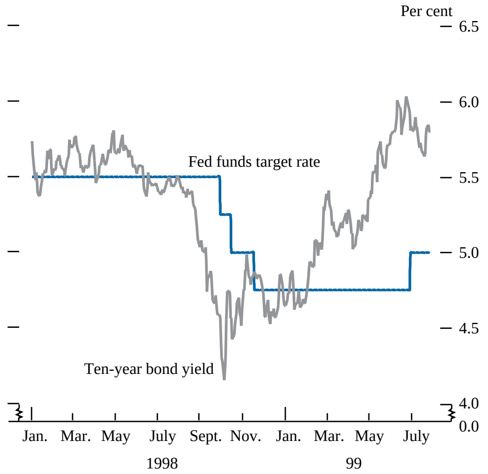
The international environment

This article discusses developments in the global economy since the May 1999 Quarterly Bulletin.[1]

- *Overall, the outlook for the world economy has improved since the previous* Quarterly Bulletin.
- *Most short and long-term interest rates increased across the major international financial markets, partly reflecting developments in the United States.*
- *The Federal Open Market Committee increased the federal funds target rate by $^1/_4$% to 5% on 30 June, and reverted to a neutral monetary stance. Growth slowed somewhat in the second quarter, after above-trend growth in the first quarter.*
- *Growth in the euro area appeared to have strengthened in the first quarter, after slowing throughout last year. Euro-area inflation remained at low levels, and the European Central Bank left interest rates unchanged, though noted some potential for upward pressure on prices in the future.*
- *In Japan, measured GDP grew by 1.9% in the first quarter of 1999, after six quarters of falling output. This increase may reflect one-off factors, and the impact of the recent fiscal stimulus.*
- *Oil prices increased by more than 15% since the previous* Quarterly Bulletin, *but indices of other commodity prices were broadly flat in dollar terms.*
- *In most emerging markets, output growth has been stronger than expected, and forecasts for growth were revised up.*

Chart 1
US interest rates



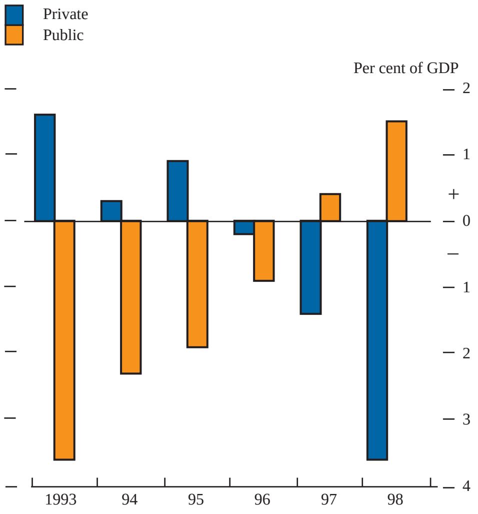
In the United States, the federal funds target rate was increased by $^1/_4$% to 5% on 30 June. Growth slowed somewhat in the second quarter, after above-trend growth in the first quarter.

The Federal Open Market Committee (FOMC) increased the federal funds target rate by $^1/_4$% to 5% on 30 June (see Chart 1). The Committee said that, following the policy easing last autumn, 'much of the financial strain has eased, foreign economies have firmed, and economic activity in the United States has moved forward at a brisk pace'. The Committee noted that 'labour markets have continued to tighten over recent quarters, but strengthening productivity growth has contained inflationary pressures'. The FOMC also announced that it had returned to a neutral stance on near-term monetary policy.

In its previous meeting on 18 May, the FOMC had announced a bias towards tightening with 'prospective developments more likely to warrant an increase than a decrease in the federal funds rate'. Benchmark bond yields increased by about 60 basis points between 1 May and 30 June, partly in response to the announcement, but also because of data releases interpreted as indicating a build-up in inflationary pressure, particularly the April consumer price inflation data released on 14 May. After the FOMC announcement of its

(1) Covering the period from 1 May to 30 July 1999, with charts finalised on 28 July.

Chart 2
US financial balances



Source: IMF.

Chart 3
US consumer price index

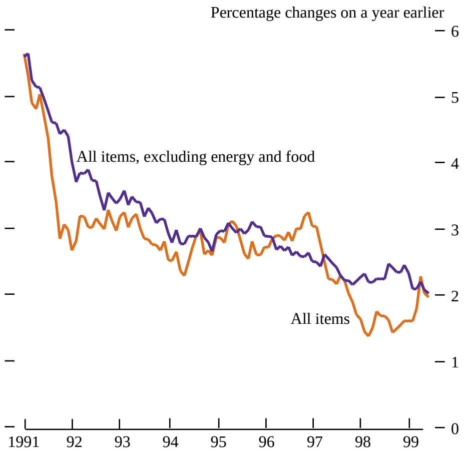
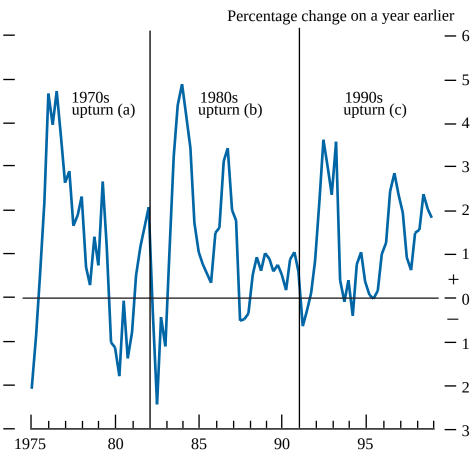


Chart 4
US non-farm labour productivity



(a) 1975 Q1–1982 Q4.
(b) 1983 Q1–1990 Q4.
(c) 1991 Q1–1999 Q1.

return to a neutral stance, benchmark yields fell back by around 20 basis points (see Chart 1). Between 1 May and 16 July, US equity prices increased by more than 6%, but they fell back at the end of July.(1)

In the final release of GDP growth for the first quarter, output grew by 1.1%, with strong growth in consumption and investment partly offset by a fall in exports and strong growth in imports. But according to advance estimates, GDP growth slowed to 0.6% in the second quarter. The slowdown reflected a fall in government expenditure, slower growth in consumption, and a lower level of stockbuilding. However, investment continued to grow strongly and, although net trade made a negative contribution to growth, exports increased on the quarter, and import growth slowed.

Private consumption growth slowed from 1.6% in 1999 Q1 to 1.0% in 1999 Q2. This reflects a return to more normal levels of growth, but also possibly a response to lower growth in personal disposable income. Nevertheless, consumption still grew faster than income, and the measured saving rate continued to fall. The saving rate has been on a downward trend since 1993, but has fallen particularly sharply in recent years. This probably reflects increases in household wealth, owing partly to the strength of equity prices but also to increases in house prices. (Annual house price inflation has been around 5% in the last two years, compared with just under 3% on average between 1990 and 1996.) One possible indication that the strength in the housing market has supported consumption is the increase in remortgaging, which rose from 30% of total new mortgages in 1996 and 1997, to more than 50% last year. This reflects households refinancing their mortgages at lower interest rates, and possibly greater equity withdrawal. Either explanation would imply that more household resources are available for consumption.

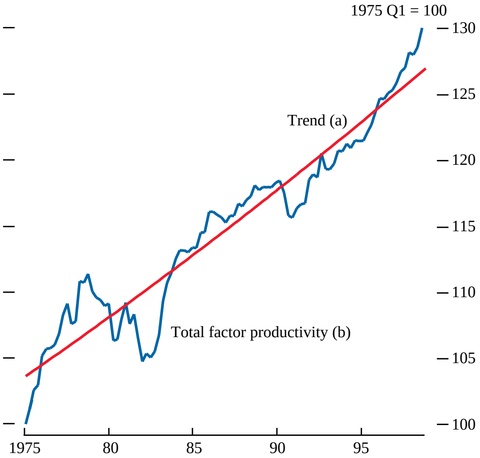
Investment continued to grow strongly in the second quarter. Most categories showed strong growth, but expenditure on information technology grew particularly strongly: for example private fixed investment in computers and peripheral equipment grew by 9.1%.

The level of exports has been somewhat erratic, with a small increase in exports in the second quarter following a fall in exports in the first quarter. The general weakness in export growth reflects the strength of the US dollar and weak growth in domestic demand in the United States' main trading partners. In contrast, US imports have continued to grow strongly, reflecting the strong growth in US domestic demand. As a result, the US current account deficit was 3.1% of GDP in 1999 Q1, and trade data suggest that the deficit widened further in the second quarter.

In the 1980s, the US government ran a significant financial deficit, which was the counterpart to the trade deficit. But Chart 2 shows how US financial balances have changed over the 1990s. The government financial balance has moved into surplus in recent years, as a result of expenditure restraint by the government and cyclical influences, which have boosted tax revenues and reduced some government expenditure. By contrast, the private sector has moved into deficit, reflecting the falling household saving ratio and strong private investment growth relative to profits. According to

(1) See the 'Markets and operations' article on pages 237–52 for further discussion of financial developments.

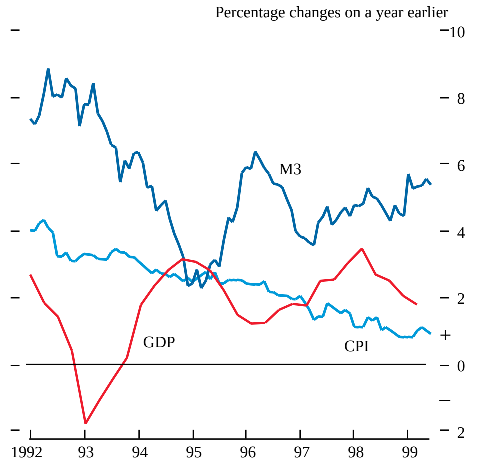
Chart 5
US total factor productivity



(a) Estimated by regressing productivity on time trend.
(b) Output growth not explained by changes in labour or capital.

Chart 6
Euro effective exchange rate

Chart 7
Euro-area GDP, CPI and M3



IMF figures, the whole-economy aggregate financial deficit was 2.1% of GDP in 1998, and this was the counterpart to the US current account deficit.

Throughout 1998, US CPI annual inflation was around 1.5%, but it has risen to 2.0% in recent months, reflecting increases in oil prices. Core inflation (excluding energy and food) has continued to be on a flat or downward trend (see Chart 3), and has been below 2.5% since May 1997. The continued low inflation after such a protracted period of growth can be explained partly by the continued strength of the dollar depressing the price of imported goods. But it also reflects weak earnings growth and continued strong productivity growth, which has held down unit labour costs. Employment costs grew quite strongly in the second quarter, by 1.1%, but annual growth remained subdued.

Productivity has grown strongly in recent years, especially relative to the same stage of past upswings (see Chart 4). In the 1970s and especially the 1980s, productivity grew strongly at the start of the upswing, but then flattened off. In the current cycle, by contrast, productivity growth has been almost as high in the first quarter of this year as it was at the start of the upturn.

Chart 5 compares total factor productivity (the change in output not explained by growth in labour input and the capital stock) with our estimate of a simple linear trend. The chart suggests that for much of the 1990s, the level of productivity has been below its long-run trend. But in the last two years, the productivity level appears to have moved slightly above trend. This might suggest that productivity growth could moderate from its current high levels, particularly as the economy slows down. But it is also possible that supply-side developments—for example related to information technology—have increased the potential level, or growth rate, of productivity.

Growth in the euro area appeared to have strengthened in the first quarter, after slowing throughout last year. Euro-area inflation remained at low levels, and the European Central Bank left interest rates unchanged, though noted some potential for upward pressure on prices in the future.

The euro effective exchange rate has fallen substantially since its launch in January 1999. It continued to fall in May, but was more stable from early June and picked up somewhat in July (see Chart 6). The fall in the exchange rate in May appeared to reflect rising uncertainty about prospects for growth in the euro area relative to the United States, and possibly market reaction to the revised fiscal deficit for Italy. In July, stronger survey data caused markets to revise up their forecasts for growth in the euro area, which partly explained the increases in the euro effective exchange rate. Ten-year bond yields in the euro area increased by around 90 basis points between 1 May and 30 July. This reflected developments in US interest rates in May and June, but in July euro-area yields increased relative to US yields, perhaps owing to stronger output data in Germany and France. Equity prices in Germany fell by 6% between 1 May and 30 July, and by 2% in France.

Since April, the European Central Bank (ECB) has left interest rates unchanged. The annual growth of M3 increased slightly over the

Chart 8
Contributions to euro-area GDP growth

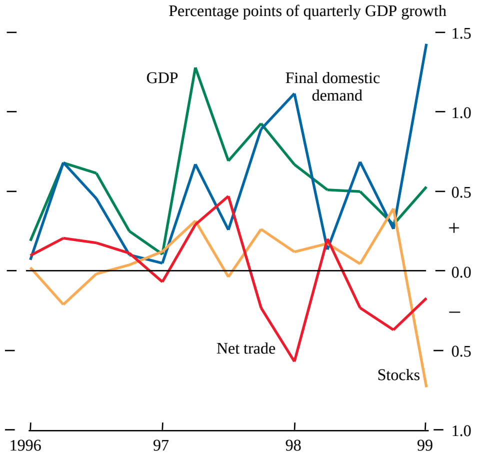
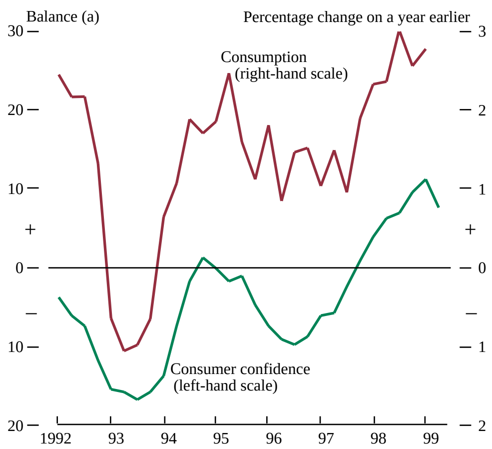
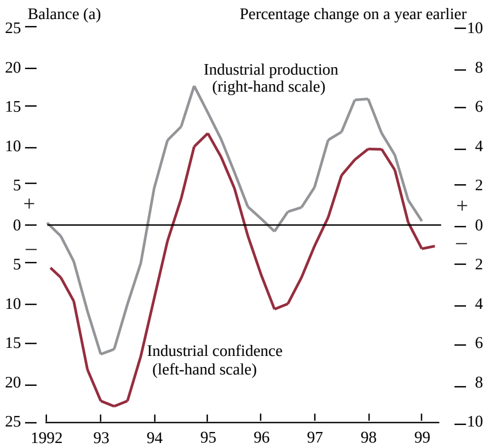


Chart 9
Euro-area consumption and consumer confidence



(a) Deviation from mean, calculated since 1985.

Chart 10
Euro-area industrial production and industrial confidence



(a) Deviation from mean, calculated since 1985.

period (see Chart 7), and was above the ECB's reference value of 4.5%. But euro-area inflation remained close to 1%, with increases in oil prices offset by lower inflation in other goods and services prices. Euro-area GDP increased by 0.5% in the first quarter of 1999, after growing by 0.3% in the fourth quarter of last year, suggesting that output growth may have stabilised after slowing during 1998. The annual growth rate of GDP continued to fall (see Chart 7). In July the ECB stated that the outlook for price stability was 'favourable', but 'upward pressures on prices will have to be monitored very carefully', given signs that output growth and consumer credit have started to pick up.

The latest measures of euro-area GDP reflect the new European System of National Accounts (ESA95) for most countries. The new system includes intangibles in investment, uses basic prices rather than factor cost valuation, and deflates the current price data using 1995 prices. The changes have meant relatively small amendments to estimated growth in Italy and France, but larger downward revisions (of 0.5 percentage points) to growth in Germany since 1996.

Chart 8 shows how the main components of euro-area GDP have contributed to quarterly growth in recent years. According to preliminary estimates, final domestic demand grew strongly in the first quarter of this year, particularly in Germany. Growth in household consumption was 1.2% in the first quarter, its strongest growth since 1991 Q4, and investment also grew strongly. The strong growth in final domestic demand in the first quarter was offset by a sharp fall in stockbuilding (again particularly in Germany). But estimates of stockbuilding are prone to large revisions, because it acts as the residual between measures of expenditure growth and output growth in preliminary estimates of GDP. So the picture of actual stockbuilding in 1998 and 1999 is still unclear.

Net trade continued to make a negative contribution to GDP growth in the first quarter. Export volumes were virtually flat, but import growth increased by 0.5%, reflecting stronger growth in domestic demand. As a result, the euro-area current account surplus fell from 1.2% of GDP in 1998 Q4, to 0.6% in 1999 Q1.

Charts 9 and 10 compare the European Commission surveys of business and consumer confidence with measures of actual manufacturing output and consumption. Both survey indicators are correlated with the actual measure of activity. Consumer optimism fell back in the second quarter, but remained at historically high levels, suggesting continued strong growth in consumption in 1999 Q2. Industrial confidence stabilised in 1999 Q2 after falling throughout 1998. Within the quarter, the monthly data increased consistently between April and June, possibly signalling a turning-point in business sentiment. There were also significant increases in the French and German measures of business confidence in June. This may suggest that growth in industrial production in the euro area has started to increase.

The stronger euro-area growth in the first quarter is attributable to higher growth in Germany and Italy. Growth fell slightly in France and was unchanged, in aggregate, in the rest of the euro area (see Chart 11). Nevertheless, the pattern of growth within the euro area continued, with somewhat weaker growth in the three largest

Chart 11
Euro participants' GDP

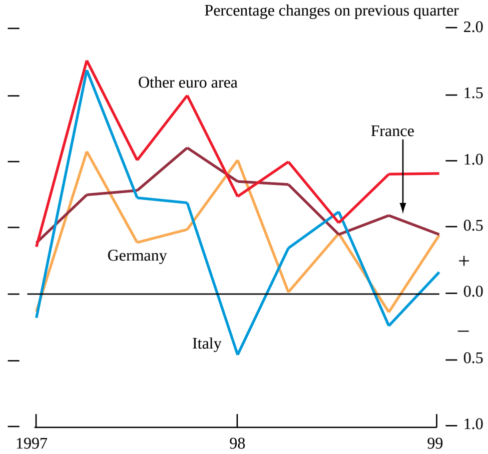


Chart 12
Nikkei 225 index

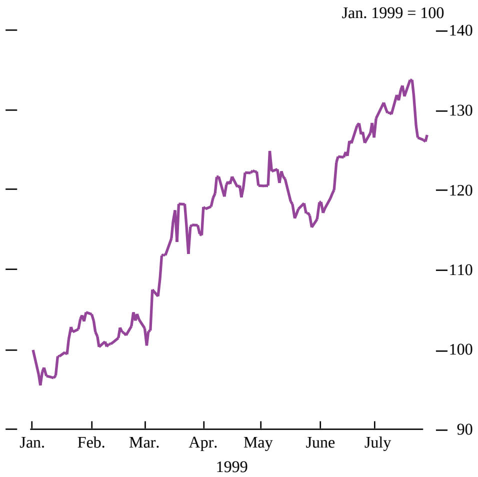
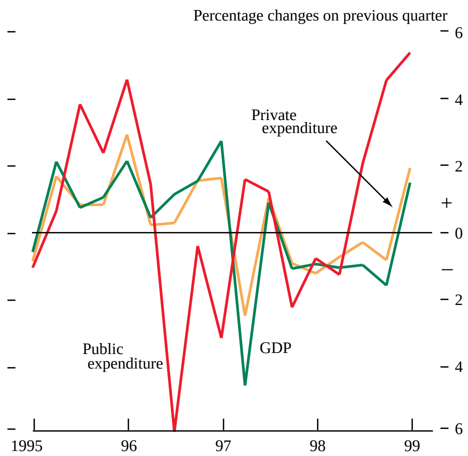


Chart 13
Japanese GDP



economies than in the rest of the euro area. Differentials in inflation rates persisted within the euro area, largely reflecting the level of output relative to potential in different member countries. Annual inflation in Spain, Ireland, the Netherlands and Portugal has been around 2% in recent months. Inflation in Austria, Germany and France has been closer to 0.5%, and other euro participants, including Italy, have had inflation of close to 1%.

Italy and Germany both announced plans for their fiscal budgets in 2000. The Italian government announced that, while its fiscal deficit in 1999 would be 2.4% of GDP (up from 2.0% in the stability programme), the government would take sufficient measures to ensure that the deficit fell to 1.5% of GDP in 2000. The German government stated that as a result of planned cuts in expenditure, it envisaged that its fiscal deficit would also fall to 1.5% of GDP in 2000, compared with its January 1999 stability programme forecast of a deficit of 2% of GDP.

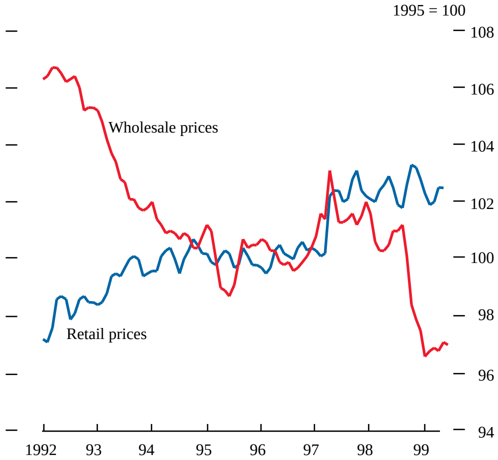
In Japan, measured GDP grew by 1.9% in the first quarter, after six quarters of falling output. This increase may reflect one-off factors, and the impact of the recent fiscal stimulus.

In Japan, the preliminary estimate of first-quarter real GDP growth showed that the economy grew at 1.9%, following six quarters of falling output (see Chart 13). This was considerably higher than expected; for example, the Consensus Economics survey of forecasts, published shortly before the data were released, suggested that the average forecast was for a 0.2% rise.

The Japanese Nikkei 225 stock market index increased by 6.9% between 1 May and 30 July (see Chart 12), with particularly strong increases following the release of first-quarter GDP data, and the US Federal Open Market Committee announcement of a return to a neutral stance on interest rates, which appeared to lift market confidence in most major economies. Equity prices fell by almost 6% at the end of July, but then recovered somewhat. There was upward pressure on the yen exchange rate in June and July, and the Japanese authorities intervened to hold down the value of the yen on several occasions. The yen/dollar exchange rate varied between ¥115 and ¥124 over the period; the rate showed no clear trend in May and June, but increased somewhat in July. Japanese overnight rates have remained close to zero, and yields on short-term instruments have also fallen towards zero, as the Bank of Japan has maintained its stance of keeping the overnight rate near to zero. However, Japanese longer-term bond yields have increased by about 30 basis points since the end of May, possibly relating to markets believing that a further fiscal stimulus package is more likely.

The strong upturn in first-quarter GDP growth was driven in part by a large increase in growth in private domestic demand (see Chart 13), with private consumption up by 1.2% and non-residential investment up by 2.5%. Both series had fallen throughout 1998. Private consumption was supported by stronger household income and the government's issue of free shopping vouchers. There were also reports of strong growth in sales of automobiles. Private investment was supported by the government's latest credit guarantee scheme, which appears to have enabled small firms to implement previously deferred investment. The fiscal package continued to boost GDP, with public investment up by 10.3% in 1999 Q1.

Chart 14
Japanese price level(a)



(a) Not seasonally adjusted.

Chart 15
Japanese GDP, retail sales and manufacturing output

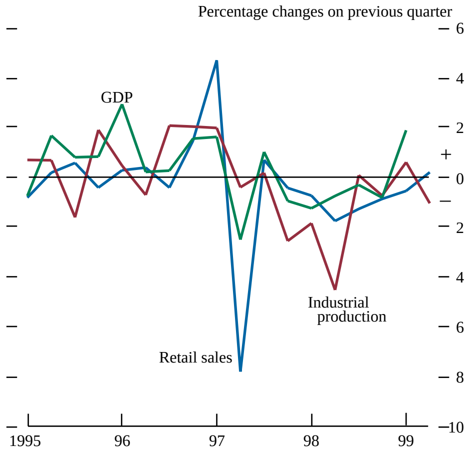
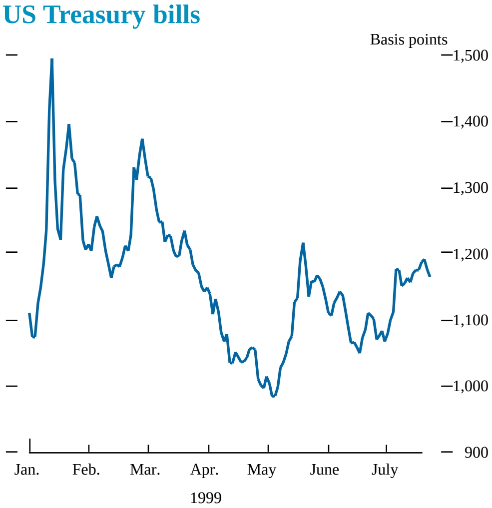


Chart 16
Emerging markets sovereign spread over US Treasury bills



Source: J P Morgan (EMBI+).

Net trade made a negative contribution to growth in the first quarter, owing to a strong pick-up in imports (up by 1.8%), which was consistent with strong growth in private sector demand. As a result, Japan's current account surplus fell sharply in the first quarter. However, monthly trade data suggest that the decline in the trade surplus is likely to be considerably smaller in the second quarter.

Despite the strong growth in recorded output in Q1, employment continued to fall, down in June by 1.3% on the previous year. Unemployment increased to 4.9% in June, after an erratic fall in May. On 11 June, the Japanese government announced a ¥520 billion (0.1% of annual GDP) emergency employment package intended to place more than 700,000 unemployed in jobs. The package consists of job subsidies for private companies that take on unemployed workers, and the creation of temporary jobs in the public sector.

Manufacturing unit labour costs remained flat, growing at 0.1% in April, with little growth in either wages or productivity. Japanese annual retail price inflation has been negative since February, and was -0.4% in May. Wholesale price deflation was stronger, with the June figure down 4% on the previous year. But this reflects a sharp fall in wholesale prices towards the end of 1998. So far this year, wholesale prices have been relatively stable (see Chart 14).

The strong estimate of GDP growth in the first quarter does not necessarily indicate that growth will continue to be strong. Growth may have been affected by seasonal factors, particularly a rush to spend budgets before 31 March, the end of the Japanese financial year. The Bank of Japan interpreted the growth in GDP as a sign that the 'economy had stopped deteriorating', but 'the prospect of a self-sustained economic recovery remained unclear'.

Chart 15 shows that the quarterly growth rates of retail sales and industrial production have shown some correlation with GDP growth. Industrial production growth picked up quite strongly in the first quarter, but retail sales fell on the quarter despite the estimated strength of total private expenditure. In 1999 Q2, industrial production fell back and retail sales were flat. The June Tankan survey, which reported business sentiment in the second quarter, showed an improvement, but the balance of sentiment was still at a low level. Firms also reported that employment and inventory levels continued to be too high, suggesting that employment might continue to fall in the coming months. However, firms did report that their financial situation was starting to improve, which should help to stabilise the economy.

Bond spreads in emerging markets increased by 200 basis points in May, but equity prices increased strongly in some economies, as economic data suggested that growth was starting to increase. In general, commodity prices stopped falling, and oil prices continued to increase.

The spread between emerging market bond yields and US Treasury yields rose by more than 200 basis points in May (see Chart 16). The sharp increase in spreads reflected higher market expectations of US interest rates, in response to announcements by the US Federal Reserve and stronger US data. Markets perceived that higher US interest rates might reduce economic growth in those economies with strong economic links to the United States, and

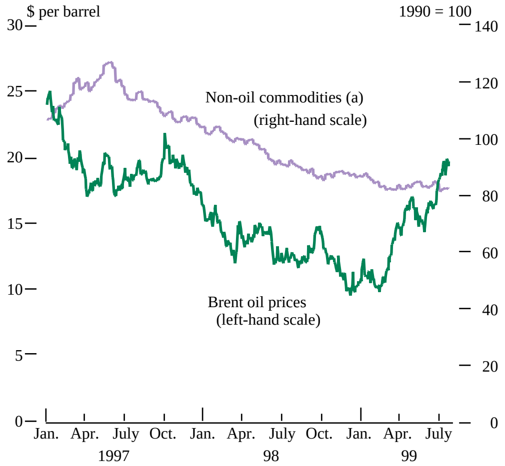
Consensus Forecasts of GDP growth in 1999

	April	Latest (a)	Change
Latin America (b)	-1.0	-0.5	0.5
Eastern Europe (c)	-0.9	-0.3	0.6
North East Asia (d)	4.7	5.7	1.0
South East Asia (e)	-0.8	1.3	2.1
Other developing countries (f)	0.8	2.2	1.4

Source: Consensus Economics.

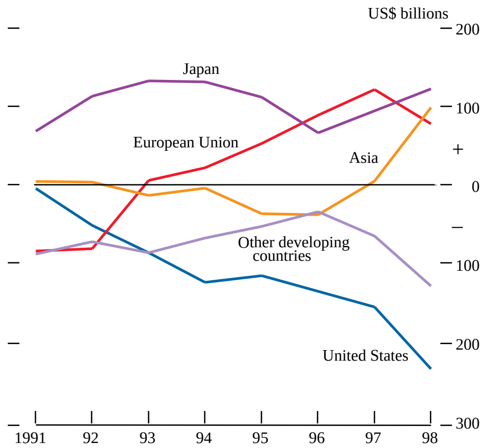
(a) July, except Latin America surveyed in June.
(b) 14 countries including Argentina, Brazil and Mexico.
(c) 19 countries including Russia, Poland and Turkey.
(d) China, Hong Kong, South Korea and Taiwan.
(e) Indonesia, Malaysia, Singapore, Thailand and the Philippines.
(f) Egypt, Israel, Nigeria, Saudi Arabia and South Africa.

Chart 17
Oil and commodity prices



(a) The *Economist* dollar index.

Chart 18
Current account balances



Source: IMF.

might also put downward pressure on emerging market currencies relative to the US dollar. Spreads fell back in June, but concerns about a possible Argentinian devaluation pushed Latin America spreads back up in July.

Despite the increase in emerging market bond yields, equity prices and currencies strengthened in Asia, as economic data continued to suggest that recovery was under way. In Brazil the financial situation appeared to have stabilised, with little change in the exchange rate or equity prices. However, there has been some market speculation that the perceived fiscal difficulties in Argentina might threaten their currency board, and Argentinian equity prices have fallen by almost 20% since the May *Quarterly Bulletin*.

In general, private sector forecasts of GDP growth in emerging markets have been revised up in recent months (see the table). There have been particularly strong upward revisions to growth forecasts in most Asian economies, in response to stronger-than-expected output data. Revisions to forecasts of growth in Latin America have been more mixed. Forecasts of growth in eastern Europe have been revised up, reflecting some indications that the situation in Russia is at least stabilising.

Conditions have started to improve for most commodity-producing economies. After the sharp increase over the first quarter of 1999, the oil price slipped back in May but then increased again in June and July (see Chart 17). On 30 July, the price of Brent oil was $20.10 per barrel, up by more than 15% since the previous *Quarterly Bulletin*. The continued increase in oil prices appears to be the result of improving prospects for world demand and, more crucially, the successful reduction in oil supply by OPEC agreed in March. In dollar terms, most metal prices increased over the quarter, while food prices continued to fall, leaving the *Economist* non-oil commodity price index broadly flat since April (see Chart 17). In sterling terms, commodity prices are now slightly higher than they were a year ago.(1)

The US current account deficit has continued to increase, and the current account surpluses of Japan and the rest of Asia remain high. The increase in the US deficit partly reflects lagged effects of the Asian crisis, but is also the result of cyclical divergence between the major industrial economies.

This section considers how the current account positions of different regions of the world have changed in recent years.

As Chart 18 shows, current accounts in 1998 were in greater imbalance than in any other year this decade. The US deficit increased throughout the 1990s, from 0.1% of GDP in 1991 to 2.7% in 1998. Over the same period, the European Union moved from deficit to surplus, while Japan had a current account surplus throughout the decade of between 1.4% and 3.2% of GDP. In aggregate, other developing countries (principally Latin America) ran current account deficits in the 1990s, which increased in 1998, but have since started to fall.

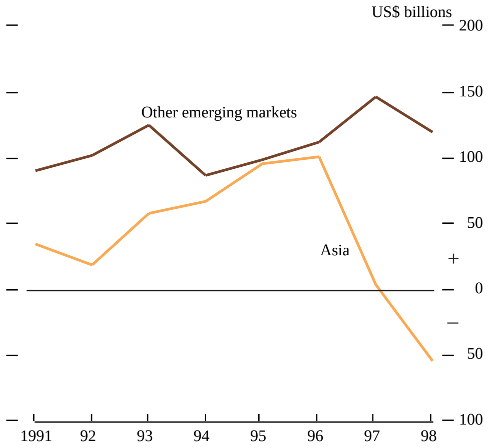
Chart 18 also shows the sharp move from current account deficit to surplus by the Asian emerging market economies between 1996

(1) For a fuller discussion, see Chapter 4 of the August 1999 *Inflation Report*.

and 1998, as a result of the emerging market crises. This was the counterpart to the sharp reversal of investor funds into Asian economies. In 1996, emerging Asia received a net inflow of $100 billion in inward investment. By 1998 there was a $50 billion net outflow (see Chart 19). The sharp turnaround in Asian current accounts was almost entirely associated with a reduction in domestic demand, which caused import volumes to fall sharply. The dollar value of exports was little changed, with a sharp increase in volumes mostly offset by lower dollar-denominated export prices, following the sharp currency depreciations. The monthly profile of Asian current accounts suggests that this correction was completed in mid 1998, with little change in current account surpluses since then.

Although the Asian crisis caused yield spreads to increase in most emerging markets, the net flow of funds to other emerging markets (predominantly Latin American countries) remained positive (see Chart 19). At the beginning of 1999, however, investor confidence in Brazil and other Latin American countries weakened, but the effect on capital flows does not appear to have been as large as for the Asian economies. The IMF's latest estimate is that net capital flows to Latin America will remain positive in 1999, but will be around $30 billion below their level in 1998.

Chart 19
Net capital flows to emerging markets

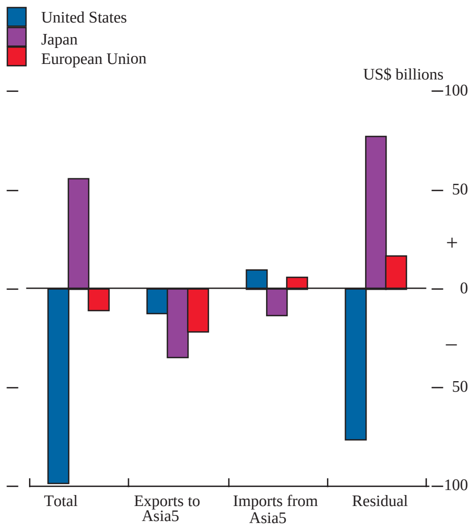


Source: IMF.

In the June 1999 *Economic Outlook*, the OECD identifies changes in current accounts due to direct trade with the Asia5 (South Korea, Thailand, Malaysia, Indonesia, and the Philippines). Chart 20 shows that exports to the Asia5 from the United States, Japan and the European Union fell strongly, but Japanese exports fell the most, as Japan exports more than the United States and European Union to the Asia5. The value of exports from the Asia5 to the United States and the European Union increased somewhat, but exports to Japan fell, owing to falling domestic demand during much of 1997 and 1998.

The large residual category in Chart 20 can be attributed partly to indirect effects from the Asian crisis, such as intensified competition in third markets. But the OECD argues that the bulk of the residual relates to cyclical divergence between the major economies (particularly the strong growth in the United States and recession in Japan), differences in saving preferences between the major economies, and possible misalignment of exchange rates.

Chart 20
Changes in current account 1996–98



Source: OECD.

Many forecasters project that current account imbalances among the major economies are unlikely to diminish in the short run. The IMF highlights two risks relating to these imbalances. The persistent US current account deficit has meant that US external debt has risen sharply, from 7% of GDP in 1989 to almost 20% of GDP in 1999. There is a risk that external demand for US assets could fall, causing a correction in the dollar exchange rate and in US asset prices, which could lead to a sharp reduction in US growth. There is also a risk that the counterpart to the current account deficit—a move into financial deficit by the private sector—makes the US economy more vulnerable to shifts in private sector sentiment. But the IMF notes that the US fiscal surplus gives some room for counter-cyclical fiscal policy, if GDP growth were to fall sharply.

Summary

Overall, data released since the previous *Quarterly Bulletin* suggest a further improvement in the outlook for the world economy. In the United States, growth slowed somewhat in the second quarter, after above-trend growth in the first quarter. So far, there has been little indication of upward pressure on inflation. The Federal Open Market Committee raised the target federal funds rate by $^1/_4$% on 30 June, and announced that it had reverted to a neutral monetary stance. In the euro area, growth appeared to be strengthening in the first quarter, after slowing throughout last year. Survey indicators suggest a further pick-up in growth in the second quarter. In Japan, measured output grew very strongly in the first quarter, probably reflecting one-off factors and the impact of the recent fiscal stimulus. As yet, however, there are fewer signs of a sustainable, broadly based recovery in private demand. In most emerging markets, output growth has been stronger than expected, and forecasts for growth were revised up.