The international environment

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

- *Domestic demand growth remained strong in the United States, and with continued tightness in labour markets, the Federal funds target rate was increased by $^1/_4$% to 5$^1/_4$% in late August.*

- *Growth in the euro area remained moderate in the second quarter, but survey evidence suggests that growth may have increased in the third quarter.*

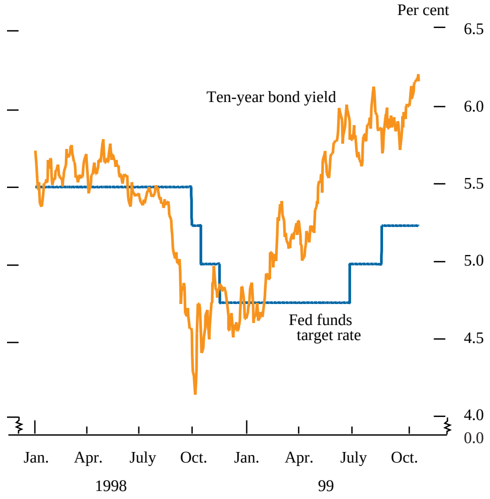
- *In Japan, there was further evidence of a recovery in output in the second quarter. But with declining business investment and the possibility of further falls in employment, the recovery remains fragile.*

- *Current account imbalances between the major economies increased further in the second quarter.*

- *World trade growth appears to be increasing, partly in response to continued recovery in many emerging market economies.*

- *Sharp increases in oil prices put upward pressure on the major economies' import prices. But consumer price inflation remained subdued.*

Chart 1
US interest rates



Overview

World GDP growth slowed to 2.5% last year, from 4.2% in 1997, but forecasters generally expect growth to increase, with the latest IMF *World Economic Outlook* forecasting growth of 3% this year and 3.5% next year. Consequently, growth in the 1990s is likely to average about 3% per year, compared with 3.5% in the 1980s and 4.5% in the 1970s.

World growth in the second half of the 1990s has depended, to a large extent, upon the US economy. But a more balanced pattern of growth has emerged in recent months. There has been more evidence of a recovery in a number of emerging markets, particularly in Asia, a largely unexpected pick-up in Japan, and evidence that growth is increasing in the euro area. In the United States, growth slowed in the second quarter but increased in the third quarter. However, the current account imbalances between the major economies that resulted from sustained divergences in growth persist.

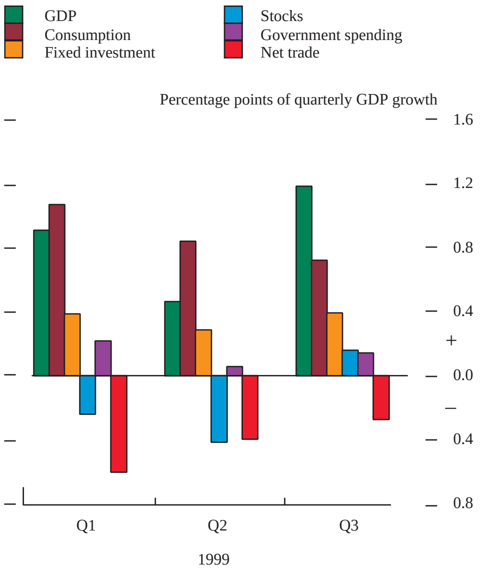
One consequence of the contraction in demand in many emerging market economies over the last two years has been falling commodity and trade prices. There are signs that these deflationary forces are abating, most notably the strong rise in oil prices since the beginning of this year, but also the increase in industrial commodity prices. So far, consumer price inflation has been muted in most countries. Nevertheless, signs of emerging inflationary pressures will need to be watched carefully.

(1) Based on data up to 28 October 1999.

Domestic demand growth remained strong in the United States, and with continued tightness in labour markets, the Federal funds target rate was increased by 1/4% to 5 1/4% in late August.

The Federal Open Market Committee (FOMC) increased the Federal funds target rate by 1/4 percentage point to 5 1/4% on 24 August (see Chart 1). In support of this increase it cited 'financial markets functioning more normally,…persistent strength in domestic demand, foreign economies firming and labour markets remaining very tight'. It also said that the increase in the Federal funds target rate, combined with previous monetary tightening and improved financial conditions more generally, 'should markedly diminish the risk of rising inflation going forward'. Subsequently, the rate was left unchanged on 5 October, but the FOMC announced a 'bias toward a possible firming of policy going forward', citing the risk of higher labour cost pressures, given the continued tightness of the labour market. But the Committee also emphasised that 'such a directive did not signify a commitment to near-term action'.

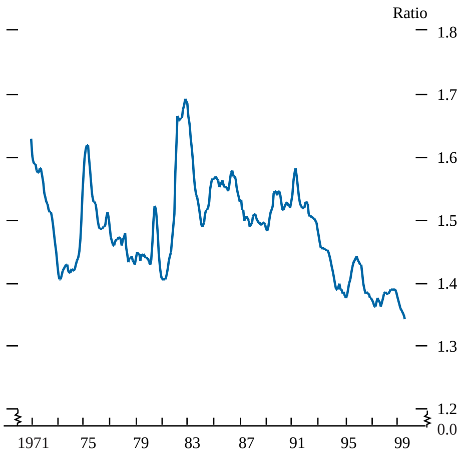
Chart 2
Contributions to US GDP



In financial markets, perhaps the most significant development between 1 August and 28 October was the 9% appreciation of the yen against the dollar (see the section on Japan for more details). The dollar appreciated by about 2% against the euro. Ten-year bond yields increased by almost 30 basis points (see Chart 1). Equity prices increased in August, but then fell back. For example, the Dow Jones index increased by more than 6% up to 25 August, but then fell back by around 8% by 28 October, partly reflecting higher expectations for interest rates.[1]

GDP growth increased to 1.2% in the third quarter of 1999, after slowing in the first two quarters. Chart 2 shows the contributions to growth from different expenditure components. Consumption slowed in the first three quarters, but continued to grow strongly (by 1.1% in the third quarter). With growth in real personal disposable income of 0.6%, the personal savings rate fell further. Fixed investment remained strong, reflecting continued increases in expenditure on equipment and software. Net trade made a smaller negative contribution to growth in the third quarter than in the previous two quarters because of increasing growth in exports (import growth also increased slightly). The increase in export growth may partly reflect the weaker dollar, but it is more likely to relate to stronger external demand.

Chart 3
US ratio of business inventories to sales[(a)]



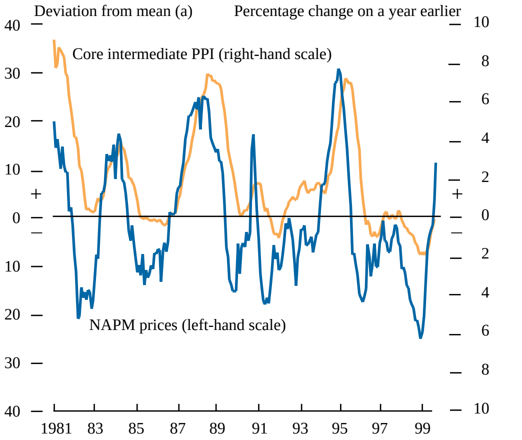
(a) Three-month moving average.

The main reason for the increase in GDP growth in the third quarter was the positive contribution from stockbuilding after a strongly negative contribution in the second quarter. The increase in stockbuilding may partly relate to preparations for the Millennium. (The September National Association of Purchasing Managers (NAPM) survey suggested that 38% of manufacturers intend to build up inventories ahead of the Millennium.) If this is the case, the growth in inventories could be lower in the new year.

Over the longer run, inventory levels have fallen relative to final sales during the 1990s (see Chart 3). This reflects the adoption of improved inventory management systems, related to continued improvement in information and communications technology. Federal Reserve Chairman Greenspan has suggested that these developments have increased the efficiency of distribution and

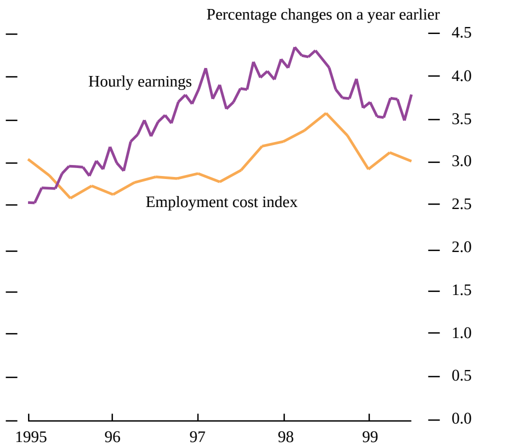
(1) See the *Markets and operations* article on pages 327–43 for more information on financial market developments.

Chart 4
US intermediate producer prices and NAPM price survey



(a) Mean calculated over period since 1980.

Chart 5
US earnings and employment costs



production and so 'apparently added to growth of multifactor productivity'.[1] The adoption of better stock systems may also have reduced the volatility of US output,[2] partly because it enables a better matching of supply to demand, and so reduces the need for large corrections in output levels. Moreover, it has reduced the level of stockbuilding relative to GDP, and stockbuilding is the most volatile expenditure component.

On 28 October, the US Bureau of Economic Analysis (BEA) released the 1999 comprehensive revisions of the national income and product accounts. These included some significant changes to the way US GDP is measured. The key changes include recognising business and government expenditure on software as investment, which has the effect of increasing measured GDP and the gross national savings rate. And there are various reclassifications which increase the level of personal saving and reduce government saving. As a result of all of the changes, the average measured growth rate of real GDP has increased by 0.2 percentage points between 1959 and 1992, and by 0.4 percentage points between 1992 and 1998. However, the profile of GDP growth was little changed in recent quarters. At the same time, average measured growth in GDP prices (which measure whole-economy price inflation) was reduced by 0.2 percentage points between 1959 and 1998.

The recovery in industrial production continued. The three-month on three-month growth rate of industrial production rose from near zero at the start of 1999 to 0.9% in September, despite a small fall in production in September because of Hurricane Floyd. NAPM survey data indicated that manufacturers' confidence had continued to improve, suggesting that growth in industrial production may remain strong in the months ahead.

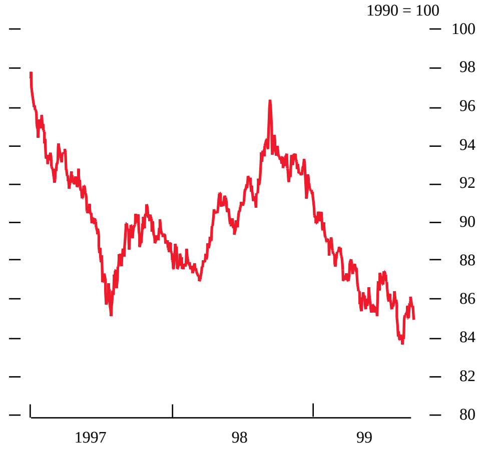
Headline consumer price inflation was 2.6% in September, up from 2.1% in July. But the increase in inflation was mainly attributable to further increases in energy prices. Core price inflation (which excludes energy and food prices) was 2.1% in September, little changed from 2.0% in July. Oil price inflation had a greater impact on producer output prices: annual inflation increased from 1.1% in April to 3.1% in September. Excluding energy and food, producer output price inflation was 1.7% in September, up from 1.3% in August. But this pick-up seems to be entirely attributable to a sharp increase in tobacco prices in September (up 8.8% on the month).

Further up the supply chain, deflationary pressures appear to be coming to an end. The twelve-month rate of growth of core intermediate producer prices (the prices paid for basic materials and semi-finished inputs, but excluding energy prices) increased from –1.8% in January to +0.3% in September. The NAPM survey of manufacturers showed that prices had increased strongly in September (see Chart 4). The survey question refers to manufacturers' input prices, and in the past it has been a good leading indicator of intermediate goods price inflation.

The labour market remained tight, with unemployment unchanged, at 4.2%, in September. Employment fell slightly in September

(1) 'The American economy in a world context', speech at the Federal Reserve Bank of Chicago on 6 May, 1999.
(2) See, for example, McConnell, Mosser and Quiros (September 1999), 'A decomposition of the increased stability of GDP growth', *Federal Reserve Bank of New York—Current Issues*.

Chart 6
Euro effective exchange rate



Source: Bank of England.

Chart 7
Contributions to euro-area GDP

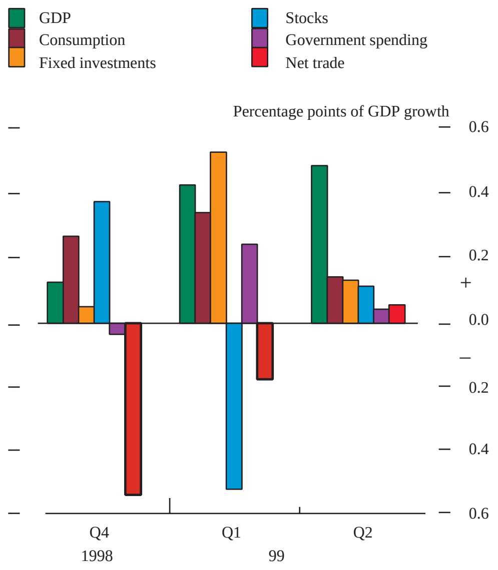
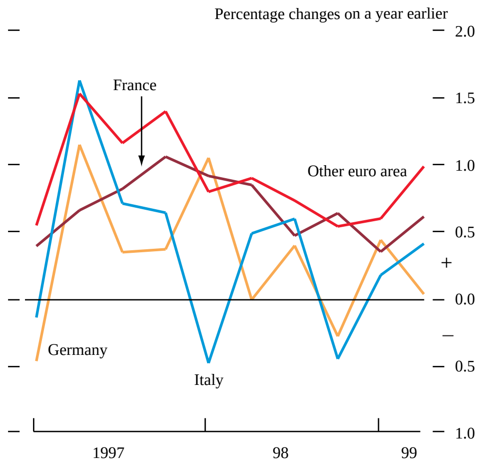


Chart 8
Euro-area GDP



after modest growth in August. The US Bureau of Labour Statistics attributed some of this slowdown to the effects of Hurricane Floyd, which disrupted some activities.

Despite low levels of unemployment, wage inflation remained subdued. Chart 5 compares the growth of hourly earnings with growth in the employment cost index (a broader measure of labour costs). Annual average hourly earnings growth was broadly flat, at 3.7%, in the first three quarters of 1999. Growth in the employment cost index has also been flat this year, at close to 3%. Employment costs have risen less than earnings because they include benefits which have grown less quickly than earnings.

Growth in the euro area remained moderate in the second quarter, but survey evidence suggests that growth may have increased in the third quarter.

The European Central Bank (ECB) left interest rates unchanged between August and October. Euro-area M3 increased at an average annual rate of 5.9% between July and September, compared with the ECB reference value of 4.5%. Growth in private sector credit also remained strong (up by 10.5% on a year earlier in September). Consumer price inflation, as measured by the harmonised index, increased slightly, to 1.2% in September, but was still consistent with price stability, defined by the ECB as below 2%. In September, the ECB commented that 'upward risks to price stability merit closer attention as monetary growth has been moving upwards from the reference value'.

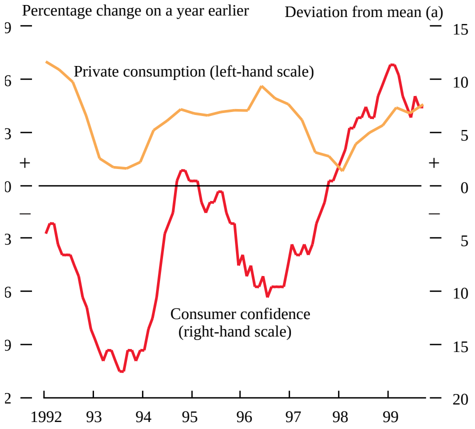
Between 1 August and 28 October, the euro effective exchange rate fell by 3%. It fell against the yen and, to a lesser extent, the dollar in August and September, but strengthened in October (see Chart 6). Ten-year bond yields continued to increase, and rose by more than 60 basis points over the same period. Equity prices also increased; for example the German Dax index increased by 5%, and the French CAC index increased by more than 7%.

Euro-area GDP increased by 0.5% in 1999 Q2, following growth of 0.4% in Q1. Growth in final domestic demand was considerably weaker in the second quarter than in the first, with lower growth in both private consumption and gross fixed capital formation. However, this was mostly offset by a slightly positive contribution from stockbuilding, after a strongly negative contribution in the first quarter (see Chart 7).

There was a sharp increase in trade in the second quarter, with exports and imports both growing by more than 2%. Exports grew slightly more than imports, so net trade made its first positive contribution to euro-area GDP since 1998 Q2. The growth in exports may reflect strengthening demand in Asia and the effects of the euro depreciation earlier this year. Survey data suggest that export growth may strengthen further in the second half of 1999.

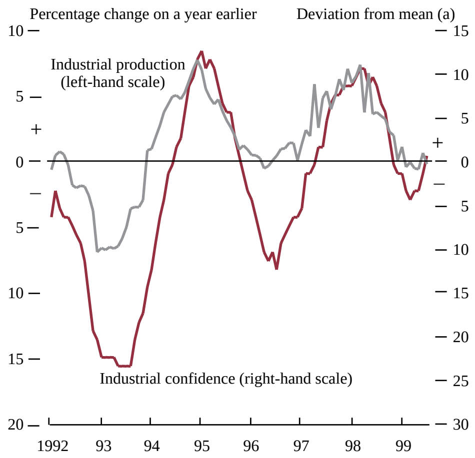
Chart 8 compares growth in the different euro-area economies. French and Italian growth picked up in the second quarter. Output in Germany was flat, after 0.4% growth in the first quarter. This may have been, at least partly, because mild weather, announced tax changes and the timing of holidays in Germany brought expenditure forward into Q1, at the expense of growth in Q2. Growth in the rest of the euro area increased to 1.0% in Q2, significantly above growth in the three largest euro-area economies.

Chart 9
Euro-area private consumption and consumer confidence



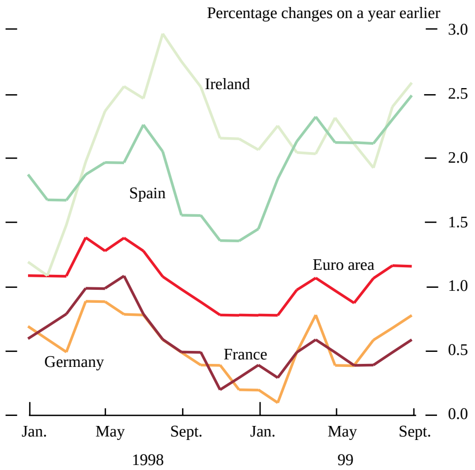
(a) Mean calculated over period since 1985.

Chart 10
Euro-area industrial production and industrial confidence



(a) Mean calculated over period since 1985.

Chart 11
Harmonised index of consumer prices



The European Commission (EC) survey of consumer confidence was broadly unchanged in the third quarter, remaining at historically high levels. But the survey data have shown only weak correlation with growth in euro-area consumption in the past (see Chart 9).

The level of industrial production in the euro area was broadly flat from March 1998 to July 1999. But there is evidence that growth may have resumed in the second half of this year. German industrial production grew by 2% between June and August, and German manufacturing orders in August were up 8.8% on a year earlier. The EC survey indicated that business confidence (which has shown strong correlation with euro-area industrial production) continued to rise in Q3, taking it back to its longer-run average level (see Chart 10).

In the three months to September, consumer price inflation remained subdued, with euro-area annual inflation of 1.2% on a harmonised basis in September. This was slightly higher than the average rate of 1.0% in 1999 Q2, largely reflecting sharp increases in oil prices. This upward pressure was partially offset by slowing food price inflation, as a result of good harvests. Excluding energy, food, alcohol and tobacco, annual price inflation was 0.9% in September—broadly unchanged from its rate in Q2.

Headline inflation increased in most euro-area countries in September. But it increased more in Ireland and Spain, countries which already had relatively high inflation (see Chart 11).

In the euro area as a whole, firms' costs showed positive annual inflation for the first time since April 1998. Industrial producer output prices (excluding construction) were 0.5% higher than a year earlier in August. However, this reflected the effect of higher oil prices on intermediate goods prices. Capital and consumer goods price inflation remained at 0%. The growth of labour costs was subdued, at 2.2% on a year earlier in Q2 compared with 2.3% in Q1. Labour costs grew at different rates in different countries, broadly in line with the inflation differentials mentioned above.

In Japan, there was further evidence of a recovery in output in the second quarter. But with declining business investment and the possibility of further falls in employment, the recovery remains fragile.

The Bank of Japan continued its policy of targeting a zero overnight interest rate between August and October (see Chart 12), but made some changes to operational policy. On 21 September, because 'monetary policy had attracted unusually high attention', the Bank issued a statement describing its policies. The statement explained that in order to achieve interest rates of virtually zero, the Bank was continually providing funds in excess of the required reserve, and that the majority of the excess funds had been accumulated by fund brokers rather than other financial and non-financial institutions. The Bank of Japan concluded that any further injections of liquidity were unlikely to influence interest rates, asset prices or the exchange rate.

The Bank of Japan's statement was followed by a series of operational changes on 13 October affecting the structure rather than the scale of its operations. The Bank announced that it would

Chart 12
Japanese interest rates

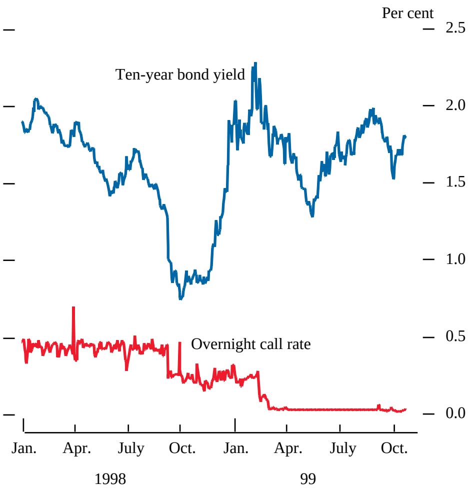


Chart 13
Japanese export prices and the exchange rate

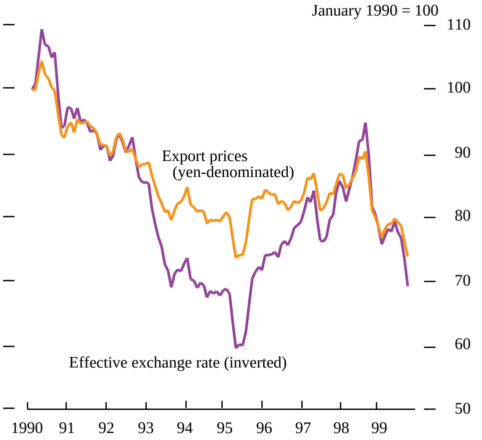
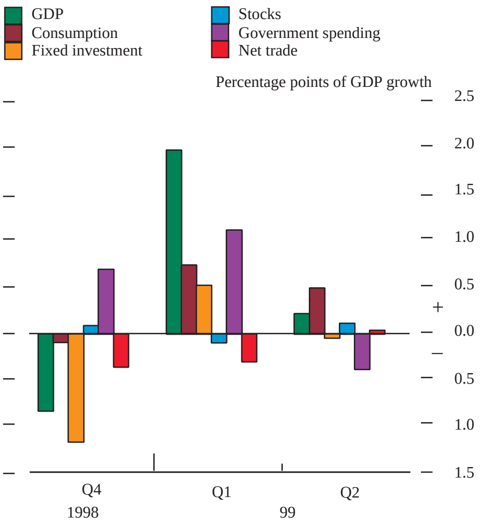


Chart 14
Contributions to Japanese GDP



conduct outright purchases of Treasury bills, and include two-year government bonds in its repo operations. There were a series of other measures related to Y2K issues.

The Bank also said that it ‘views the current state of the Japanese economy as having stopped deteriorating with some bright signs, though a clear and sustainable recovery of private demand has yet to be seen’. It added that it would continue a policy of ‘easy monetary policy for the periods ahead’.

Over the August-October period, expectations of Japanese short-term interest rates six months ahead, implied by futures contracts, fell by around 20 basis points. The profile of futures contract rates implies that the markets expect the Bank of Japan to continue a policy of virtually zero overnight interest rates until the second half of next year. The ten-year benchmark bond yield had been on an upward trend since May 1999, but fell from 2.0% on 25 August to 1.7% by 28 October (see Chart 12). Equity prices fell by 2.6% over the period, but had still risen by more than 30% since 1 January.

The yen exchange rate continued to appreciate. Between 1 August and 28 October, the effective exchange rate increased by more than 10%. The rise of the yen was fairly consistent against all major currencies and other Asian currencies.

It is unclear how much the appreciation of the yen is likely to depress growth in Japan. Japan is a relatively closed economy—both exports and imports make up about 10% of GDP. This is a similar proportion to the United States and the euro area, but much lower than the proportion of output typically traded by smaller economies. Furthermore, exporting firms have been able to offset some of the loss in competitiveness by reducing their yen-denominated export prices (see Chart 13). Since August 1998, the exchange rate has appreciated by 36%, while export prices have fallen by 18%.

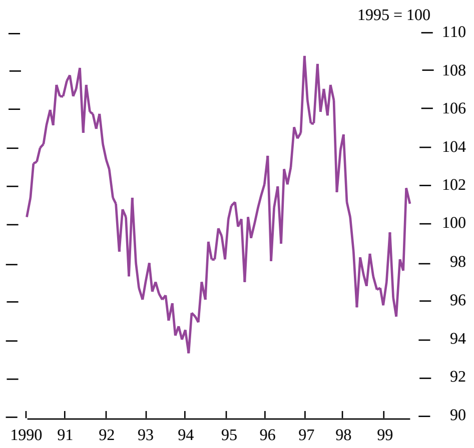
However, if Japanese exporters do not pass on the yen appreciation to their export prices, it will be at the expense of their profitability. Lower profitability might reduce growth in investment in the future and put downward pressure on equity prices, which would also depress growth in investment and consumption. And even if the yen appreciation does not reduce Japanese export volumes, it could cause import volumes to increase, at the expense of domestic production.

GDP grew by 0.2% in the second quarter, after 2.0% growth in the first quarter and four quarters of falling output in 1998. Chart 14 shows the contributions to GDP growth of different expenditure components. The stimulus to growth from government spending was very strong in 1999 Q1, but was negative in Q2. This may have reflected an unusual pattern of public expenditure around the end of the financial year (in March), and consequently a drop-off in expenditure in the second quarter. Public work starts declined in both July and August, suggesting that public expenditure is unlikely to make a significant contribution to growth in the second half of 1999. However, on 8 October, the government announced plans for a further fiscal package, which should support growth in 2000.

Private demand increased in the first half of 1999, compared with falling expenditure in 1998. Growth was weaker in the second quarter, but this partly reflected the unwinding of special factors. For example, in the first quarter there was a strong increase in car sales. There was also a large increase in investment by small firms, before the government's loan guarantee scheme ended. In the second quarter, although consumption growth was weaker (0.5% compared with 0.7% in Q1), it was reported to be more broadly based. Business investment fell in the second quarter, but this was mostly offset by continued strong growth in housing investment (up by 16.4%), which has been supported by very low interest rates and targeted fiscal measures.

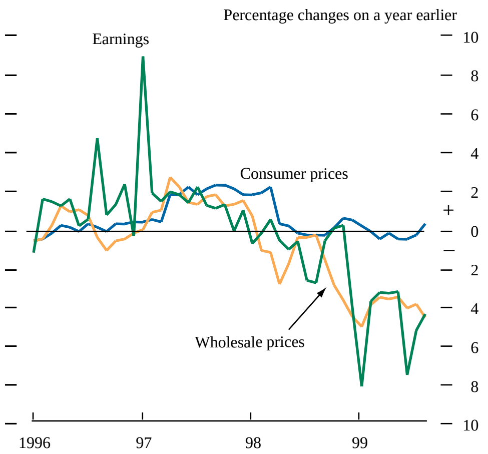
Net trade made a small positive contribution to growth in the second quarter, after two quarters of negative contributions. This partly reflected further recovery in demand in Asia.

Chart 15
Japanese industrial production



Developments in the third quarter have been broadly positive so far. Industrial production grew by 3.8% in Q3, the strongest rise since 1976 Q2. As Chart 15 shows, the level of production was still below output in 1997, but after broadly flat output from May 1998, there is increasing evidence of recovery. This was supported by the September Tankan survey which showed an improvement in business confidence in all sectors, although confidence remained low. Employment grew by 1% in August, largely in the construction sector, and the unemployment rate fell back (from 4.9% to 4.7%). The large increase in employment (+610,000) relative to the fall in unemployment (-130,000) suggests that inactivity also fell in August.

Chart 16
Japanese consumer prices, wholesale prices and earnings

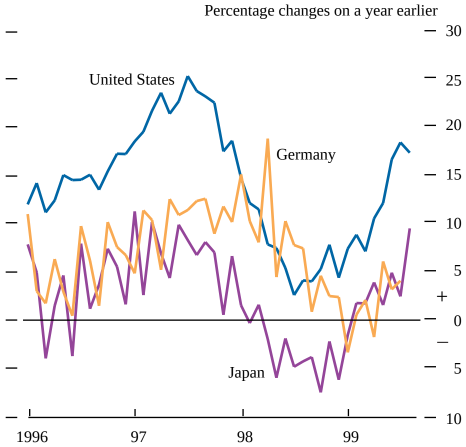


Nevertheless, some questions remain over whether the recovery in Japan will be sustained. As well as showing an increase in confidence, the September Tankan survey also showed that firms continued to expect to reduce employment, so it is not clear that the labour market has stopped deteriorating. Firms also still believed that inventory levels were too high, and that investment would continue to fall. Furthermore, the growth in consumption in the first half of this year corresponds to a lower savings ratio, given that income from employment declined over the period. Should Japanese households start increasing their savings rate, consumption might stop increasing and could even fall back. But this seems unlikely, at least in the short run, as consumer confidence increased slightly in Q3.

Japanese consumer price inflation was 0.4% in August compared with -0.2% in July. This reflected strong increases in prices of food, with other prices showing zero annual inflation on average. (The stronger oil price was offset by falling prices elsewhere.) Wholesale prices continued to show annual inflation of -4%, and earnings also fell by 4% on a year earlier (see Chart 16). Unemployment may continue to increase, perhaps putting further downward pressure on earnings. And the appreciation of the yen will also dampen any inflationary pressures from import prices.

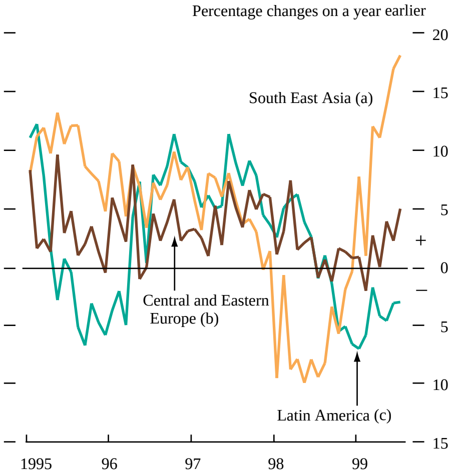
Current account imbalances between the major economies increased further in the second quarter. World trade growth appears to be increasing, partly in response to continued recovery in many emerging market economies.

Chart 17
Trade flows(a)



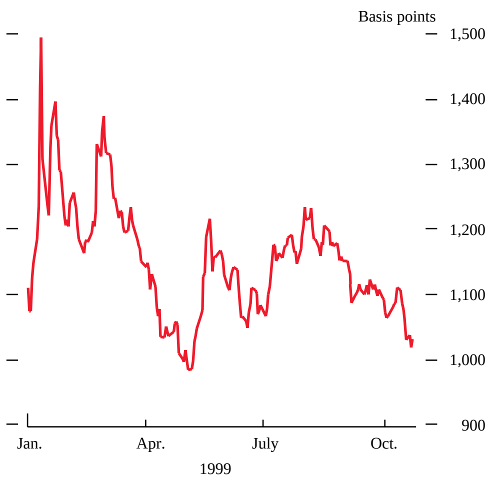
(a) Average of goods' import and export volumes.

Chart 18
Emerging market industrial production



(a) Korea, Malaysia, Singapore, Taiwan and Thailand.
(b) Czech Republic, Hungary, Poland and Russia.
(c) Argentina, Brazil, Colombia, Peru and Venezuela.

Chart 19
Emerging market sovereign spread over US Treasury bills



Source: J P Morgan (EMBI+).

Current account imbalances persisted in the second quarter of this year. The US deficit rose from 3.1% of GDP in Q1 to 3.6% in Q2, while the current account surplus rose in Japan (from 1.5% of GDP to 1.6%) and the euro area (from 0.8% to 1.0%). Monthly data suggest that the US deficit may have increased further in Q3. But the Japanese surplus appears to have fallen in the third quarter, owing to a decline in yen-denominated export prices.

Chart 17 shows the growth in trade (the average of imports and exports) for the United States, Japan and Germany. Despite very different growth rates in domestic demand, trade growth declined sharply for all three countries in the second half of 1997. (World trade growth is estimated to have slowed from 9.9% in 1997 to 3.6% in 1998.) This followed the collapse in domestic demand in some emerging markets as a result of financial crisis. However, growth in trade started increasing again in mid 1998 in Japan and the United States, and at the start of 1999 in Germany, suggesting that world trade may be starting to grow at more normal levels.

There has been a general improvement in the prospects for output in many emerging markets (see Chart 18), which is consistent with the increase in world trade growth. Industrial output in most South East Asian economies grew strongly in the second quarter of this year, as business confidence started to return. By July, the level of industrial output in most of these economies was above pre-recession levels. In the Central and Eastern European countries, after flat industrial production in the first quarter of this year, annual growth increased to about 5% in July. Industrial production in Latin America continued to fall, compared with output in the previous year. In Argentina the rate of decline in industrial production was unchanged (-12.5%), but the rate of decline in most other Latin America countries had started to moderate.

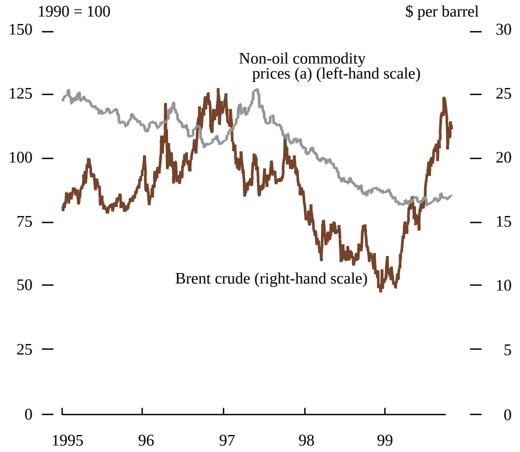
As a result of the improvements in the prospects for output, the IMF revised up their forecast for most developing economies in the October *World Economic Outlook*. For example, the forecast of GDP growth in developing countries in 1999 was revised up from 3.1% to 3.5%, with particularly large upward revisions to forecast growth in South East Asia, Brazil, and Russia. Private sector forecasts, as surveyed by Consensus Economics, were also generally revised up.

The average spread between emerging market bond yields and US Treasury yields fell during much of August and September, reflecting stronger evidence of recovery in many emerging markets. By 28 October, spreads were more than 100 basis points lower than at the start of August, indicating some reduction in financial markets' assessment of emerging market risk (see Chart 19). Nevertheless, in the third quarter, the volume of gross financial flows to emerging markets was less than half the volume in 1997, and showed little sign of increasing.

Sharp increases in oil prices put upward pressure on the major economies' import prices. But consumer price inflation has remained subdued.

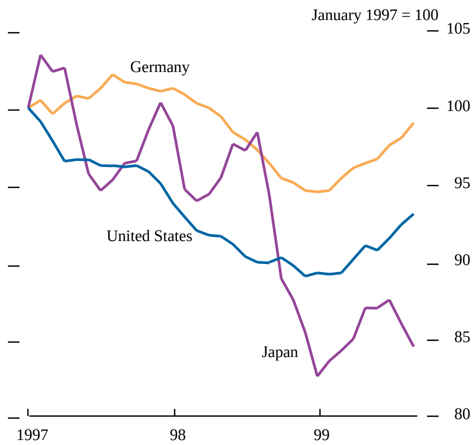
The price of oil continued to increase. On 28 October Brent crude was $21.66 per barrel, up by 13% since the previous *Quarterly Bulletin* (see Chart 20). The increase in oil prices can be attributed

Chart 20
Commodity prices



(a) Economist ($) index.

Chart 21
Major economies' import prices(a)



(a) Not seasonally adjusted.

to several factors: OPEC members' unexpectedly high compliance with the quotas agreed in March; low production by non-OPEC members as a result of low oil prices over the past few years; a stronger than expected bounce-back in demand from Asian countries; low and falling stocks of oil; and possibly a desire to increase stocks ahead of the Millennium. Some of these factors may have only a temporary effect on the oil price. On 28 October, oil futures suggested a price of $19.82 per barrel by April 2000.

After falling by around 30% since mid 1997, commodity prices in dollar terms increased 2.8% between 1 August and 28 October (see Chart 20). While food prices were unchanged overall, industrial commodity prices (mostly metals) increased by 4.8%, partly as a result of stronger demand in Asia following the strong recovery in industrial production.

The turnaround in oil prices, and to a lesser extent other commodity prices, has impacted on import prices to the major economies. Between January and September, import prices increased by 4.3% in the United States, 4.7% in Germany and 2.3% in Japan (although Japanese data may have been affected by seasonal factors). Throughout much of 1997 and 1998 the major economies enjoyed falling import prices (see Chart 21).

The IMF's October *World Economic Outlook* contained some analysis of the potential impact of higher oil prices on the world economy. They estimate that a sustained 10% increase in oil prices would increase CPI inflation in the major economies by between 0.1 and 0.2 percentage points, and reduce the level of GDP by 0.1 percentage points. However, Consensus Economics surveys showed little change in private sector forecasts of CPI inflation in the major economies between April and September, although the oil price increased by about 40% over that period.

The IMF's estimates suggest that a sustained 10% increase in oil prices would reduce the current account balances of advanced economies by around $13 billion in total. Reflecting this, the current account balances of Middle Eastern economies would increase by $7 billion, and the remainder would be divided between the African, Latin American and Eastern European oil producers. Although this could significantly change the current account balances of some developing countries, the magnitudes involved are small relative to, for example, the US current account deficit of around $300 billion and the Japanese surplus of $150 billion.