The international environment

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

- *The slowdown in Asia has spread to more countries.*[2] *Japanese output fell for the second successive quarter in 1998 Q1. The Japanese authorities have announced further plans to tackle financial instability.*
- *Growth in the United States rose strongly in the first quarter of 1998.*
- *Recovery in the prospective euro area*[3] *continued.*
- *Inflation remained low throughout the United States, the prospective euro area and Japan.*
- *Equity prices remained buoyant in most major markets, with the exception of Japan.*
- *Official interest rates were unchanged in the major industrial economies. Bond yields have fallen in the major markets, though are little changed in Japan, where yields remain low.*

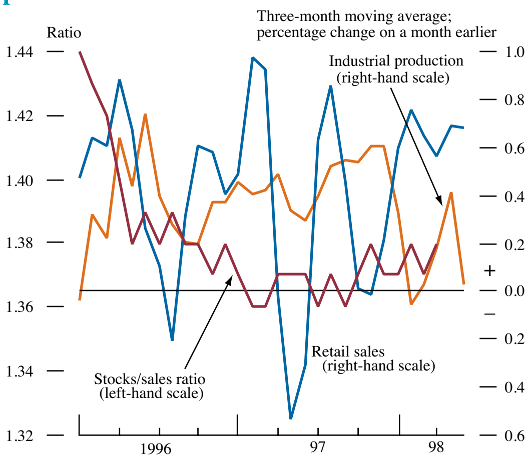
Table A
Quarterly contributions to US GDP growth[a]

Percentage points

	1997			1998
	Q2	Q3	Q4	Q1
Private consumption	0.3	1.0	0.5	1.0
Government consumption	0.1	0.1	0.0	-0.1
Investment	0.4	0.4	0.1	0.7
Stocks	0.3	-0.4	0.2	0.3
Domestic demand	**1.1**	**1.2**	**0.8**	**2.0**
Net trade	**-0.1**	**-0.1**	**-0.1**	**-0.7**
GDP	**1.0**	**1.0**	**0.7**	**1.4**

(a) Contributions may not sum because of rounding.

Chart 1
US retail sales, stocks and industrial production



GDP growth in both the United States and the prospective euro area rose in Q1, but Japanese GDP fell for the second consecutive quarter.

The US economy remained strong in the first quarter of 1998. GDP rose by 1.4% (see Table A), on the back of increased domestic demand growth, and was 4.2% higher than a year earlier. This followed growth of 1% and 0.7% in the third and fourth quarters of 1997.

US consumption grew by 1.5% in Q1. This largely reflected strong rises in durables consumption, perhaps boosted by the discounting of motor vehicle prices following the dollar appreciation against Asian currencies. Consumption is also likely to have been strong in Q2: retail sales rose by 1.9% in Q2, to a level 6.3% higher than a year ago (see Chart 1); household income and employment growth were strong in Q2; and consumer confidence reached its highest level since 1969, though it fell subsequently in July.

Stockbuilding made a positive contribution to US growth, as in 1997 Q4. Despite rising stock levels, the stocks/sales ratio was little changed in the first quarter, as Chart 1 shows.

Net exports fell in 1998 Q1, as in 1997 as a whole. The widening trade deficit reflects continued dollar appreciation and the strength of domestic demand in the United States, relative to that of its trading partners. The monthly trade deficit rose to a record $15.8 billion in May.

(1) Based on data up to 30 July 1998.
(2) Developments in East Asia are discussed separately in the note on pages 216–19.
(3) The eleven countries that will enter into EMU on 1 January 1999, ie Germany, France, Italy, Austria, Belgium, Luxembourg, Finland, Ireland, the Netherlands, Portugal and Spain.

Chart 2
US non-farm payrolls and hourly earnings

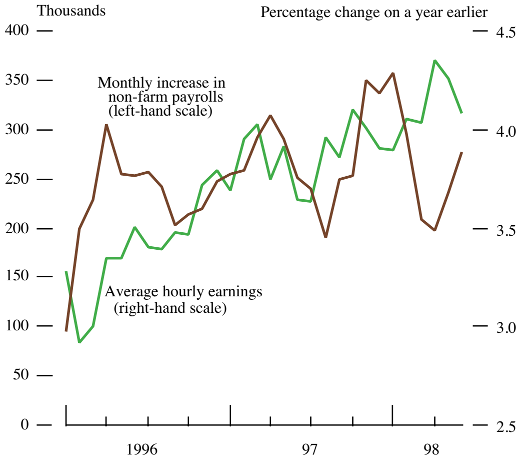


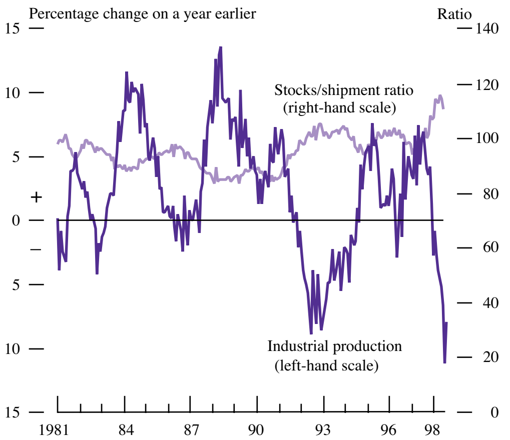
Table B
Quarterly contributions to Japanese GDP growth[(a)]

Percentage points

	1997			1998
	Q2	Q3	Q4	Q1
Private consumption	-3.2	0.9	-0.6	0.1
Government consumption	-0.1	0.1	0.1	-0.1
Investment	-0.8	-0.1	-0.3	-1.0
Stocks	0.3	0.0	-0.1	0.0
Domestic demand	**-3.8**	**0.9**	**-0.9**	**-1.0**
Net trade	**1.0**	**-0.1**	**0.6**	**-0.4**
GDP	**-2.8**	**0.8**	**-0.4**	**-1.3**

(a) Contributions may not sum because of rounding.

Chart 3
Japanese stocks/shipment ratio and industrial production



Industrial production growth in Q2 was stronger than in Q1 (see Chart 1), when it had been weak because warm weather had reduced utilities output. But annual production growth continued to slow, in line with the National Association of Purchasing Managers' index, which fell during Q2. The twelve-month growth rate of industrial output was 4.2% in Q2, down from 4.7% in Q1 and 5.8% in 1997 Q4.

The US labour market continued to tighten: non-farm payrolls rose by a monthly average of 278,000 in Q2, compared with 208,000 in 1998 Q1 and 282,000 in 1997 (see Chart 2). Increases in employment have been concentrated in the service sector: on average, service sector employment grew by 0.7% in Q2, whereas manufacturing employment fell by 0.1%. The US unemployment rate fell to 4.3% in April and May, its lowest level since February 1970. Although unemployment then rose to 4.5% in June, this seems to reflect recent strikes in the US vehicle manufacturing industry, rather than weakening demand.

The advance estimate of US GDP in the second quarter, which is subject to revision, suggests that US growth slowed to 0.4% in 1998 Q2, largely because of a negative contribution from stockbuilding and a further fall in net exports. Consumption and investment growth remained strong.

In contrast with the United States, the Japanese economy continued to weaken in the first quarter of 1998. GDP fell by 1.3%, after a fall of 0.4% in 1997 Q4, as domestic demand and net exports both fell (see Table B).

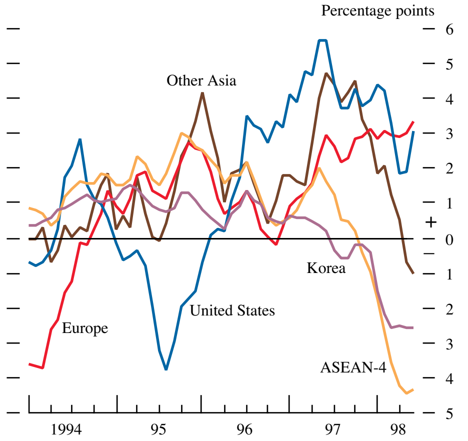
Non-residential investment fell by 5.1% in Q1: rising stock levels have reduced the incentive to invest, and survey evidence suggests that many firms face difficulties in obtaining bank finance. Weakening demand, following the tax rise in April 1997, falling government spending in the 1997 fiscal year and the slowdown in other Asian countries, has prevented firms from reducing stocks, which have risen to near-record levels, despite cuts in production. Industrial production in Q2 was 8.6% lower than a year earlier (see Chart 3). The June Tankan Survey suggests that firms will continue to cut production to reduce unwanted stocks.

Private consumption rose by 0.1% during the first quarter, following its 1% fall in 1997 Q4. The rise in consumption was smaller than the 0.7% increase in workers' incomes in Q1. Consumption seems likely to have remained weak in Q2: retail sales fell by 4.8% in the year to June. Consumer confidence remains low, and surveyed household incomes have fallen in Q2 so far, as production cuts have led to lower overtime payments and higher unemployment; unemployment rose to 4.1% in May, its highest rate on record.

Net exports fell in Q1, after a strong rise in 1997 Q4. Imports fell by 1.4%, because of weak domestic demand. But exports fell by 3.8%, as increased exports to the European Union and United States were more than counterbalanced by falls in exports to other countries in Asia (see Chart 4). According to customs-cleared trade data, the trade surplus has widened since Q1, with imports continuing to fall.

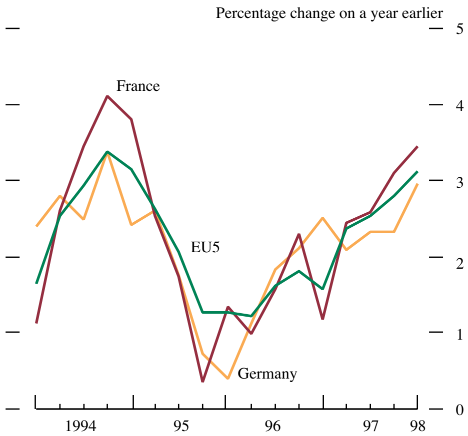
The outlook for Japan has worsened, as reflected by successive downward revisions to Consensus forecasts of 1998 GDP growth.

Chart 4
Japan: contributions to annual export growth[(a)]



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

Chart 5
GDP growth



Note: EU5 consists of Germany, France, Italy, Spain and the Netherlands.

Table C
Quarterly contributions to German GDP growth[(a)]

Percentage points

	1997			1998
	Q2	Q3	Q4	Q1
Private consumption	0.5	-0.4	0.3	0.6
Government consumption	0.2	-0.3	-0.3	0.3
Investment	0.1	0.1	0.0	0.6
Stocks	-0.5	0.4	0.7	0.0
Domestic demand	**0.3**	**-0.2**	**0.7**	**1.5**
Net trade	**0.6**	**0.9**	**-0.4**	**-0.6**
GDP	**1.0**	**0.7**	**0.3**	**1.0**

(a) Contributions may not sum because of rounding.

In response, the government announced a fiscal package in April, which has passed through parliament, and has since made further proposals to restore financial stability. But uncertainty remains as to whether these measures will succeed in bringing about self-sustaining recovery in Japan. Policy developments in Japan are discussed in the box on pages 210–11.

Growth in the prospective euro area[(1)] increased in the first quarter, as domestic demand growth strengthened. GDP grew by 0.6%, and was 3.1% higher than a year earlier (see Chart 5). This followed growth of 0.5% in 1997 Q4.

German GDP rose by 1% in the first quarter of 1998, following growth of 0.7% and 0.3% in the third and fourth quarters of 1997 respectively (see Table C). As in 1997 Q4, growth in Q1 was more than accounted for by domestic demand, offset by a fall in net exports. But in contrast with 1997, when stockbuilding made the largest contribution to domestic demand growth, all components of domestic demand except stockbuilding grew strongly in 1998 Q1.

Consumption growth increased, but the Q1 figure may overstate the underlying strength of German consumption. The rise was partly because of growth in real incomes, following the reduction of the solidarity tax, and lower-than-expected inflation. In addition, April's VAT rise led consumers to bring forward purchases of durables—especially cars—into the first quarter. So consumption growth is likely to be weaker in Q2. Average retail sales (including motor vehicles) in April and May were 3.5% lower than in Q1 (see Chart 6). And consumer sentiment in Germany weakened during Q2, despite a 0.8 percentage point fall in unemployment since its peak of 11.8% in 1997 Q4. This may be because falls in unemployment have come partly from government job creation schemes, and have not yet been reflected in significant increases in private-sector employment (see Chart 7).

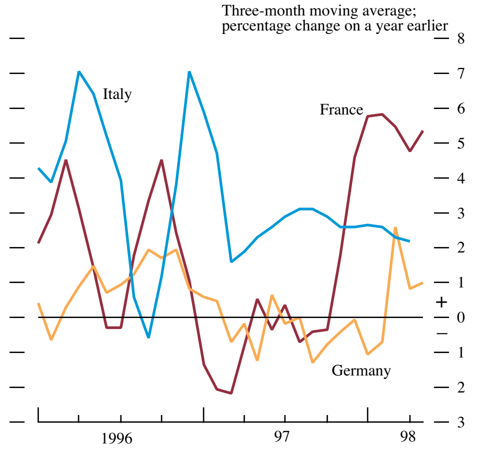
Investment also grew strongly in Q1, boosted, like consumption, by VAT-related effects. And the most recent investment survey (spring 1998) suggests that continued growth is likely in coming quarters: interest rates are low, and capacity utilisation remains close to its highest rates since 1990. But industrial production has fallen slightly since Q1, perhaps reflecting weaker demand (see Chart 8). West German business sentiment has moderated in 1998, though it remains quite strong by historical standards.

Net exports fell in Q1: exports rose by 1.2%, but imports rose by 3.2% (again, boosted by VAT-related purchases). Customs-cleared trade data suggest that the German trade surplus has increased since Q1. However, falling import prices mean that Q2 figures are likely to overstate any rise in net exports in real terms.

GDP in France rose by 0.6% in Q1 to a level 3.4% higher than a year previously, following 0.9% and 0.8% growth in the third and fourth quarters of 1997 respectively (see Table D). Growth slowed because of a fall in net exports in the first quarter, and unusually mild weather reduced energy output. During 1997, the contribution of domestic demand to growth increased, and in 1998 Q1, consumption, investment and stocks all made positive contributions to growth.

(1) As approximated by GDP-weighted growth figures for Germany, France, Italy, Spain and the Netherlands, which account for 88% of prospective euro area GDP.

Chart 6
Retail sales in Germany, France and Italy



Note: Retail sales include motor vehicles except for Italy.

Chart 7
Employment growth in Germany and France

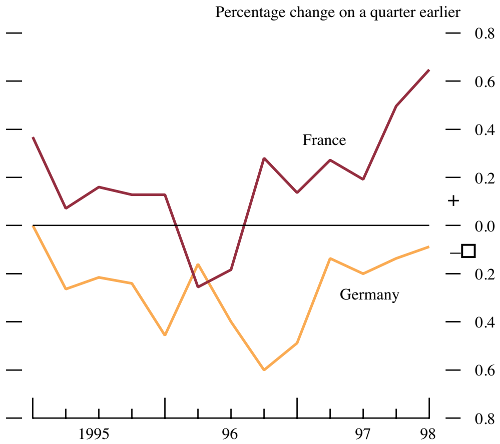


Table D
Quarterly contributions to French GDP growth(a)

Percentage points

	1997			1998
	Q2	Q3	Q4	Q1
Private consumption	0.2	0.7	0.6	0.4
Government consumption	0.0	0.0	0.0	0.0
Investment	0.3	0.1	0.0	0.3
Stocks	0.1	0.0	-0.1	0.5
Domestic demand	**0.6**	**0.9**	**0.4**	**1.4**
Net trade	**0.6**	**0.0**	**0.3**	**-0.8**
GDP	**1.1**	**0.9**	**0.8**	**0.6**

(a) Contributions may not sum because of rounding.

Private consumption growth slowed in 1998 Q1. But this seems to have been largely because unseasonally warm weather led to reduced energy consumption: retail sales grew at the same quarterly rate in 1998 Q1 as in 1997 Q4, and continued to be strong in Q2 (see Chart 6). Employment (see Chart 7) grew by 1.7% in the year to March 1998, resulting in robust growth of incomes and consumer spending. Consumer confidence remains high.

Business investment grew by 2.8% in 1998 Q1, in line with the latest investment survey, which suggested that firms planned marked increases in investment in 1998. The high level of capacity utilisation in manufacturing, and the strength of the equity market and corporate cashflows, suggest that business investment probably remained robust in Q2.

Industrial production growth has slowed in Q2 so far (see Chart 8). Average production in April and May was 1.1% higher than in Q1, when production rose by 1.3% on the previous quarter. But services output is likely to have increased in Q2 because of the World Cup, and business sentiment remains strong.

Net exports fell in Q1, their first quarterly fall since 1996 Q2. The growth of net exports has slowed progressively since the first half of 1997, as the lagged effects of the franc depreciation have worn off, and the Asian slowdown has taken effect.

In Italy, GDP fell by 0.1% in 1998 Q1. This follows quarterly growth rates of 0.5% and 0.2% in Q3 and Q4 respectively, suggesting a slowdown. Recorded growth was slower in Q4 partly because there were fewer working days than in Q3; working-day effects are not adjusted for in the official GDP statistics. Growth also slowed in Q1, even after allowing for the fewer working days than in Q4. Falling net exports largely account for weak Q1 growth, probably reflecting the effects of the Asian slowdown on Italian exports, which fell by 1.6%. Consumption growth was also weak, following the end of the government's car incentive scheme, which had supported consumption in 1997. But Q1 GDP growth understates the underlying strength of the Italian recovery: retail sales and industrial production in Q1 were respectively 2.3% and 3.3% higher than a year earlier.

Growth remained robust in other countries in the prospective euro area. GDP in the Netherlands rose by 1.1% in Q1, to a level 4.1% higher than a year earlier. Spanish GDP grew by 0.9% in 1998 Q1, as in 1997 Q4, and was 3.7% higher than a year earlier.

Consensus forecasts have been revised down for growth outside the United States, Japan and the prospective euro area (see Table E).

The slowdown in East Asia that followed financial market turbulence in the second half of 1997 has intensified, and spread to more countries. This has been reflected in downward revisions to Consensus forecasts for Asia. Developments in East Asia are discussed separately in the note on pages 216–19. Consensus Forecasts have revised down their 1998 growth projections for Eastern Europe. But this is largely accounted for by a lower projection for Russia following interest rate rises: Russian official interest rates rose to 150% in May, but have since fallen to 60%,

Policy developments in Japan

Japanese GDP fell by 1.3% in 1998 Q1. This was its second consecutive quarterly fall, so the economy technically entered recession. Weak demand in Japan, and in Asia as a whole, has resulted in stocks rising to near-record levels. In response, firms have been cutting investment, production and employment. With interest rates already very low, the government has announced another expansionary fiscal package to stimulate demand, and further proposals to address financial fragility.

Fiscal policy

In April, the government announced its largest-ever economic package, which included a fiscal injection of ¥12.3 trillion. Together with the tax cuts in February, this amounts to a total fiscal injection of ¥15.2 trillion (3% of GDP) into the economy in fiscal years 1998 and 1999. April's package (see the table below) comprises tax rebates and public works spending, which the government estimates will add 2–3 percentage points to GDP in fiscal year 1998; the OECD estimates the effect at $^{3}/_{4}$–$1^{1}/_{4}$ percentage points in calendar year 1998.

Japanese fiscal package

¥ trillion

	April package	May Bill
Public works	7.7	4.7
Tax cuts	4.6	2.6
Total	**12.3**	**6.2**
Total as percentage of GDP	**2.4**	**1.2**

Note: Figures are for fiscal year 1998, except for tax cuts in April package, which are for fiscal years 1998 and 1999.

The May 1998 supplementary Budget Bill implements the central government part of the package in fiscal year 1998. It correspondingly specifies smaller amounts than the April package, which includes tax cuts in fiscal year 1999 and local government spending. But the additional public spending from the package may still be smaller than originally specified. The May Bill suggests that much of the spending will come from accelerating existing projects. And of the ¥7.7 trillion originally specified, ¥4.1 trillion involves local government.(1) This part may be difficult to implement, because slower growth has reduced local government revenues.

The fiscal package provides only a temporary stimulus. In the medium term, fiscal consolidation is likely to be necessary: Japan faces an increasing fiscal burden from an ageing population, and the OECD project the gross debt/GDP ratio to rise to 96.5% in 1998. The Fiscal Structure Reform Law of December 1997 provides a timetable for consolidation. General government deficits are to fall to 3% of GDP by 2003 (since extended to 2005) and the gross debt/GDP ratio is to be stabilised. To achieve this, the government has cut planned public spending from fiscal year 1998 onwards. So the April package is needed partly to maintain spending levels.

The OECD takes a broadly positive view of fiscal policy effectiveness in its June *Economic Outlook*, suggesting that in tackling weak Japanese demand, 'monetary policy is likely to be of little assistance, . . . this points to the desirability of fiscal stimulus'.

The likely effect of a fiscal stimulus is, according to economic theory, ambiguous. Output is partly determined in the short run by aggregate demand, so in a recession, a fiscal stimulus would increase total spending and activity. But fiscal loosening might be ineffective for a number of reasons: if households expected higher taxes to follow, they might save any extra income from tax cuts; and if interest rates increase, fiscal expansion might be offset by falling private investment—although this seems unlikely in Japan, as interest rates are so low.

There are additional risks to Japanese fiscal policy effectiveness from weak consumer confidence and concerns about financial stability. These may have impaired the transmission mechanism and further reduced the fiscal multiplier, which already seemed low in earlier fiscal expansions. If Japanese demand is weak because of low consumer confidence, tax rebates (and funds received from higher government spending) may be mainly saved, rather than spent. And concerns about financial stability mean that these funds may be largely deposited outside the Japanese banking system, preventing further expansionary effects that would have come from banks offering these funds as credit to industry.

Monetary policy

In the May *World Economic Outlook* (*WEO*), the IMF advised that Japanese economic stagnation justified the continuation of easy monetary conditions, 'with no increase in official rates in the near future; indeed, the limited scope that remains for decreases in official rates may need to be utilised, together with continued activity to ensure ample liquidity'. Japanese official interest rates have remained at their 'emergency' level of 0.5% since September 1995.

Some have argued that, with aggregate demand below capacity despite short-term nominal interest rates close to zero, Japan appears to be in a liquidity trap.
Professor Krugman(2) suggests that 'what is needed is a

(1) ¥3 trillion of local government spending plus ¥1.1 trillion of central government spending on joint central/local government projects.
(2) Paul Krugman is Ford International Professor of Economics at Massachusetts Institute of Technology.

credible commitment to future monetary expansion, so as to generate expectations of inflation'.(3) With inflation expectations sufficiently high, zero nominal rates of interest would mean strongly negative real interest rates, less saving and increased demand.

However, the effect of monetary expansion on inflation (and perhaps inflation expectations) might be limited by financial fragility. This has impaired the ability of banks to provide credit, regardless of interest rate levels. Banks might invest additional funds in less risky assets than business loans. Although broad and narrow money rose by 3.5% and 7.6% respectively in the year to June, bank lending to business actually fell by 2.5% in the year to March. Some slowdown in business loans might have been expected from improvements in banks' credit risk management. But this fall, together with survey evidence, suggests a credit crunch in parts of industry. And low consumer confidence, and the high savings rate (13.6% in 1997), may mean that consumers save, rather than spend, an unusually large proportion of any additional funds.

Financial stability

In the June *Economic Outlook*, the OECD advised that for Japan, 'dealing promptly and comprehensively with the crisis in the banking sector has become an overriding priority': 'Macroeconomic stimulus alone will not suffice to generate a sustained expansion'. Their key policy suggestions are that 'balance sheet problems must be resolved and the banking system must be recapitalised' and that 'the legal, regulatory and supervisory environment in which financial institutions operate will need to be improved'. The Financial Supervision Agency recently reported that loans in need of management or in danger of default total ¥88 trillion; ¥7 trillion of which banks have serious concerns about, or judge to be non-collectable.

In the May *WEO*, the IMF examined three previous financial crises and their impact on growth (see the chart). In each case, activity recovered only once decisive action was taken to deal with banking sector problems.

The Japanese authorities have made some progress in tackling bad loans problems. They have encouraged banks to recognise the full extent of bad debts, and to write off and provision bad loans using operating profits. In February, the government allocated ¥13 trillion to recapitalise the financial system and allow debts to be written off, but only ¥2 trillion has been used so far.

More recently, the government has proposed additional measures to reform the financial sector, the key features of which are:

- The introduction of a 'bridge bank' mechanism, in which administrators would take over failed banks, ensure that loans to good borrowers are maintained, and either merge the bank with a healthy institution or pass it on to the state for eventual liquidation.

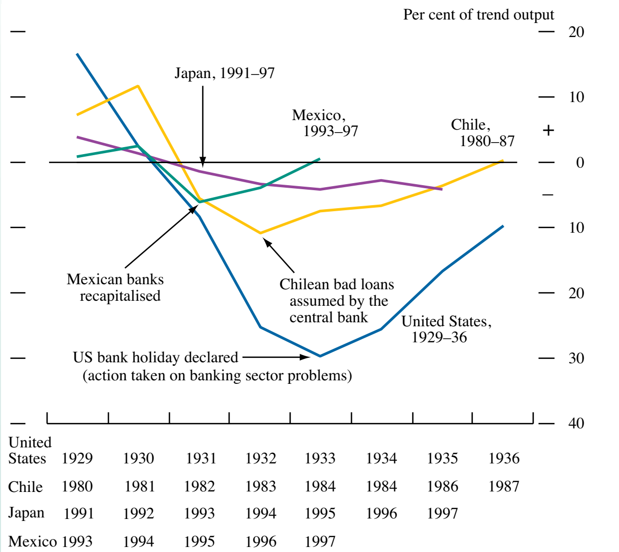
- The establishment of a secondary market for bad loans; the Cooperative Credit Purchasing Company would buy bad loans from banks and recycle them in the market.

- Reform of the property market to allow disposal of collateral for bad loans, and increase land market liquidity.

- The improvement of transparency and disclosure requirements regarding banks' bad loans, based on the Securities and Exchange Commission standard, and the promotion of 'voluntary and aggressive disclosure'.

- The strengthening of bank supervision and prudential standards. The Financial Supervision Agency will conduct an inspection of major banks, in collaboration with the Bank of Japan, to ensure that they are applying risk management effectively.

Paths of output gaps following financial sector shocks



Source: IMF.

These measures, if pursued rigorously, would seem likely to resolve many of the financial sector's problems, especially by removing unhealthy institutions from the banking sector, and eliminating bad loans from the balance sheets of healthy banks.

(3) 'Further notes on Japan's liquidity trap' (July 1998), P Krugman (see his website: http://web.mit.edu/krugman/www/).

Chart 8
Industrial production in Germany, France and Italy

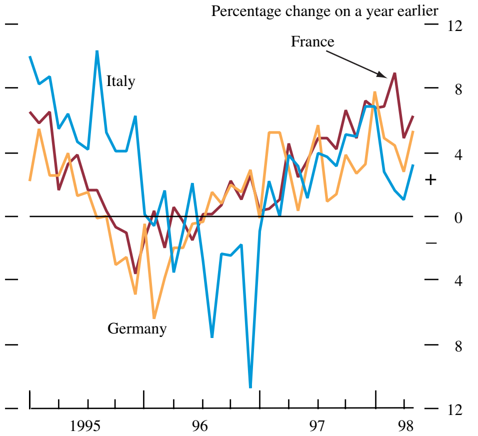


Table E
Consensus forecasts for 1998 GDP growth

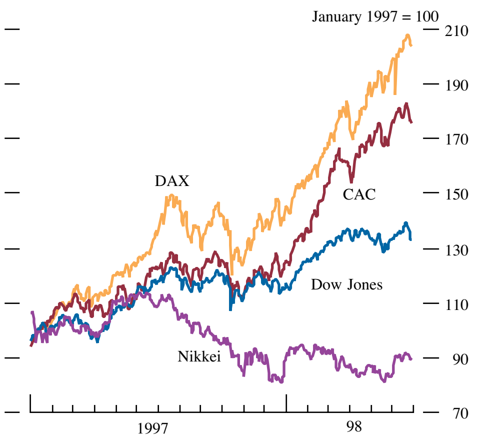
Percentage change on a year earlier

	Jan. 1998	July 1998	Change
North East Asia	5.1	2.7	-2.4
South East Asia	0.5	-7.4	-7.9
Eastern Europe	2.9	1.3	-1.6
Latin America	3.2	3.2	0.0

Note: *Eastern Europe Consensus Forecasts* uses a wider definition of Eastern Europe than that used here.

Source: Consensus Forecasts.

Chart 9
Equity markets[(a)]



(a) In local currencies.

following financial market turbulence reflecting concern about the fiscal position. Growth projections for some other Eastern European economies have been revised up.

The buoyancy in most major equity markets in 1997 has continued in the first half of 1998. Japanese share prices are little changed, remaining low.

Equity prices in the United States and major continental European markets have risen strongly in 1998 so far (see Chart 9). French and German equity prices have been particularly buoyant, rising by 38% and 37% respectively in the first half of the year, compared with 12% in the United States. European equity markets have been more volatile than in the United States during 1998.

Japanese stock prices were, on average, lower in 1998 Q2 than in 1998 Q1, when they recovered from falls at the end of 1997. The weakness of share prices in Q2 reflected continued uncertainty about prospects for the Japanese and Asian economies. There has been some recovery in stock prices since the co-ordinated central bank intervention to support the yen on 17 June, followed by the announcement of further measures to tackle financial instability. Japanese equity prices are about 7% lower than their average since January 1997.

Equity prices in a number of other countries have been volatile in recent months. In particular, Russian equity prices have fallen by around 50% since the start of May. Stock prices in other Eastern European markets also fell in May but, in contrast with Russia, have since largely recovered. As discussed in the note on pages 216–19, East Asian stock markets have continued to be weak following falls in April and May. Equity prices, and exchange rates, have also fallen sharply recently in Pakistan and South Africa.

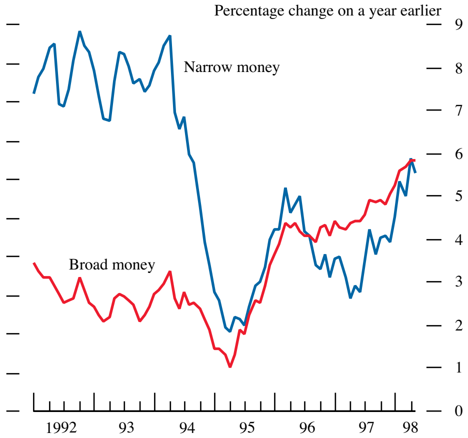
Since the start of the year, the annual growth rates of both broad and narrow money have risen strongly in the major six overseas economies[(1)] (see Chart 10).

In the major six overseas economies, average annual broad money growth rose from 5% in January to 5.6% in May (near peak levels for the 1990s). Real broad money growth rose from an annual rate of 3.2% in January to 4.2% in April. In the absence of velocity shifts, this may lead to a strengthening of nominal demand at some stage in the future.

US M2 growth increased to an annual rate of 7.3% in June, and has been above the upper end of the Federal Reserve's monitoring range (of 1%–5%) throughout 1998 so far. Italian M2 strengthened to an annual growth rate of 10.1% in May, the highest rate among the major six overseas economies. In contrast with narrow money, which has been growing strongly in recent months, Japanese broad money growth remained subdued, at 3.5% in the year to June. Annual broad money growth in Germany remained within the Bundesbank's target range (of 3%–6%); in June, the stock of M3 was an annualised 5.3% higher than its average in the fourth quarter of 1997. French M3 grew at an annual rate of 5.0% in May. Canada remained the only major country where broad money fell; the annual growth rate of M2+ was -1.5% in May.

(1) As measured by the GDP-weighted average of narrow and broad money growth in the major six overseas economies.

Chart 10
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.

Chart 11
US inflation

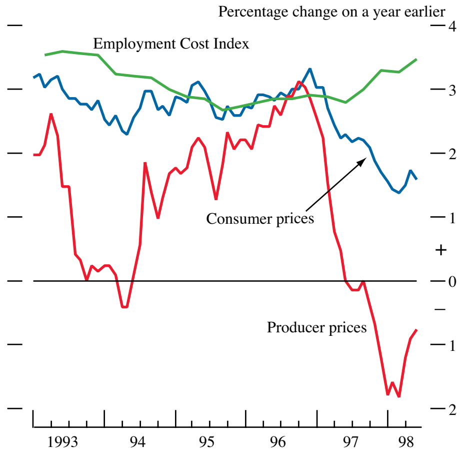
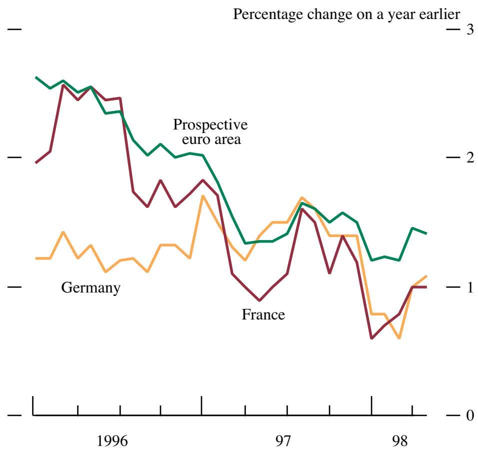


Chart 12
Harmonised CPI inflation



As with broad money, the annual rate of narrow money growth in the major six overseas economies has risen in 1998, from 4.5% in January to 5.6% in May. In real terms, average annual narrow money growth increased even more, from 2.8% in January to 4.5% in April.

Japanese narrow money growth moderated from an annual rate of 10.2% in February to 7.6% in May. Reserve money has been growing at an annual rate of around 10% since January 1998, largely as a result of the Bank of Japan's open market operations to provide the banking system with short-term liquidity. M1 growth in the United States has been rising since 1997 Q3, and has returned to positive annual growth rates since March this year. In May, the annual growth rate of M1 fell in France to 10%, but remained above 12% in Italy and Canada.

Consumer price inflation fell across the United States, the prospective euro area and Japan in the first quarter, largely because of falls in energy and commodity prices. Inflation has continued to be subdued in Q2.

Despite low unemployment and strong output growth, US consumer price inflation remains muted, but has risen slightly to an annual rate of 1.6% in June, having fallen since late 1996 (see Chart 11). The earlier decline reflected falls in commodity and energy prices, and inflation continues to be restrained by low energy prices; core consumer price inflation (excluding energy and food) is correspondingly higher than headline consumer price inflation, at 2.2% in June. Inflation is concentrated in the service sector, as goods prices have been stable: service prices rose by 2.7% in the year to June. The rate of producer price deflation has slowed as falls in commodity and oil prices have moderated: producer prices fell by 0.8% in the year to June, compared with a 1.8% fall on a year earlier in Q1.

Strong employment growth appears to be reflected in rising labour costs. Annual hourly earnings growth increased to 4.2% in 1998 Q2, compared with 4% in Q1 and 3.9% in 1997. And the annual rate of growth of the overall Employment Cost Index rose to 3.5% in Q2, up from 3.3% in both 1997 Q4 and 1998 Q1. But the inflationary impact of this has been mitigated by strong productivity growth, which is examined in the box on page 214.

In Japan, annual consumer price inflation fell sharply as the effects of the 2 percentage point consumption tax increase in 1997 dropped out of annual figures. In May, consumer prices were 0.5% above those of a year ago, reflecting the weakness of consumer demand and the significant spare capacity in the Japanese economy. Wholesale prices in May were 1.7% lower than a year earlier.

Consumer price inflation in the prospective euro area remained subdued (see Chart 12). In Germany, there seems to have been strong resistance to price rises following April's 1 percentage point increase in the rate of VAT. If fully passed on, this would have added 0.7 percentage points to annual inflation for a year. However, inflation in June, at 1.2%, was only 0.1 percentage points higher than in March. Inflation in France remains low, but has picked up a little since the start of the year: consumer prices in June were 1% above those of a year ago. The rate of Italian consumer price inflation remained stable.

US productivity growth

The US economy is generally viewed as being in an upturn that began in 1991. Productivity (as measured by output per person-hour) grew strongly at the start of the upswing, before slowing during 1993–95. But since 1996 it has picked up again, with annual non-farm business sector productivity growth averaging 1.8%, compared with its average of 1.4% since 1971. This is unusual: sustained increases in productivity growth usually occur earlier in a recovery. This box looks at possible explanations for the recent increase.

Average US labour productivity growth

Percentage per year

	Whole economy	Manufacturing
Since 1971	1.4	3.0
Since 1990	1.1	3.3
1997	1.7	4.5

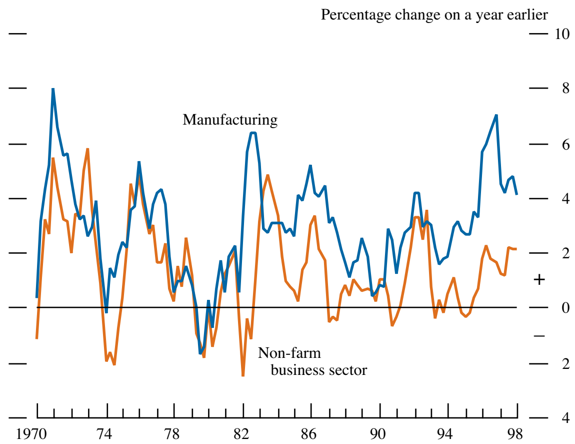
One possible explanation is the corporate restructuring that took place in the late 1980s and early 1990s, which may still be feeding through to productivity growth. But this seems a more plausible explanation for the upturn in US productivity growth in the early 1990s than the more recent rise.

A second, more likely, explanation is the unusually high rates of investment since 1996. In this period, quarterly investment growth averaged 3.1%, compared with an average of 1.2% since 1971. And this has been concentrated in advanced technology goods, which anecdotal evidence suggests have generated efficiency gains in firms' production processes.

There is a third explanation, related to the US economic cycle. As in other countries, productivity growth is strongly cyclical. It typically rises in the early years of a cycle, as producers expand output using existing capacity to meet growth in demand. On conventional measures, the United States is in the eighth year of an upswing. The Federal Reserve's tightening of monetary policy in 1994/95 resulted in a temporary slowdown in GDP growth, rather than a recession followed by a new upturn. But in the past three years, the US economy has in many ways behaved as if in the early phases of a boom, rather than in the later phases of an established recovery.

The behaviour of several cyclical variables suggests that the United States can be viewed as being in its second upturn of the 1990s. Since 1995, US real GDP growth has risen, especially in industries such as consumer durables and housing, where increases in growth are often seen in the early stages of an upturn. There has been a rapid rebuilding of US stock positions during the past three years, particularly in manufacturing. After falling following the rise in interest rates, capacity utilisation rates rose from early 1996 until early 1998. Correspondingly, as the chart shows, US labour productivity growth picked up in 1992, slowed, and then rose again in 1996.

US productivity growth



It seems likely that the explanation for the recent increase in US productivity growth is a combination of cyclical factors and technological investment. Some commentators have suggested that recent faster productivity growth marks a rise in trend productivity growth. But official data provide little evidence to support this: although the current rate of productivity growth is above its long-run average, it is slower than during previous peaks, including that reached in 1992, of 3.2% on the previous year. Indeed, productivity growth may now be slowing: productivity growth fell in Q1. And in Q2, annual industrial production growth has slowed, despite continued strong rises in employment; growth in new orders of capital goods has also fallen.

As Table F shows, there is some divergence in inflation within the prospective euro area. Annual consumer price inflation in a number of the faster-growing countries, such as the Netherlands, Ireland, Portugal and Spain, is at or above 2%. For some of these countries, the convergence of short-term interest rates ahead of the introduction of the single currency may increase inflationary pressures, other things being equal.

Table F
Harmonised index of consumer prices

Percentage changes on a year earlier

	1998	
	February	May
Austria	1.0	1.0
Belgium	0.8	1.3
Denmark	1.7	1.4
France	0.7	1.0
Finland	1.7	1.6
Germany	0.8	1.1
Greece	4.1	5.0
Ireland	1.1	2.4
Italy	2.1	2.0
Luxembourg	1.1	1.3
Netherlands	2.1	2.1
Portugal	1.3	2.2
Spain	1.7	2.0
Sweden	2.0	1.6
United Kingdom	1.5	2.0

Official interest rates have remained unchanged in the major six overseas economies since the publication of the May Quarterly Bulletin. *Bond yields have fallen in the major markets, but Japanese yields have changed little. Several smaller European countries have changed their interest rates.*

Official interest rates were unchanged in the major six overseas economies. Bond yields have fallen, though Japanese yields have changed little.

Official rates in both Spain and Portugal were cut in May, by 25 basis points and 20 basis points respectively, reflecting the continued convergence of their short-term rates with those of France and Germany.

Official rates in Sweden, who will not be participating in the first wave of EMU, have also been cut. In June, the Riksbank reduced its repo rates by 25 basis points, following falls in inflation. By contrast, Denmark raised its official rates in May: an initial rise of 50 basis points was followed by a cut of 25 basis points; and Norway raised rates by 125 basis points, following a 25 basis point rise earlier in 1998.

Developments in East Asia

The May 1998 *Quarterly Bulletin* discussed developments in East Asia up to mid April 1998.[1] This note outlines developments since then in the region.[2]

Financial markets and activity in the countries initially affected by financial market difficulties during 1997—the ASEAN-4[3] and Korea—have been weak. Growth elsewhere in the region has also slowed. Consensus forecasts of growth in Hong Kong SAR and China fell, after lower-than-expected GDP growth in 1998 Q1. Growth in Singapore and Chinese Taipei, which has been relatively unaffected to date, is also expected to slow. The recovery in financial markets in some Asian countries in 1998 Q1 reversed during Q2. This reflected political turmoil in Indonesia, as well as market concerns that China might devalue the renminbi.

An important factor behind this slowdown has probably been the economic and financial weakness in Japan. Japanese domestic demand and imports have fallen, and Japanese banks, previously important financiers to the Asian region, have retrenched. Weak Japanese demand means that Asian firms are likely to seek growth in exports to outside the region. So the deepening slowdown in East Asia is likely to result in increasing current account imbalances elsewhere.

ASEAN-4 and Korea

Financial markets generally weakened in the second quarter, after some recovery in 1998 Q1.

Equity prices in the ASEAN-4 and Korea fell in the second quarter, reaching new record lows (see Table 1). The Thai and Korean stock markets fell by about 46% and 38% respectively in 1998 Q2.

Table 1
Currency and stock market movements in Asia

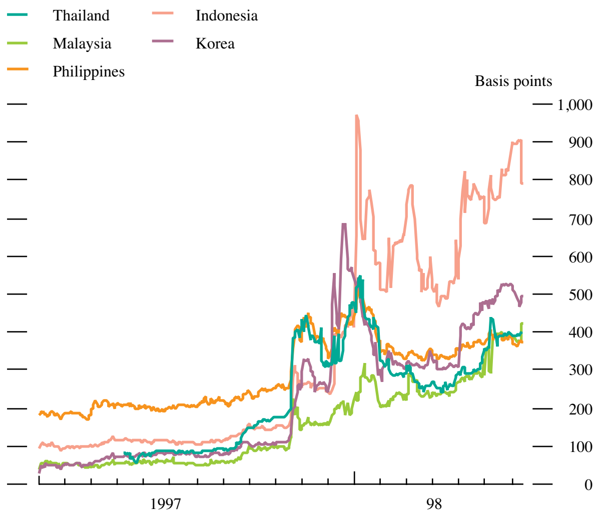
	Percentage change between start July 1997 and end March 1998		Percentage change between end March 1998 and end June 1998	
	Equity market (a)	Exchange rate (b)	Equity market (a)	Exchange rate (b)
Japan	-18.1	-13.6	-4.2	-4.1
China	-10.0	0.1	6.8	0.0
Hong Kong SAR	-23.7	0.0	-26.2	0.0
Singapore	-15.1	-11.4	-27.2	-4.8
Chinese Taipei	0.7	-15.2	-17.0	-4.5
Indonesia	-26.0	-71.6	-20.4	-42.8
Korea	-36.5	-35.8	-38.1	0.8
Malaysia	-33.3	-30.5	-36.7	-12.0
Philippines	-20.5	-30.4	-21.4	-9.7
Thailand	-12.9	-37.0	-46.4	-8.1

Source: Bloomberg.

(a) Major indices expressed in local currencies: Nikkei 225; Hang Seng; Korean composite; Straits Times Industrial; Taiwan Stock Exchange; Thai Set; Malaysian Kuala Lumpur composite; Philippines composite; Jakarta composite.
(b) Nominal rate against US dollar.

Bond spreads over US Treasuries widened in 1998 Q2 (see Chart A). Spreads are still below the peaks reached during 1997 Q3, except for Malaysia, where concerns about economic policy reversals led spreads over US Treasuries to widen to new heights in June.

Chart A
ASEAN-4 and Korea: benchmark bond spreads over US Treasuries



Note: Denominated in US dollars.

Source: Bloomberg.

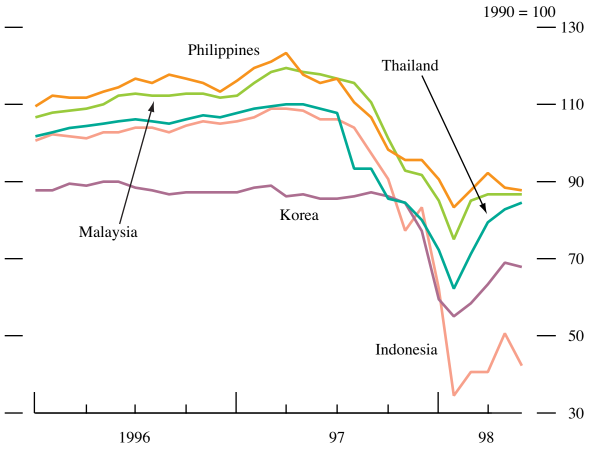
The ASEAN-4 currencies have continued to depreciate against the dollar, especially the Indonesian rupiah, although the Korean won was little changed in the second quarter. But because intra-regional trade is important, the depreciation of the effective exchange rate of any individual country is significantly less than any depreciation against the dollar. This, and high inflation in the ASEAN-4 and Korea, has meant that real effective exchange rates were either little changed in the second quarter, or appreciated; in the case of Korea and Thailand, real appreciations were quite large (see Chart B).

First-quarter GDP growth in the ASEAN-4 and Korea was weaker than markets had expected, with domestic demand contracting (see Table 2). This has been reflected in falling Consensus forecasts for 1998 GDP growth (see Chart C), which are negative for all these countries except the Philippines. However, there are some signs that output is stabilising in Thailand and Korea.

(1) See the May 1998 *Quarterly Bulletin*, pages 133–35.
(2) This note is based on events up to 24 July 1998.
(3) Indonesia, Malaysia, the Philippines and Thailand.

In the ASEAN-4, tight monetary policy, aimed at maintaining currency stability, has contributed to falling demand. Weakening demand led to an increase in net exports as imports fell. And there were signs that export credits were increasingly available, which should help to promote export growth in the near future. But this effect might be limited, because the similarity of ASEAN countries' export patterns means that they compete against each other in third markets, such as the United States. This, and the real effective appreciation of some currencies, might result in weaker net export growth than bilateral dollar exchange rate movements would suggest.

Chart B
ASEAN-4 and Korea: real effective exchange rates



Source: J P Morgan.

In Malaysia, the economic downturn has been worse than markets expected. Retail sales remain on a downward trend, and manufacturing production fell in 1998 Q1. The government has responded to the slowdown by pursuing fiscal reflation. A series of fiscal measures announced in June increased spending by 0.5% of GDP.

In the Philippines, annual GDP growth remained positive in Q1, reflecting rising net exports. Exports were 11.6% higher than a year earlier, largely because of strong US demand. The Philippine banking system is also stronger than in other countries in the region, providing exporters with easier access to financing. But the budget position is deteriorating: the official target of a PhP5 billion surplus (0.2% of GDP) in 1998 is unlikely to be met, because of slower growth. And consumer price inflation has risen in 1998—to 10.7% in the year to June.

Table 2
Real GDP growth

Percentage change on a year earlier

	1997				1998
	Q1	Q2	Q3	Q4	Q1
Malaysia	8.5	8.4	7.4	6.9	-1.8
Indonesia	8.5	6.8	2.5	1.4	-7.9
Korea	5.7	6.6	6.1	3.9	-3.8
Thailand	n.a.	n.a.	n.a.	n.a.	n.a.
Philippines	5.5	5.6	4.9	4.8	1.7

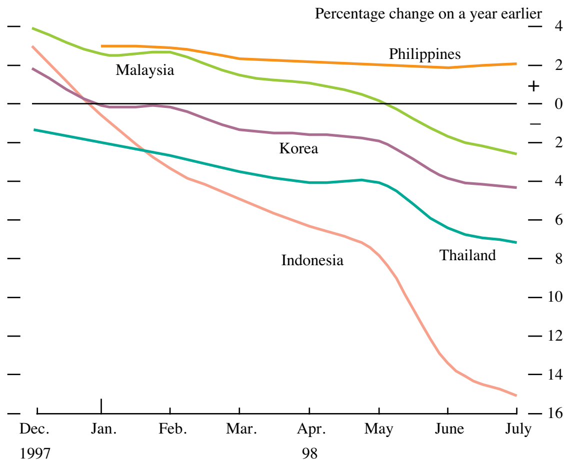
n.a. = not available.

Note: Quarterly data not available for Thailand.

Source: Datastream; data for Indonesia from the Bank of Indonesia and The Central Bureau of Statistics.

In Indonesia, a framework agreement for the restructuring of interbank debt, the maintenance of trade financing and the voluntary renegotiation of the external debts of Indonesian corporations was reached with foreign banks in early June. Bankruptcy laws have been amended, allowing the Bank Restructuring Agency to take control of Bank Central Asia (the largest private sector bank), which had been experiencing a deposit run. The IMF and Indonesia signed a further letter of intent, which revised an earlier agreement on a $23 billion package of multilateral official support. The agreement is based on forecasts of a fall in GDP of 10%–15% in 1998, for inflation in 1998 to remain below 80%, and for the budget deficit in 1998/99 to remain below 8.5% of GDP. Following the letter of intent, the Asian Development Bank released a $1.5 billion loan for restructuring the banking sector. On 3 July, the World Bank approved a $1 billion loan, delayed from May; $600 million was disbursed immediately, with the balance due in September. The IMF disbursed $1 billion on 16 July.

Chart C
ASEAN-4 and Korea: Consensus forecasts of 1998 GDP growth



Source: Consensus Forecasts.

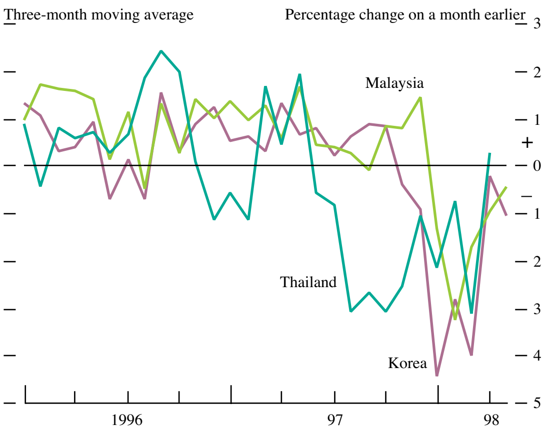
Following the signing of the letter of intent, a fall in GDP of 16.5% in the year to 1998 Q2 has been announced, and Consensus forecasts for 1998 GDP growth have fallen below the projections in the letter. Consumer prices rose by 59.5% in the year to June, and inflation seems likely to increase as administrative controls on prices are removed.

In Thailand, manufacturing output fell by 17% in the year to 1998 Q1, reflecting falling demand. The authorities have started a programme of structural adjustment. Bankruptcy and foreclosure laws have been amended, which should enable the corporate sector to be restructured and bad debts in the banking sector to be written off. The fourth letter of intent with the IMF increased the budget deficit target from 1% to 3% of GDP, excluding the interest cost of debt incurred from recapitalising the banking sector (estimated at between 2%–3% of GDP). So the underlying fiscal position has loosened. Export volumes have risen by more than 20% since July 1997, though currency depreciation has lowered the dollar value of exports.

In Korea, GDP fell in 1998 Q1 on a year earlier, because of falling domestic demand. This has allowed Korea to restore its balance of payments position quickly: the merchandise trade surplus was $4.25 billion in May, largely because of falling imports, and foreign exchange reserves rose to $40.9 billion by the end of June. In response to falling demand, the government has announced a won5 trillion (1.2% of GDP) fiscal stimulus package, involving increased infrastructure spending and a reduction in the car sales tax. This is expected to increase the budget deficit to 3% of GDP for the current fiscal year. The government has also announced a $15 billion privatisation programme and won50 trillion (12% of GDP) of support for the financial system. It has rationalised the banking system by merging five insolvent banks with five solvent ones, and further bank mergers are possible. This raised concerns among some international investors.

In Korea and some ASEAN-4 countries, activity seems to have stabilised, following rapid contraction of output in late 1997 and 1998 Q1. Seasonally adjusted data show that for Korea, Thailand and Malaysia, the rate of decline of industrial output seems to have slowed in recent months (see Chart D).

Chart D
Asian industrial production



Note: Official Korean data already seasonally adjusted; data for Thailand and Malaysia seasonally adjusted by the Bank of England.

Hong Kong SAR, Singapore, China, and Chinese Taipei

Growth in Singapore, China and Chinese Taipei slowed in 1998 Q1, and GDP in Hong Kong SAR fell (see Table 3). As with other East Asian economies, Consensus forecasts for GDP growth have fallen, probably reflecting the strong trade links with this region (see Chart E). With monetary policy largely constrained by exchange rate considerations, most governments have loosened fiscal policy.

In Hong Kong SAR, GDP fell in 1998 Q1 relative to a year earlier. Demand has been weakened by a fall in tourism receipts and construction activity. The unemployment rate reached 4.5% in June, a 15-year high. In the second quarter, the Hang Seng share price index fell by 26%, and property prices have also fallen (by about 50% since their peaks in August 1997). Concern that China would devalue the renminbi led to speculation against the Hong Kong dollar in June; overnight interbank rates rose to 15%, as the Hong Kong Monetary Authority defended the exchange rate peg against the US dollar, but have subsequently fallen back. The government announced a fiscal stimulus of HK$32 billion (2.4% of GDP). The package includes rebates of property tax, cuts in interest income tax and a suspension of land sales.

Table 3
Real GDP growth

Percentage change on a year earlier

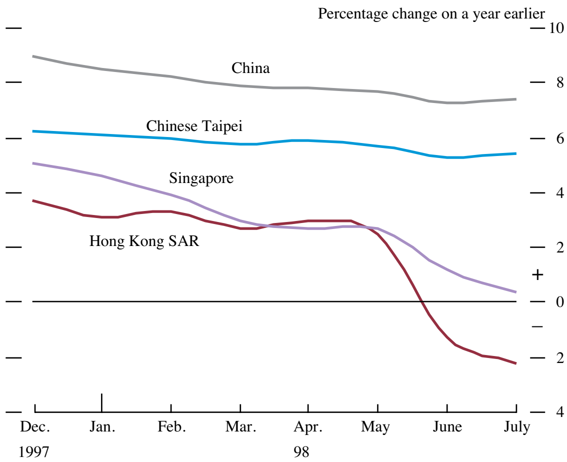
	1997				1998
	Q1	Q2	Q3	Q4	Q1
Hong Kong SAR	5.9	6.8	6.0	2.7	-2.0
Singapore	4.2	8.5	10.7	7.6	5.6
Chinese Taipei	6.9	6.3	6.9	7.1	5.9
China	9.4	9.5	9.0	8.8	7.2

Note: Chinese GDP is cumulative, from the beginning of the year.

Source: Datastream; data for China from the People's Bank of China *Quarterly Statistical Bulletin*.

In China, the annual rate of real GDP growth has slowed in 1998 so far, to 6.8% in Q2, partly because of continued industrial restructuring and tight monetary conditions. But Consensus forecasts for real GDP growth remain above 7% for 1998. Although monetary policy remains tight, lending rates were cut in June. Other policy measures have included official encouragement to commercial banks to provide working capital to state-owned enterprises.

Chart E
China, Hong Kong SAR, Chinese Taipei, Singapore: Consensus forecasts of 1998 GDP growth



Source: Consensus Forecasts.

Speculation about the prospect of a devaluation by the Chinese authorities, triggered by the weak yen, led to financial market turbulence at the end of June. But following intervention in support of the yen by the US and Japanese authorities on 17 June, the Chinese reaffirmed their commitment to a stable currency. This reduced speculation that the Hong Kong dollar would also be forced to devalue.

In Singapore, slowing GDP growth in Q1 reflected falls in consumption, and in both manufacturing and services output growth (Singapore is a major exporter of services to the ASEAN region). The government announced a S$2 billion (1.4% of GDP) stimulus package in late June, targeted at the property sector. Stamp duty has been suspended, to protect stockbrokers' revenues. And the government has cut public sector tariffs and brought forward infrastructure projects. The government estimates that the package will result in a budget deficit of S$800 million (0.6% of GDP), compared with an earlier forecast of a S$2.7 billion surplus (1.9% of GDP). But Singapore still has one of the strongest fiscal positions in the region.

Despite the slowdown in the rest of the region, GDP growth in Chinese Taipei remained relatively strong in 1998 Q1. Domestic demand growth has been supported by public investment in infrastructure and private consumption. The strength of domestic demand relative to the rest of the region resulted in a fall in net exports in the first quarter.