.9	-1.4	-1.0	11.1	111
France	2.9	2.8	-1.4	-0.8	11.3	114
Italy	2.4	2.7	-1.8	-0.9	11.8	87
Austria	2.7	2.9	-0.8	-0.3	5.9	100
Belgium	2.7	2.8	-1.4	-0.6	11.9	116
Luxembourg	3.4	3.5	n.a. (d)	n.a. (d)	3.5	n.a. (d)
Finland	4.2	3.0	0.8	0.4	11.0	80
Ireland	8.6	6.6	3.1	2.3	8.2	86
Netherlands	3.7	3.2	0.7	0.6	4.8	114
Portugal	3.8	3.2	-0.2	0.1	6.0	49
Spain	3.5	3.3	-1.2	-0.9	18.4	88
EU11	3.7	3.4	-0.4	-0.1	9.4	103
Standard deviation	1.7	1.1	1.5	1.0	4.3	21

(a) Percentage of potential output. Source: OECD *Economic Outlook*, May 1998.
(b) Standardised percentage rate.
(c) Index, United States = 100. Source: N Crafts 1997, 'Economic Growth in East Asia and Western Europe since 1950: Implications for Living Standards', *National Institute Economic Review*.
(d) n.a. = not available.

following the release of payroll data that showed a decline of 36,000 in March, and reflected a marked downward reassessment of the chances of interest rate increases in the near term.

Official rates were increased in Canada by 50 basis points, to 5%, in January. This was the third increase in as many months, and was primarily designed to offset the impact of the depreciation of the Canadian dollar on the monetary conditions index targeted by the central bank.

The Bank of Finland raised its tender rate by 15 basis points in March, to 3.4%, citing concerns about inflationary pressures.

The Bank of Italy cut its official discount rate by 50 basis points on 21 April, reflecting the expectation that inflation had stabilised at 1.7% in March and April, following its slight increase in February.

The Bank of Portugal cut official rates by 20 basis points in March, continuing convergence of its short-term rates with France and Germany.

Developments in East Asia

The February 1998 *Quarterly Bulletin* included a note discussing developments in Asia up to the end of January 1998.(1) Since then, the situation appears to have stabilised a little. Further international financing packages, linked to undertakings to accelerate macroeconomic and structural adjustment, have to some extent helped to restore the confidence of international investors, allowing the currencies and stock markets of the affected countries to stabilise or strengthen from the very low levels reached at the beginning of 1998. Fears that other emerging markets would be destabilised have not so far been borne out.(2)

The ASEAN-4(3)

Since the beginning of February, there have been a number of positive developments. In Thailand, the IMF has agreed a target budget deficit of 1%–2% of GDP for 1998, and released another $270 million tranche of its $3.9 billion loan. The Asian Development Bank has approved a $500 million loan to Thailand, and the United States has agreed to provide $1.7 billion. The Thai central bank has announced its willingness to fund the write-off of $11.6 billion of the banking sector's bad loans, reporting that it has spent $25.6 billion on supporting the banking sector since mid 1996.

The Malaysian government has announced a package of reforms designed to restore the confidence of international investors. The Philippine government has raised $600 million from private banks to supplement its currency reserves; World Bank President Wolfensöhn commented that the Philippine government has responded correctly to the economic situation.

Developments in Indonesia have been more difficult to interpret, following the decision in January to accelerate implementation of the package of reforms agreed with the IMF last October. A number of measures have been undertaken. Tariffs and export taxes have been reduced, budgetary support for certain sectors is to be ended, a programme to rehabilitate the banking sector has been announced, and new bankruptcy laws are being developed. Indonesia has also raised some bilateral financing: Japan is reported to have pledged $560 million, and Singapore has offered $2 billion of trade finance. However, early in February, Indonesian Finance Minister Ma'rie Mohammed announced plans to link the rupiah to the US dollar via a currency board. The IMF considered this to be outside the terms of Indonesia's agreement, and threatened to withdraw its $43 billion assistance plan. It also delayed release of the second, $3 billion, tranche of assistance scheduled for 15 March, which triggered a delay in the release of $2.5 billion of World Bank and Asian Development Bank funds. Uncertainty continued until mid March, when the plans for a currency board appeared to have been dropped. Renegotiation of the IMF's assistance plan was concluded on 8 April, which should shortly lead to the release of further IMF and associated funds. The plan is intended to reduce inflation rapidly, stabilise the exchange rate, and restore normal trade flows and economic growth. It calls for more comprehensive and rapid structural reform and banking sector restructuring, and for funding to be released more frequently, in smaller tranches, associated with a higher-frequency monitoring and review programme.

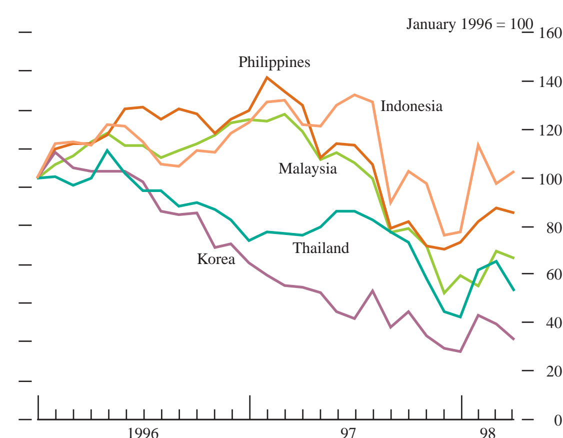
Korea

The situation in Korea now appears to be more stable. Korea's compliance with most of the components of the IMF's package helped to regain the confidence of international investors, leading to an agreement with commercial creditors to exchange $22 billion of short-term debt for longer-term government-guaranteed loans; of this, $21.4 billion had been rolled over by mid March. This reduced the proportion of foreign debt with a maturity of less than one year to 30%, from 44% at the end of 1997. Following the passage of labour reforms specified by the assistance package, the IMF approved a further $2 billion tranche of funds. The Korean government's first overseas bond issue was heavily oversubscribed, and raised $1 billion more than expected ($4 billion in total).

Market reactions

Market reactions to the developments described above have generally been favourable. Equity markets in the ASEAN-4 and Korea recovered sharply in early February 1998, though

Chart A
Asian share prices

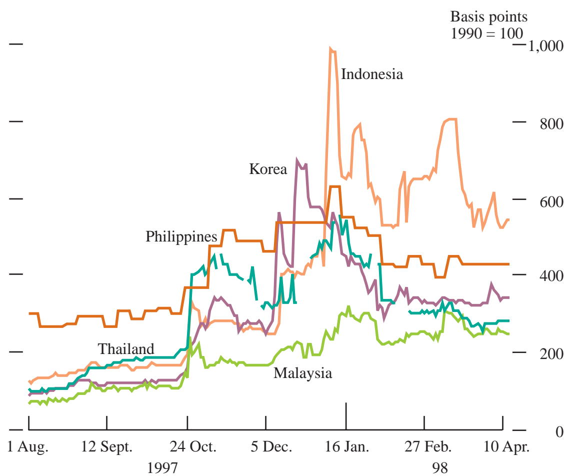


(1) See the February 1998 *Quarterly Bulletin*, pages 26–29.
(2) This note is based on events up to 21 April 1998.
(3) Thailand, Malaysia, Indonesia and the Philippines.

they have since fallen back (see Chart A). Data for Korea suggest that foreign purchases of equities were a significant factor in the recovery: these amounted to $2.5 billion in January and February, compared with net sales of $1.3 billion in the last quarter of 1997. Equities in Thailand, Malaysia and Korea subsequently lost around half of their gains, but now stand about 20% above the lowest levels in January. In the Philippines and Indonesia, equities have fallen back rather less, and are currently 50%–60% above their lowest levels in January, though as with in all five countries, they remain well below the peak levels of 1997.

Bond spreads over US Treasuries in the ASEAN-4 and Korea dropped sharply at the beginning of February, and have been stable since then in Thailand, Korea and Malaysia, though remaining above the levels of 1997 H1 (see Chart B). By contrast, the bond spread in Indonesia rose significantly during March, though it has since fallen back close to the low level reached in February. This instability may have reflected uncertainty in the markets about the status of Indonesian negotiations with the IMF.

Chart B
Asian benchmark bonds: spreads over US Treasuries

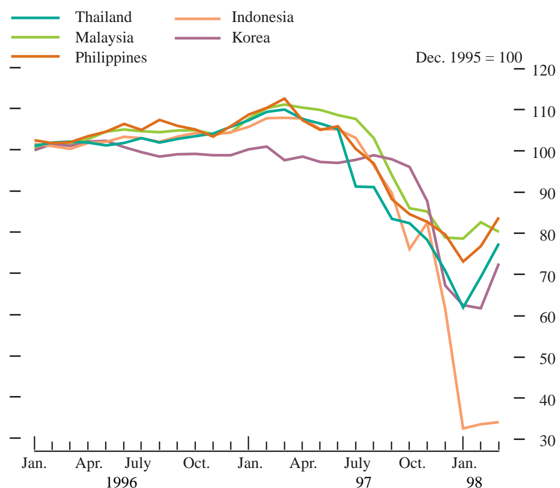


Source: Datastream; some data for Thailand unavailable.

Exchange rates have also stabilised (see Charts C and D). By February, the real exchange rates of Thailand, Korea and the Philippines had appreciated significantly from their levels in December 1997. The Indonesian and Malaysian real exchange rates were little changed during this period. Nominal exchange rates suggest that real exchange rates for the ASEAN-4 and Korea were stable in March and April. Official reserves stabilised in Thailand, Indonesia and Malaysia during the early months of 1998. Korea and the Philippines were able to rebuild their reserves, presumably reflecting improved access to credit lines.

The stabilisation of exchange rates has been associated with reductions in short-term interest rates, particularly in Korea and the Philippines (see Chart E). Perhaps because the increases in short-term rates during 1997 were smaller, the declines in short-term interest rates in Malaysia and Thailand were less marked. In late March, Indonesia raised its 90-day interbank rate from 21% to its current level of 30%. This is above the levels that occurred shortly after the

Chart C
Asian real exchange rates



Source: J P Morgan.

Chart D
Dollar exchange rates

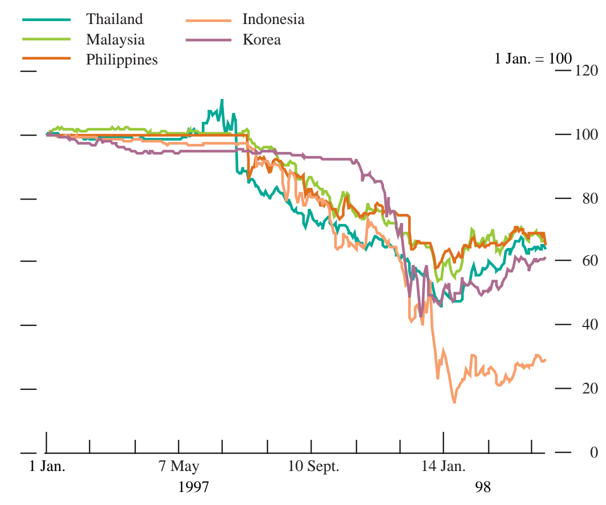
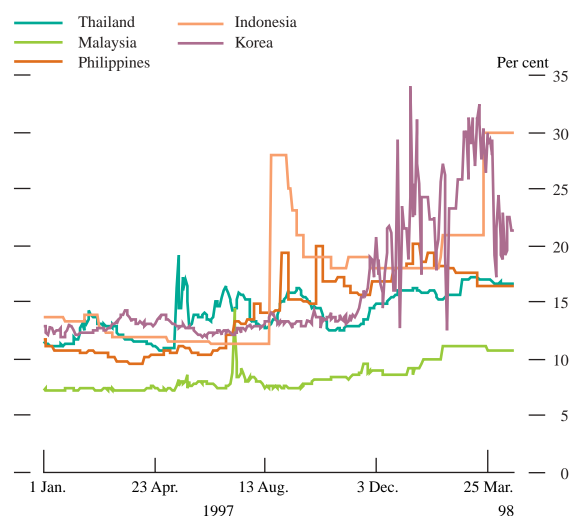


Chart E
Asian short-term interest rates



Indonesian rupiah first came under pressure in August 1997, though the real rate is now much lower, since inflation has picked up sharply.

Effects on ASEAN-4 and Korean economies

The effects of the East Asian currency depreciations are now beginning to show more clearly in other economic indicators (see Table 1). Inflation has picked up a little in Thailand, Malaysia and the Philippines. Prices have increased sharply in Indonesia, reflecting the relatively large depreciation of the rupiah, and the impact of the drought on food prices. Output has been falling in Thailand, Malaysia and Korea.(1)

Table 1
Selected economic indicators

Percentage change on a year earlier, based on non seasonally adjusted data

	Consumer prices		Industrial production (a)	
	March 1998	August 1997	Most recent available (b)	August 1997
Thailand	+9.5	+6.6	-8.6	-2.2
Malaysia	+5.1	+2.4	-2.1	+13.8
Philippines	+7.3	+4.5	+19.4	+3.7
Indonesia	+39.1	+5.7	n.a. (c)	n.a. (c)
Korea	+9.0	+4.1	-1.9	+8.5

(a) The figures for Thailand and the Philippines are for manufacturing production.
(b) The figures given are for January 1998, February 1998, November 1997 and February 1998, respectively.
(c) n.a. = not available.

The East Asian currency depreciations have led to shifts in the trade patterns of the affected countries, as Table 2 shows. In dollar terms, imports have generally declined, though by varying amounts. Exports have typically increased by 5%–10%. There have been reports that shortages of working capital and difficulties obtaining imported inputs have constrained export growth. Several countries have arranged additional finance specifically to alleviate these problems. The impact of the depreciations on domestic demand and employment is difficult to assess, because of lags in both the economic effects of these shocks, and in the publication of data.

Table 2
Trade flows

Change between 1997 Q2 and Q4, dollar terms

	Imports percentage	Exports percentage	Net exports $ billions
Thailand	-26.2	+9.1	+5.2
Malaysia	-15.9	-5.8	+2.1
Philippines	+0.7	+10.9	+0.6
Indonesia	-7.8	+5.3	+1.9
Korea	-7.6	+3.4	+4.2

Spillovers to emerging markets

Pressure on currencies in other emerging markets has eased. The Czech koruna, Brazilian real, Russian rouble and Slovak koruna have strengthened or stabilised, allowing a modest easing of interest rates. Interest rates in Argentina and China have also been reduced, although in the latter case, this may reflect easing of domestic inflationary pressures. Spreads on most emerging market debt have continued to narrow in the opening months of 1998, though they typically remain wider than during 1997 H1.

The outlook

Though the situation appears to have stabilised somewhat, considerable uncertainty remains. Recent improvements in market sentiment may not persist, particularly if adverse developments in the real economies of affected countries create pressure for policy reversal, or delays in implementation. And it will be some time before the effectiveness of reforms can be fully ascertained. In addition, developments in Japan will critically influence the recoveries of the East Asian economies.

Between December 1997 and May 1998, the IMF revised down its projection for world growth in 1998 from 3.5% to 3.1% (see Table 3). This compares with world growth of 4.1% in both 1996 and 1997, but is stronger than the global slowdown in 1990–93, when world output was rising at annual rates of 1¾%–2¾%.

Table 3
IMF and OECD forecasts for GDP growth in 1998

	IMF			OECD		
	May 1998	Dec. 1997	Oct. 1997	June 1998	Dec. 1997	June 1997
World	3.1	3.5	4.3	n.a.	n.a.	n.a.
OECD	n.a.	n.a.	n.a.	2.4	2.9	2.7
NICs	1.8	3.6	6.0	n.a.	n.a.	n.a.
ASEAN-4	-2.7	1.7	5.4	n.a.	n.a.	n.a.
Japan	0.0	1.1	2.1	-0.3	1.7	2.9
United States	2.9	2.6	2.6	2.7	2.7	2.0
European Union	2.8	2.8	2.8	2.7	2.8	2.7

Note: n.a. = not available.

The IMF's downward revision to its projection for world growth largely reflects reductions in its growth forecasts for Asia. For the newly industrialised economies (Korea, Taiwan, Hong Kong and Singapore), the IMF reduced its forecast for 1998 from 3.6% in December to 1.8% in the May *World Economic Outlook (WEO)*. For the ASEAN-4, the forecasts were reduced from 1.7% in December to -2.7% in May. The outlook in Japan has also weakened, owing mainly to a fall in domestic demand; the May *WEO* projects zero growth in Japan in 1998, compared with the IMF's December 1997 projection of 1.1%.

Revisions since December to forecasts for other regions are smaller. The IMF projection for US growth in 1998 has been revised up to 2.9% from 2.6% in October 1997. The projection for EU growth is unchanged from the October projection of 2.8%.

The OECD has also revised its forecasts, taking account of events since November 1997, the cut-off date for its previous forecast, including the deterioration in Korea and the worsening domestic environment in Japan. GDP growth in the OECD region(2) is expected to be 2.4% in 1998, down from 2.9% in the November forecast. This mainly reflects a large downward revision to expected growth in Japan, to -0.1%, from 1.7% in the November 1997 forecast.

(1) Recent figures for Indonesia are not available.
(2) The OECD area excludes the ASEAN-4 countries but includes South Korea.