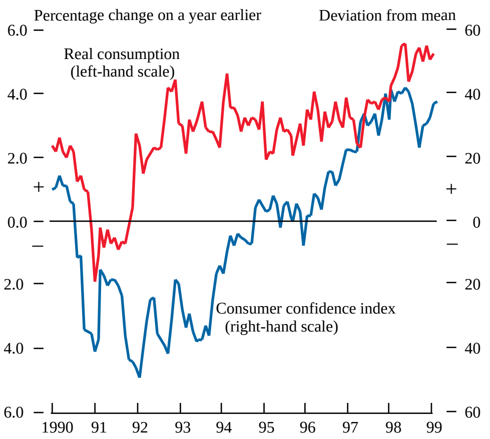
The international environment

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

- *Growth in the United States remained well above trend in the fourth quarter of 1998, and recent data suggest continued strength into 1999.*
- *Japan stayed in recession, with a sharp fall in GDP in the fourth quarter. The unemployment rate reached a record high in February. The March Tankan survey suggested that firms were less pessimistic about business conditions, but improvements in confidence may prove fragile.*
- *Euro-area GDP growth was on a downward trend throughout 1998. In Germany, GDP fell in Q4, but in France, the outturn was stronger. Growth in Italy continued to be low relative to France and Germany, as it has been since 1995.*
- *Inflation was broadly unchanged in the major industrialised countries in 1999 Q1.* OPEC *agreed oil-supply quotas on 23 March, and oil prices have risen to $16.80 dollars per barrel, an increase of more than 60% since 1 January.*
- *The Bank of Japan lowered the overnight call rate towards zero during February, and the European Central Bank cut its main refinancing rate by half a percentage point on 8 April. The Federal Reserve left US rates unchanged throughout the period.*
- *Output started to recover in a number of newly industrialised economies in Asia. The Brazilian authorities were able to reduce official interest rates without prompting large net capital outflows.*
- *Financial markets were calmer over the first quarter of 1999.*

Chart 1
US personal sector



Note: Mean calculated over period since 1989.

Source: The Conference Board.

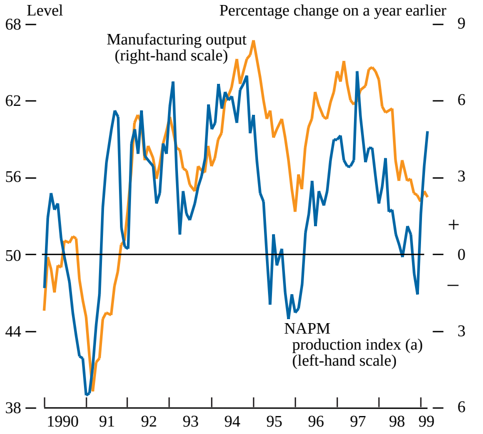
Robust consumption and a rebound in investment supported strong growth in the United States in 1998 Q4. Growth in the industrial sector may have stabilised, after declining throughout last year.

In the United States, output grew by 1.5% in the fourth quarter of last year, the highest quarterly growth rate since the middle of 1996. Growth for 1998 as a whole was unchanged from the previous year, at 3.9%. The outturn in the fourth quarter reflected continuing strong growth in domestic demand and the first positive contribution to growth from net trade for two years. But a number of special factors may have supported growth in the fourth quarter, including exports of large items, particularly aircraft, and stronger activity in construction due to mild weather. There was also a rebound in car production, following a strike earlier last year at a major producer.

Advance data for the first quarter indicate that GDP grew by 1.1%. Some of the factors supporting growth in Q4 did not persist. Net trade made a negative contribution, reflecting a fall in exports. Investment growth remained strong, but was lower than in the

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

Chart 2
US manufacturing



(a) Source: National Association of Purchasing Managers.

Chart 3
US consumer price index and unit labour costs

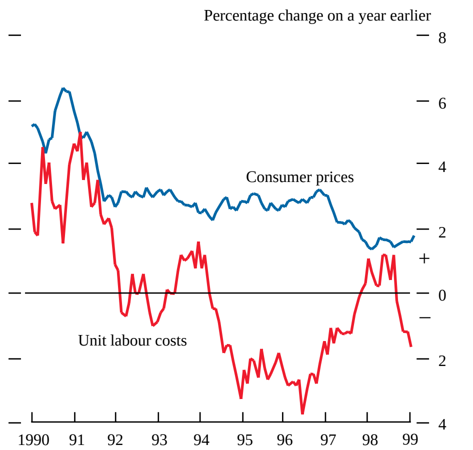
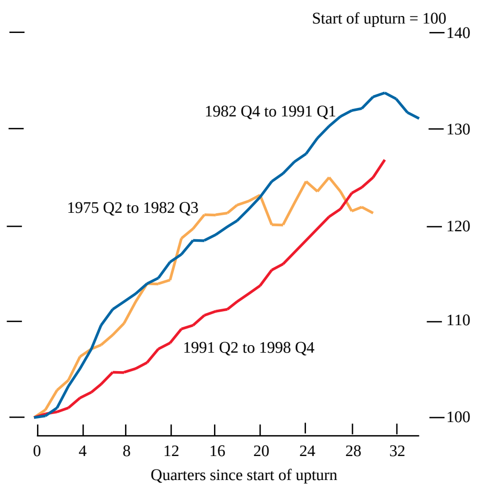


Chart 4
US GDP levels



previous quarter. However, consumption growth increased further to 1.6%.

The continued strength in consumption reflects sustained growth in employment and household income, and further increases in US equity prices. Consumption continued to grow faster than income in recent months, and the measured savings rate fell to -0.5% in 1999 Q1, from 0% in 1998 Q4. Consumer confidence has continued to rise, which might suggest further strength in consumption in the months ahead (see Chart 1).

Although growth in US export markets is still weak, there have been signs that the outlook for the industrial sector has, at least, stopped worsening. The National Association of Purchasing Managers' production index, which has been a good leading indicator of growth in manufacturing output in the past, increased strongly in the first quarter (see Chart 2). This was supported by the Federal Reserve survey of regional business conditions in January and February, which found 'the tone of manufacturing improved in most districts'. However, stronger survey data has not yet been reflected in official data; indeed, growth in manufacturing output fell slightly in March.

The US unemployment rate fell to 4.2% in March, after averaging 4.5% last year. Employment growth has been volatile in recent months, possibly reflecting erratic, weather-related influences. The annual growth in average earnings continued to ease, despite a tight labour market by historical standards.

As a result of weaker earnings growth and continuing growth in productivity, unit labour costs have fallen over recent months. This helps to explain why core annual price inflation has been unchanged at 2.1%. However, largely because of the recent rise in oil prices, the headline rate increased from 1.6% in February to 1.8% in March (see Chart 3).

The United States has experienced a period of continuous growth in the 1990s, which is as long as the period of growth in the 1980s. Chart 4 compares cumulative GDP growth in the past three upturns: 1975 Q2 to 1982 Q3; 1982 Q4 to 1991 Q1; and 1991 Q2 to 1998 Q4.[(1)] The cumulative growth in the 1990s overtook the growth in the late 1970s last year, but it is still below the cumulative growth in the 1980s upturn. However, this is somewhat misleading, as growth has been very similar in the 1980s and 1990s, apart from at the start of each period. As Chart 5 shows, the early phase of growth in the 1980s was stronger, with annual growth peaking at 8.4% at the start of the upturn, although this followed a deep recession. In contrast, in the 1990s, growth was weaker at the start of the upturn, but has tended to pick up since then.

Another feature of the 1990s has been the consistently strong growth in investment compared with the 1970s and 1980s (see Chart 6). In the 1990s upturn, the level of investment has grown continuously, whereas in the two previous upturns, investment grew strongly at the start of the period, but then stalled. The composition of growth has been very different in the 1990s in other ways, with much stronger growth in imports, but slightly

(1) The starting-point of each period is the first quarter of positive quarterly growth in GDP after at least two quarters of falling output. The period is taken forward to include the next phase of falling output.

Chart 5
US GDP growth

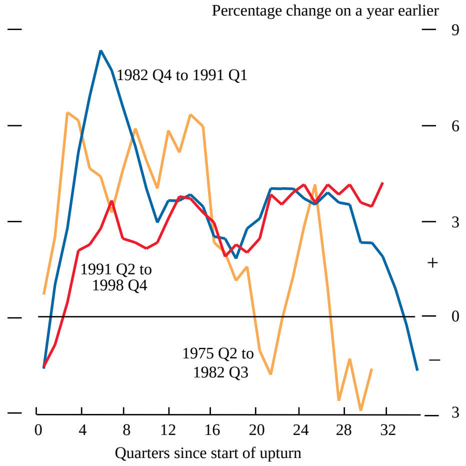


Chart 6
US gross private investment

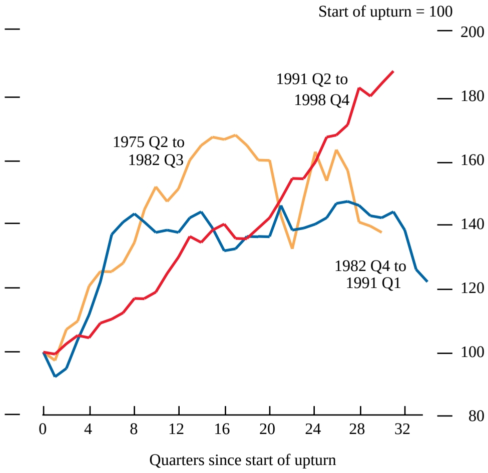
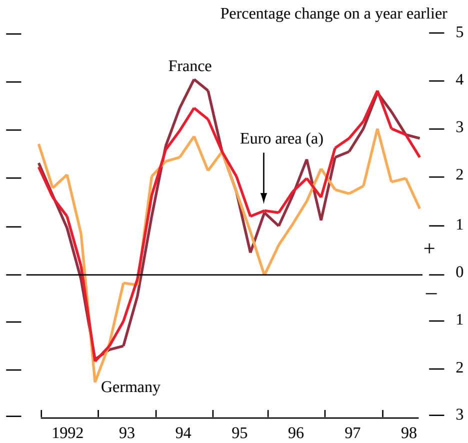


Chart 7
European GDP growth



(a) Source: Eurostat.

weaker growth in private consumption and much weaker growth in government consumption. Export growth has been quite similar in the 1990s to the 1970s and 1980s.

The strong growth in investment in the latter half of the 1990s has been driven by business investment. Residential investment grew by 5.1% on average between 1995–98, on an annualised basis, whereas business investment grew by 13.7%. Investment in information technology (IT) has been growing particularly strongly, which may partly reflect the expansion of the Internet. Because IT equipment tends to have a shorter life than buildings or machinery, more gross investment is required to achieve the same increase in the capital stock. However, this is unlikely to explain all of the increase in investment in the 1990s, so there seems to have been a marked increase in the capital stock. And this may explain the continued increase in labour productivity.

One indication of whether strong investment in the 1990s has helped to keep capacity in line with actual output is the industrial capacity utilisation rate. This increased by 10 percentage points in both the 1970s and the 1980s, suggesting a decline in spare capacity. In the 1990s, capacity utilisation increased by 5 percentage points up to 1995, but has since fallen back to its level at the start of the upturn. The fall in the capacity utilisation measure since 1995 mirrors the continued increase in investment shown in Chart 6. But it only measures capacity in the industrial sector, where growth in production fell sharply in 1995 and has since been fairly weak. Capacity utilisation may be higher in the services sector.

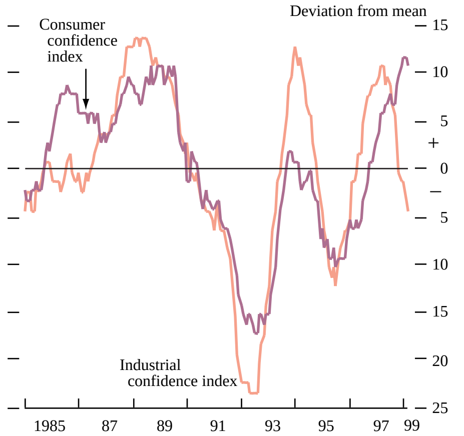
Comparison with the 1970s and 1980s suggests three key points about growth in the 1990s. First, the current upturn is now as long as that in the 1980s. Second, the rate of growth has been less volatile in the 1990s. Finally, growth in the 1990s has been supported by stronger and more sustained growth in investment than in the previous two cycles.

Growth in the euro area slowed throughout last year. Recent data for industrial production in France and Germany suggest that growth may be weak again in the first quarter of 1999.

Output in the euro area as a whole grew by 0.2% in 1998 Q4 (2.0% on a year earlier), according to preliminary Eurostat data. Growth has declined through the year (see Chart 7). Investment growth fell strongly throughout 1998, but private consumption growth increased slightly. Although net trade made a small negative contribution to growth in 1998, gross trade flows slowed sharply. Annual export growth slowed from 10.0% in the first quarter to 0.5% in the fourth quarter, and import growth fell from 11.9% to 2.7%. Net trade made a negative contribution to output in Germany, France and Italy, but for most of the other euro-area countries, imports fell more sharply than exports.

Since the preliminary Eurostat data in Chart 7 were published, GDP growth in Germany has been revised down sharply (year-on-year growth in 1998 was revised from 2.8% to 2.3%). But the recent quarterly profile has not been changed very much and still shows that growth declined throughout 1998. German consumption growth increased over the year, but there was a sharp

Chart 8
Euro-area consumer and industrial confidence



Note: Mean calculated over period since 1985.

Source: European Commission.

Chart 9
Italian export growth and real effective exchange rate

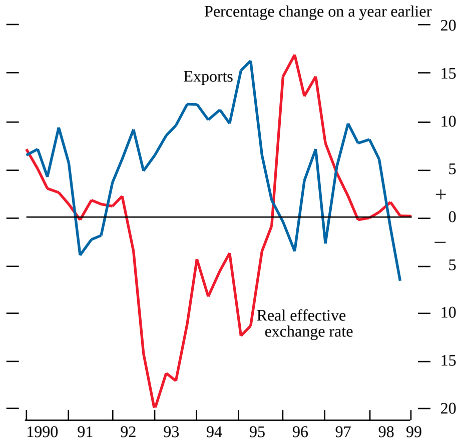
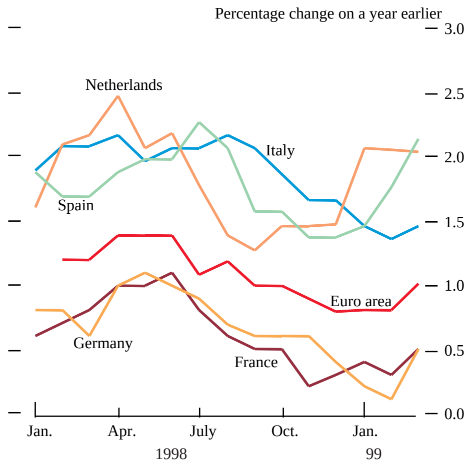


Chart 10
Harmonised consumer price indices



decline in investment growth and a negative contribution from net trade. In France, annual growth fell from 3.8% in 1998 Q1 to 2.8% in Q4, also reflecting a negative contribution from net trade. Growth in industrial production in France continued to decline in early 1999, and in Germany the level of industrial production was lower than a year earlier.

A divergence has emerged between business confidence and household confidence in the euro area (see Chart 8). The Eurostat measure of household confidence has tracked business confidence fairly closely in the past, although business confidence has shown larger swings in sentiment. But since the middle of last year, business confidence has been falling sharply, partly reflecting the weaker outlook for world trade. In contrast, consumer confidence has continued to increase, and has recently reached the same level as its previous peak in the late 1980s. This divergence between business sentiment and household sentiment has occurred in all euro-area countries.

Household confidence seems to have remained buoyant as unemployment has been falling in most euro-area countries and real household disposable income has been rising. But the weakening industrial confidence in recent months has been reflected in weaker forecasts for euro-area growth for this year (for instance, the European Commission has revised down its spring forecast to 2.2%, from 2.6% last autumn, although this was before the European Central Bank (ECB) cut its repo rate). If output growth continues to weaken, the outlook for personal sector finances will deteriorate. And this might cause consumer confidence to fall more into line with business confidence. Indeed, in the most recent release, covering March, consumer confidence fell slightly. But industrial confidence also fell, leaving the degree of difference unchanged.

Compared with France and Germany, growth in Italy has been weak since 1995. Average year-on-year growth since 1995 has been 2.1% in Germany and 2.4% in France, but only 1.2% in Italy. Much of this can be explained by low growth in Italian exports, which has averaged 2.6% since 1995, compared with 7.1% in Germany and 8.0% in France. In contrast with export performance, average domestic demand growth has been very similar in all three countries—1.8% in France, 1.7% in Germany and 1.8% in Italy—and so has the growth in imports. The relative weakness of Italian export growth can partly be explained by the sharp appreciation of the lira in 1995 (see Chart 9). But Italy may also have been more affected by the sharp depreciation of some Asian currencies (these are not included in the exchange rate index in Chart 9), because it competes more directly with those countries.

Annual harmonised consumer price inflation in the euro area increased to 1.0% in March from 0.8% in February, largely reflecting a rise in German inflation from 0.1% in February to 0.5% in March (see Chart 10). Annual growth of earnings in the euro area was 2.4% in 1998 Q4, up from 2.3% in 1998 Q3. In Germany, whole-economy hourly wage growth increased from 1.7% in November to 2.5% in January. In late February, the IG Metall union agreed a 3.2% increase in wages for 3.2 million workers (with effect from 1 March). There was also a bonus payment worth 1% of earnings.

Chart 11
Japanese private and public investment

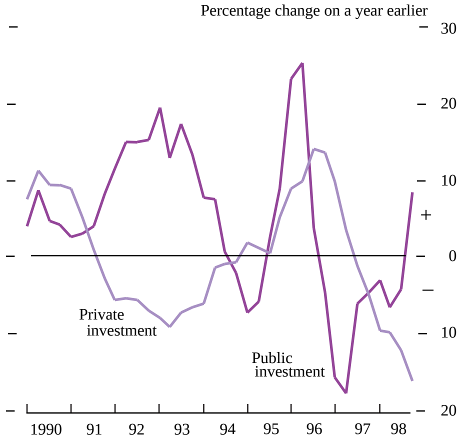
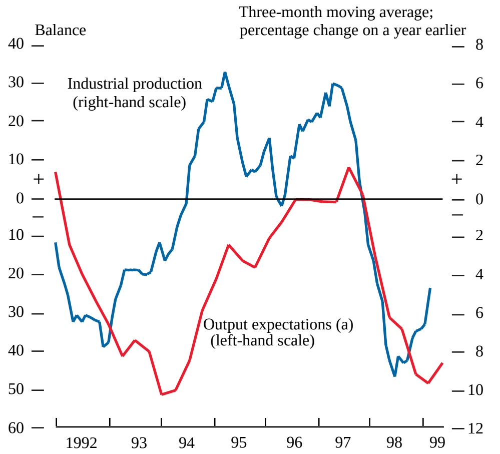
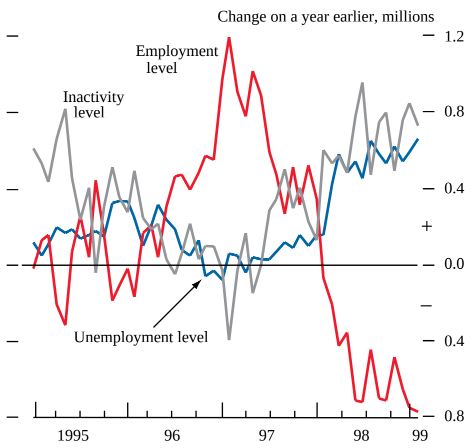


Chart 12
Japanese business sentiment and industrial production



(a) Tankan survey of business sentiment.

Chart 13
Japanese labour market



Japanese output fell in 1998 Q4 for the fifth quarter in succession. The fall in output in 1998 as a whole was the sharpest since 1955. Unemployment reached a new high in 1999 Q1; other data also suggest continued recession.

In Japan, GDP fell by 0.8% in Q4, the fifth consecutive quarterly fall. GDP fell by 2.9% in 1998 as a whole, the largest fall since national accounts were first compiled in 1955. The most recent fall in output reflected a sharp fall in exports, while private consumption fell modestly. Investment fell less sharply than in previous quarters, because public investment picked up strongly (up by 10.6% in the quarter), probably reflecting the effects of last April’s fiscal stimulus (see Chart 11). The 14% appreciation of the yen against the US dollar in October may have contributed to the Q4 fall in exports, which was the sharpest quarterly fall since 1986.

Indicators for the first quarter of 1999 show little sign of recovery. Industrial production increased in January, but fell back in February to a level 5.2% lower than a year earlier (see Chart 12). The March Tankan survey suggested that among ‘principal’ enterprises, the current economic situation had not improved for manufacturers, though non-manufacturers did report some improvement. Nevertheless, replies from both types of firm still suggested falling output. Both manufacturing and non-manufacturing enterprises reported a small improvement in expectations for output three months ahead. However, as Chart 12 shows, the Tankan survey has tended to lag official data in the past, so the upturn in the Tankan may simply reflect the upturn in official data in mid 1998.

Unemployment in Japan increased to 4.6% in February, from 4.4% in January. In the year to February 1999, the population aged over 15 increased by 640,000. Over the same period, employment fell by 770,000 and unemployment increased by 670,000. This implies that inactivity increased by 740,000 over the period (although that figure also includes the number of people retiring). In the 1990s there has been a strong correlation between changes in inactivity and changes in unemployment (see Chart 13). This suggests that as employment conditions deteriorate, some potential workers have been leaving the workforce, although they actually want to work. If this is the case, the official unemployment measure may not fully capture the effect of worsening labour market conditions on household confidence.

Wages have been broadly flat in Japan over the past year. And with deteriorating job prospects, consumer confidence in Japan has continued to decline. Retail sales in the first quarter of 1999 were down by 2.7% on a year earlier. Concerns about the banking sector depressed consumer confidence last year. But recapitalisation of Japanese banks has been continuing, and by 31 March they had received ¥7.45 trillion in public funds. The Japanese government is now confident that all of the major banks meet the appropriate capital adequacy standards.

Japanese annual consumer price inflation fell to -0.1% in February. Core inflation has been close to zero since 1995, but one-off factors, such as an increase in consumption tax in March 1997 and a temporary increase in food prices in November 1998, have made the headline series more erratic (see Chart 14). Prices have fallen quite strongly further up the distribution chain. In January, wholesale prices fell by 3.9% on a year earlier.

Chart 14
Japanese prices

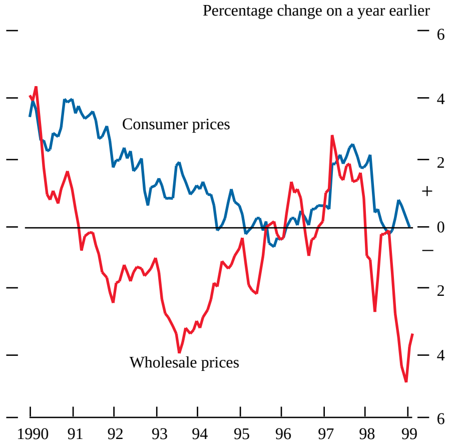
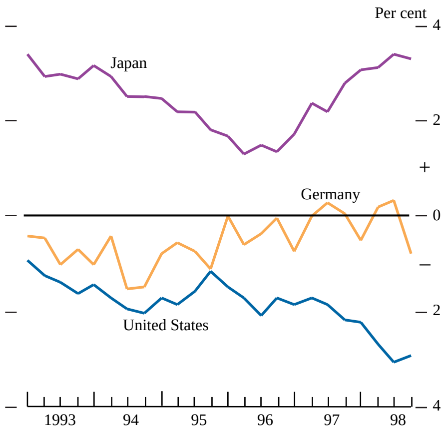


Chart 15
G3 current account balances as a share of GDP



Forecasts for GDP growth

Per cent

	IMF (a)		Consensus Economics (b)		*The Economist* poll of forecasters (c)	
	1999	2000	1999	2000	1999	2000
United States	3.3	2.2	3.4	2.3	3.6	2.4
Japan	-1.4	0.3	-1.2	0.1	-1.1	0.0
Germany	1.5	2.8	1.6	2.6	1.5	2.4
France	2.2	2.9	2.3	2.7	2.2	2.6
Italy	1.5	2.4	1.5	2.4	1.6	2.4

(a) *World Economic Outlook* (April 1999).
(b) Consensus Economics, *Consensus forecasts* (April 1999).
(c) *The Economist*, poll of forecasters (24 April–30 April 1999).

The uneven pattern of growth in the major industrial countries has led to widening current account imbalances.

As discussed in the February *Quarterly Bulletin*, financial crises since 1997 have severely reduced the flow of funds into emerging market economies. This has forced the economies affected to reduce their current account deficits, which should be balanced by a shift towards current account deficit in the industrial economies as a whole.

As Chart 15 shows, the United States current account has moved more sharply into deficit since 1997. In contrast, the Japanese current account surplus increased, and Germany's current account remained close to balance. In 1998 Q4, there was some reduction in these imbalances, but that may have been erratic. The US current account deficit fell from -3.1% of GDP to -2.9%, and there were sharp falls in exports in Japan, France and Germany, which were reflected to varying degrees in their current accounts. However, monthly trade data in the first quarter of 1999 show a sharp increase in the US trade deficit, and Japan's trade surplus also rose strongly.

One cause of the widening trade imbalances is the uneven pattern of growth across the major industrial countries. Most forecasters expect this to continue in 1999. For example, the table shows forecasts from the IMF spring *World Economic Outlook*, and also two surveys of private sector forecasts. In 1999, growth is expected to be considerably stronger in the United States than in Japan, Germany or France, and so the trade imbalances between the major industrialised countries are likely to increase.

Forecasters generally expect that US growth will moderate in 2000, while growth in Germany, Italy and France will pick up. Outside forecasts for Japan have been revised down, with continued sharp falls in output projected in 1999, and virtually no growth in 2000. This suggests that, other things being equal, the US trade deficit with Japan could continue to increase next year.

Chart 16 shows IMF data and forecasts for world GDP and trade. With growth expected to slow in the euro area and the United States, world GDP growth is forecast to be slightly lower this year than last, but to move back towards trend in 2000. Growth in trade slowed markedly in 1998, but is expected to strengthen in 1999 and 2000. However, the IMF does not expect trade to grow at the extremely rapid rates seen between 1994–97.

Partly as a result of weaker growth in world demand, but also because of increases in supply and a mild winter in the northern hemisphere, the price of oil halved between October 1997 and December 1998. But it increased to $16.80 by 30 April, a rise of more than 60% since 1 January. This was largely because OPEC reached a new production agreement in March, with plans to reduce supply by 7%. But it is not yet clear whether OPEC will manage to achieve their planned production cuts. Meanwhile, other commodity prices continued to fall.

Since the previous *Quarterly Bulletin*, there has been positive news for some emerging market economies. Brazil agreed a new IMF programme on 31 March, and the Bank of Brazil has been able to reduce official interest rates without prompting a renewal of capital

Chart 16
World trade and GDP growth

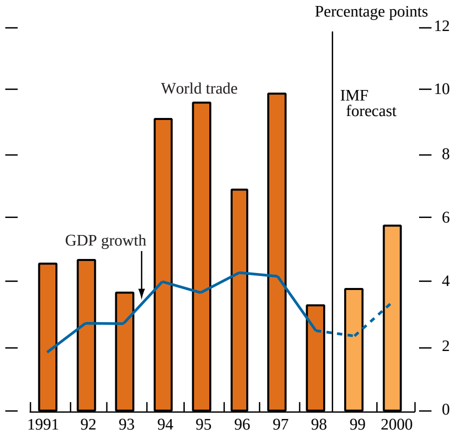


Chart 17
Nominal broad money growth in the United States, Japan and the euro area

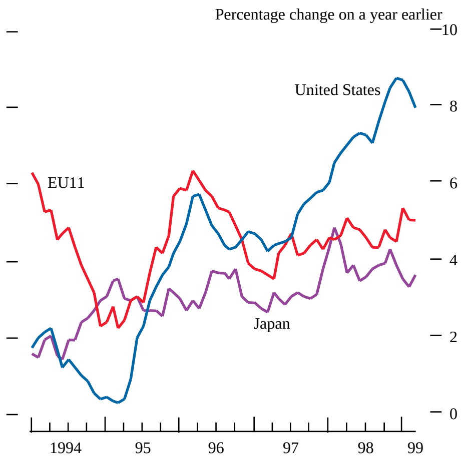
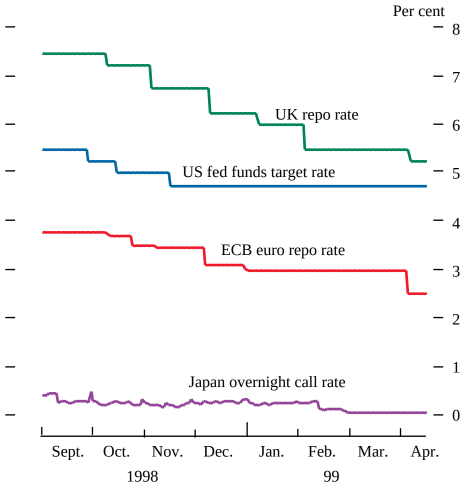


Chart 18
Official interest rates



outflows. This partly reflects a weaker-than-expected impact on inflation from the depreciation of the real to date. Although the economy remains in recession, the more positive news on inflation, interest rates and the exchange rate (which has appreciated by about 30% since its trough in early March), has contributed to a more stable situation.

Output in the Asian countries most affected by past financial crises has shown some signs of recovery. In particular, industrial production has increased in Korea and has stopped falling in Thailand and Malaysia. The Chinese economy has continued to grow strongly, with output up by 8.3% in Q1 compared with a year earlier. In Russia, consumer demand and gross fixed investment are still falling sharply, although industrial output has recovered slightly. The IMF reached a framework agreement with Russia on 29 March, though discussions are continuing on the form of a new programme.

Growth in broad money aggregates fell slightly in the United States and Japan, but increased in the euro area.

In the United States, broad money grew by 8.4% on a year earlier in February, down from an average of 8.8% in 1998. But growth was still high relative to nominal GDP growth. The implicit fall in velocity may have been linked to lower nominal interest rates. But it could also have reflected financial conditions last autumn, which have caused investors to move out of riskier assets and into money.

In the euro area, annual growth in M3 in March was 5.1%, down from 5.4% in January, compared with the ECB's reference value of 4.5%. But the ECB issued a note of caution that the data in January may have been distorted by the launch of the euro and a change in measurement.

In Japan, unadjusted broad money grew in March by 3.7% on a year earlier, up from 3.5% in February. Annual growth of narrow money (M1) increased more strongly, from 5.8% in February to 8.1% in March, reflecting the Bank of Japan's continued easing of monetary conditions.

The ECB cut its main refinancing rate by half a percentage point on 8 April, and the Bank of Japan lowered the call rate by about a quarter percentage point during February. The Federal Reserve left rates unchanged.

On 8 April, the ECB cut its main refinancing rate by 50 basis points to 2.5%. It noted that the euro-area harmonised index for consumer prices had shown inflation below 1% for some months, and that the prospects for euro-area growth had weakened, with slower GDP growth in 1998 Q4 and continued falls in industrial confidence.

The official discount rate set by the Bank of Japan (BoJ) has been unchanged at 0.5% for several years. In order to further loosen monetary conditions, the BoJ has been targeting the rate for unsecured overnight call money. On 12 February, it lowered the target for the call rate from 0.25% to 0.15%. Later in February, the BoJ encouraged the rate to fall as low as possible (see Chart 18).

Chart 19
US dollar, euro and yen nominal effective exchange rates

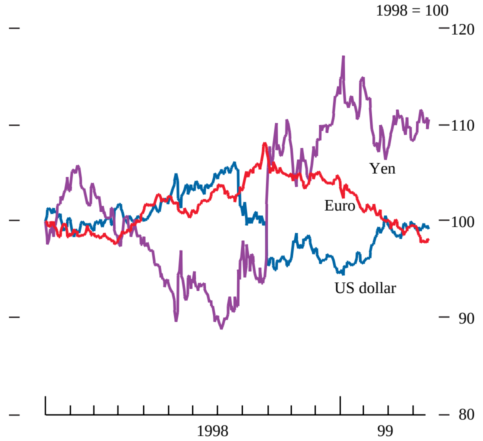
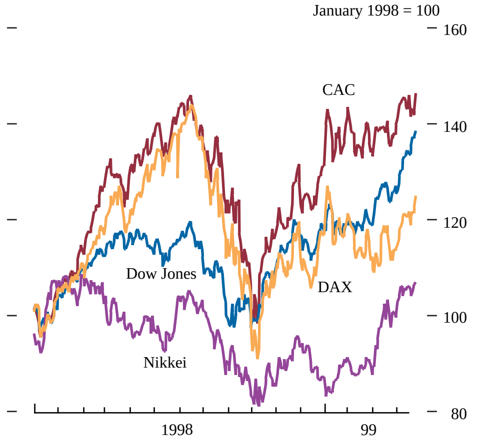
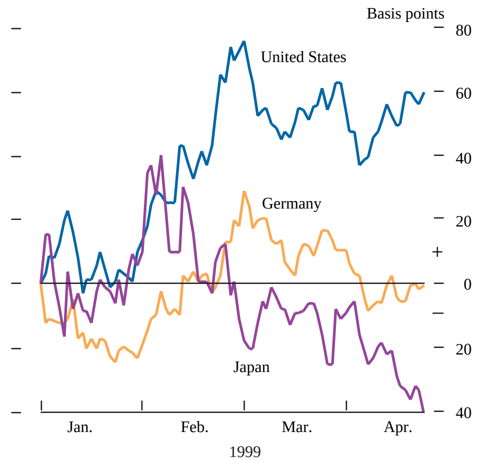


Chart 20
Equity prices[(a)]



(a) In local currencies.

Chart 21
Change in government bond yields (from 4 January 1999)



Official rates in the United States were left unchanged. In the Federal Reserve Bank's biannual report on monetary policy, Chairman Greenspan said that he expected GDP growth to slow to a more sustainable level by the end of 1999, and for inflation to remain below 2.5%. But he noted the risks from labour market tightness, and said that 'equity prices are high enough to raise questions about whether shares are overvalued'.

The euro declined against other currencies over the quarter. Stock markets generally rose, with the Japanese Nikkei showing the strongest increases.

The Bank of England's new euro effective exchange rate index[(1)] showed that the euro fell by 6.4% against a trade-weighted basket of currencies between 1 January and 30 April (see Chart 19). The depreciation of the euro reflected a deteriorating economic outlook for the euro area, anticipation of the ECB's cut in interest rates on 8 April, and the negative impact of NATO military action in the Federal Republic of Yugoslavia.

The dollar effective exchange rate has appreciated by 4.1% since 1 January. After falling to a 26-month low against the yen on 11 January, the dollar started appreciating, after reports of intervention by the BoJ. It increased further after the BoJ lowered the call rate on 12 February.

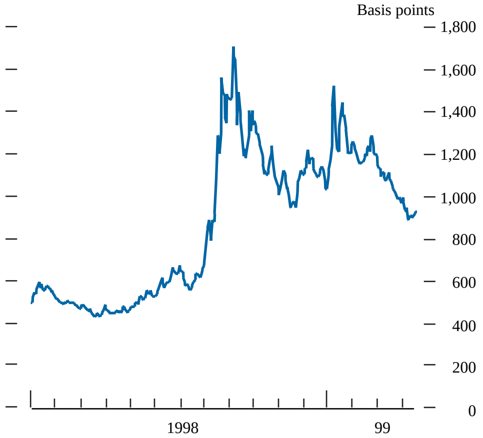
Equity prices in the major industrial economies were broadly stable in January and February, but then increased fairly sharply in March and April (see Chart 20). The Japanese Nikkei showed the strongest increase (up 20.7% between 1 January and 30 April). This may have reflected news of corporate restructurings, mergers and acquisitions activity, and an improving outlook for the banking sector. US equity prices continued to rise (up 17.4% since 1 January). The Dow closed above 10,000 on 31 March and continued to increase in April. Since the start of the year, the German DAX index increased by 1.3% and the French CAC rose by 6.2%.

Chart 21 shows movements in ten-year government bond yields since the start of the year. In general, yields were quite stable in January. US yields increased in late February, following strong US output data and the Federal Reserve Chairman Alan Greenspan's Humphrey-Hawkins testimony, which markets interpreted as suggesting that official rates might rise. In March, markets interpreted US data as suggesting weaker inflationary pressure, and yields fell by 20 basis points. German yields were less volatile, and on 30 April were little changed from the start of the year. In Japan, yields peaked in early February, but gradually fell back after the BoJ's easing of monetary policy.

The spreads on emerging market bonds over ten-year US Treasury bills—one measure of the risk premium associated with lending to emerging markets—increased sharply in January 1999, in response to the Brazilian devaluation (see Chart 22). Earlier in 1998, spreads had increased in response to the Russian debt moratorium and risks from Brazil. But since the peak in January, spreads have fallen by around 500 basis points, to a point where they are now

(1) See 'An effective exchange rate index for the euro area', pages 190–94.

Chart 22
EMBI sovereign spread over US Treasury bills



Source: J P Morgan.

about 500 basis points above their level in the first half of 1998. But there are strong differences within the average measure, reflecting the relative performance of the different economies.

Emerging markets suffered some pressure on exchange rates and stock markets at the time of the first announcement of Brazil's devaluation. But exchange rates in emerging markets strengthened and some stock markets recovered, following the decision by the Brazilian authorities to float the real. Russian equity prices have shown no sign of a similar revival.

Summary

The outlook for the world economy has improved slightly since the previous *Quarterly Bulletin*. Domestic demand in the United States remains strong, and there has been little sign of any pick-up in inflation. Growth has continued to decline in the euro area, and industrial sentiment has weakened further. In response to these developments, the ECB has cut its main refinancing rate by 50 basis points. Japan is still in recession and, with record levels of unemployment, there is little sign of a revival in consumer confidence. Events in Kosovo have led to greater uncertainty for the world economy, and have caused the euro to weaken. But there has been evidence of recovery in some of the emerging market economies most affected by past financial crises.