II. Developments in the industrial countries

Highlights

Forecasts made near the end of 1995 had envisaged that both output growth and inflation in the industrial countries, as traditionally defined, would converge towards an average of 2½% in 1996. In the event, growth was lower, and notably so in the Group of Seven countries which expanded by less than 2% on average. The rate of inflation was also lower than predicted, indicating that disinflationary forces were generally more powerful than had been expected. This was particularly evident in global goods markets whereas in several countries there was a partial reversal of earlier declines in unit labour costs.

While the average difference between the predicted and realised growth rates in 1996 may not seem large, it must be seen against the background of generally less restrictive policies and financial conditions than had been foreseen. Many countries benefited from lower short and long-term interest rates, and the appreciation of the US dollar against most other currencies generally helped to shift global demand towards regions and countries with excess capacities. Both the United States and the United Kingdom, where inflationary pressures were stronger, benefited from this process.

Macroeconomic policies also affected the pattern of growth last year. Due to differences in the lags with which fiscal and monetary policies influence demand, efforts to reduce fiscal imbalances generally constrained output growth during the first half of 1996, while the resulting more favourable financial conditions only affected demand towards the end of the year. As a result, destocking was widespread early in the year but, in most countries, the rise in business fixed investment remained disappointingly low at year-end. Sluggish growth, as well as continuing structural rigidities, also meant that the unemployment rate in the continental European Union countries rose to over 12%.

Due to the generally weaker cyclical conditions, trade between the industrial countries slowed substantially in 1996. Combined with more restrictive policies in a number of Asian countries, this reduced the growth of world trade in goods and services to only half the rate recorded in 1995. Nonetheless, the trend towards globalisation of output and employment via foreign direct investment seems to have continued unabated; foreign sales by international companies through their foreign affiliates now exceed direct trade in goods and services, and their job growth abroad commonly outstrips employment growth in the parent countries by wide margins.

Developments in the three major economies

Continuing non-inflationary expansion in the United States …

The expansion in the *United States* entered its seventh year early in 1997,

displaying remarkable resilience considering that the recovery started with a comparatively small output gap. The rate of growth of GDP in 1996 was actually higher than in 1995, although staying broadly in line with potential growth (Graph II.1). Only in early 1997 did inflation clearly begin to threaten. Several factors seem to have complemented and reinforced each other in preventing the accumulation of inflationary imbalances like those commonly seen in earlier recoveries of this length. First, the fiscal deficit was reduced, with most of the decline being structural; the federal government deficit is now at the lowest level since 1981. Second, increasingly conditioned to believe that the Federal Reserve would resist inflationary pressures, the bond market has served as an important built-in stabiliser. Thus, rates have tended to move up in response to perceived excess demand pressures but have then fallen back as these concerns have receded. In part, this reaction has alleviated the need for discretionary changes in monetary instruments. Third, despite some tightening of labour market conditions which caused the rate of unemployment to decline to a level (5¼% towards the end of the year) which used to be associated with accelerating inflation, there were only occasional signs of upward pressures on prices. Labour costs were contained through 1996 by decelerating or even falling non-wage benefits as well as by workers' concern about future job prospects. Fourth, intense competition in both domestic and world markets, combined with a growing resistance to price increases among consumers, has forced firms to reduce costs. Fifth, with the United States leading the business cycle, imports from countries with excess capacity have helped to contain the risk of bottlenecks in the US economy. Finally, over the last 12 months, an appreciation of the dollar has amplified the disinflationary forces already present.

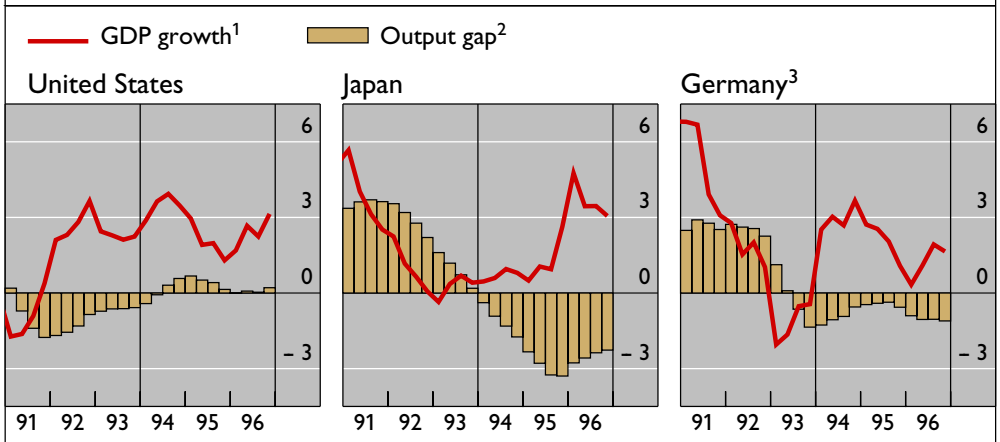
… with several stabilising factors

Boosted by higher real income, the growth of household spending accelerated last year and business fixed investment was a continuing source of strength. Indeed, the most unusual feature of this expansion has been its dependence on the increased output of the "high-tech" sector, which is estimated

Impact of "high-tech" sector

GDP growth and the output gap

In percentages



[1] Changes over four quarters. [2] As a percentage of potential GDP. Positive figures indicate excess demand. [3] Prior to 1992, western Germany only.

Sources: OECD Economic Outlook, national data and BIS estimates. Graph II.1

to have contributed over 25% to overall growth during the last three years, compared with, for instance, only 4% for the automobile sector. Moreover, falling prices for high-tech products and faster productivity growth stemming from the use of new computer-based technologies have helped to keep inflation low. However, being highly dependent on the continuous development of new technologies, the high-tech sector is not immune to cyclical swings or to the accumulation of imbalances. As past experience shows, output changes in this sector are as volatile as in most durable goods industries and can be accompanied by even larger multiplier effects on the rest of the economy.

Hesitant and uneven upturn in Japan …

The economic picture in *Japan* seemed to brighten in 1996 as output growth accelerated sharply. However, the overall figures are deceiving with respect to the strength of the upturn. Growth was highly uneven during the year and there were substantial shifts in the contribution of major demand components, indicating the absence of clear underlying trends. Despite an export-led strengthening of the economy towards the end of the year, the impetus to economic activity can mainly be attributed to developments in the first half. Moreover, almost one-third of the output growth during this period can be ascribed to fiscal measures which seem to have generated only weak multiplier effects; final domestic demand declined in the second half when the fiscal stimulus started to be withdrawn. In contrast, the depreciation of the exchange rate has provided growing support to net exports.

… with uncertain impact of financial conditions

The impact of monetary policy and domestic financial market developments is difficult to judge. On the one hand, bank credit growth remained weak, partly because large enterprises covered their funding needs by issuing bonds, but also reflecting banks' reluctance to lend to small and medium-sized companies whose collateral is commonly linked to real property. On the other hand, historically low interest rates, combined with the depreciating exchange rate, boosted the profits of large enterprises who have used some of their additional funds to repay bank debt or finance a modest increase in fixed investment. The strength of residential investment, allied with the fact that households supported consumption by reducing their saving rate, may be seen as further evidence of the stimulatory effects of monetary forces.

Hesitant recovery in Germany too

Germany also experienced a very uneven growth pattern in 1996, especially during the first half when weather-related factors had a significant adverse influence on activity in the construction sector. Although less pronounced than in Japan, growth was supported by easier monetary and fiscal policies and by a depreciating exchange rate. However, in sharper contrast to the Japanese case, GDP growth decelerated in Germany last year as the result of a large inventory correction and falling capital spending in both the public and private sectors. Moreover, reflecting the overall deceleration of output growth, as well as the effects of continued efforts by firms to reduce costs, employment declined and the rate of unemployment rose to a postwar high early this year. These developments depressed household income as well as consumer confidence and the growth of private consumption fell far short of earlier predictions. At the same time, with falling unit labour costs reinforcing the effects of a nominal depreciation of the exchange rate, about one-half of total growth was attributable to net exports.

Developments in the other major European economies

Growth also weakened in France …

The deceleration of output growth in *France* was rather similar to that in Germany, as were some of the immediate causes; in particular, the need to correct a large inventory overhang and falling government investment. Net export growth accelerated but mainly as the result of sluggish import demand; in fact, export growth actually declined to a rate somewhat below that of export markets. Business fixed investment was also weak, in spite of favourable cash flows. This may have reflected the overall weakening of demand but was also influenced by the need of both banks and non-financial corporations to recognise earlier losses on property investment.

… but employment stabilised

In other respects, however, trends in France and Germany differed last year. Stimulated by fiscal measures, but also owing to a rebound from the strike-influenced fourth quarter of 1995, household spending was a main engine of growth early in 1996 in France. Labour market developments differed as well, even though unemployment increased almost as much as in Germany. Reflecting policy incentives to hire low-income workers and the long-term unemployed, employment stabilised in France. However, because the employment measures and wage moderation also seem to have lessened firms' incentives to lower costs, the rate of productivity growth decelerated and unit labour costs rose more than in Germany.

Cyclical downswing in Italy …

Starting with a progressive weakening of export demand, *Italy* experienced a cyclical downswing last year, as a major inventory correction in the industrial sector caused an actual decline in output. Tighter monetary conditions and fiscal consolidation, leading to lower government consumption and falling household real income, reinforced the downswing even though the effect on consumption was "cushioned" by a 1 percentage point fall in the household saving rate. Investment in machinery and equipment also weakened, partly influenced by narrower profit margins, as the appreciation of the lira made it difficult for firms to shift higher costs into prices. In contrast, residential and non-residential construction spending seems to have strengthened in the course of the year, possibly due to the marked decline in bond rates. Furthermore, as imports were cut sharply in response to the weakening of domestic demand, net export growth remained positive despite the appreciation of the currency.

… contrasts with stronger growth in the United Kingdom

The slow growth which had characterised the *UK* economy during most of 1995 continued into the first half of 1996. Falling net exports, a large inventory correction, further cutbacks in public sector investment and declining residential construction all played a role. However, business fixed investment in machinery and equipment grew strongly and combined with other expansionary forces to rekindle growth in the second half of 1996. Net exports turned positive and growth in residential construction resumed as the period of correcting an excess housing stock came to an end. Household consumption alone contributed almost 2½% to the rise in output in spite of continuing sluggish employment growth. Even though part-time work grew sharply in response to a shift of overall demand towards services, employment increased by only ¾% last year and the total number of hours worked may have been constant. On the other hand, the effect of this low employment growth, combined with a faster

expansion of output than in most other major countries, was relatively high productivity gains.

Developments in smaller European economies

Growth in the smaller European economies averaged 3% last year, higher than for the G-7 countries. There were, however, significant differences across countries which seem mainly attributable to domestic factors and policies. The contribution of domestic demand was substantially higher in countries with GDP growth exceeding 2½% than in most of the countries experiencing lower output growth (Table II.1). In addition, those countries which expanded significantly faster than their potential rate of growth saw clear or emerging signs of inflationary imbalances.

Inflationary imbalances in Turkey …

This latter effect was most pronounced in *Turkey*, where domestic demand has been expanding at an unsustainably high rate and monetary financing of the public sector deficit (which may have reached 10% of GDP last year) combined with entrenched inflationary expectations to keep the rate of inflation at about 80%. Reflecting growing financial market uncertainty, domestic real interest rates rose to around 30% last year, prompting the Government to issue bonds denominated in US dollars. In the other countries with rapid growth, the monetary authorities responded pre-emptively when faced with potential imbalances. In *Ireland*, short-term interest rates were raised and the exchange rate was allowed to strengthen due to concerns about rapid credit growth and rising house prices. Similarly, the monetary authorities in *Norway* and *Iceland* tightened monetary conditions in response to signs of eroding wage restraint and, in the case of Norway, a less restrictive fiscal policy than initially intended.

… but pre-emptive policies in other countries

Rebound in the Netherlands and Portugal; slowdown in Finland

In the *Netherlands*, activity rebounded early last year from the relatively mild downturn in 1995 and, by the end of the year, the output gap had virtually been eliminated. Although continued fiscal consolidation slowed the growth of real disposable income, private consumption was the principal force behind the

Contributions to changes in real GDP in 1996

In percentages

	Growth >2½%							
	Turkey	Ireland	Iceland	Norway	Finland	Portugal	Nether-lands	Average
Domestic demand	12.1	5.2	7.6	2.0	3.2	3.5	3.4	6.3
Net exports	−4.6	1.5	−2.1	2.8	0.1	−0.5	−0.7	−1.5
GDP	7.5	6.7	5.5	4.8	3.3	3.0	2.7	4.8
	Growth ≤2½%							
	Greece	Den-mark	Spain	Belgium	Sweden	Austria	Switzer-land	Average
Domestic demand	4.5	2.1	1.6	1.4	0.0	1.2	−1.0	1.2
Net exports	−2.0	0.3	0.6	0.0	1.1	−0.1	0.3	0.3
GDP	2.5	2.4	2.2	1.4	1.1	1.1	−0.7	1.5

Sources: OECD Economic Outlook and national data. Table II.1

upturn. With improving confidence, perhaps reflecting the success of long-standing efforts to restructure the economy and rising house prices, households appear to have used additional mortgages to finance consumption. Employment also increased as the share of part-time workers in total employment (already the highest in Europe) rose further. *Portugal's* recovery started only in the second half of last year, reflecting an overhang of inventories and relatively tight policies which, however, contributed to reducing inflation to 3%. In *Finland*, falling exports of forestry products led to a marked deceleration of output growth. Nonetheless, business investment expanded at a high rate and household spending was as buoyant as in 1995, notwithstanding a continuing high rate of unemployment (16–17%).

Continuing wage restraint in Spain …

In the other smaller European economies, developments with respect to output and employment were even less satisfactory although inflationary pressures were generally more restrained. Supported by a resumption of export growth and more buoyant household consumption, the *Spanish* economy started a modest recovery during the first half of last year. However, private fixed investment slowed in spite of moderate real wage growth and public investment was cut or deferred. Against the background of a tight monetary policy, this meant that unemployment remained close to 22%, even though employment growth was considerably above the EU average. Unemployment also remained high in *Greece* but, unlike in Spain, real wages rose. While this temporarily boosted consumption and residential construction, it reinforced the adverse effects of upward pressures on the nominal exchange rate on the competitiveness of Greek enterprises. *Denmark* remained slightly ahead of the European business cycle in 1996 due, in part, to stronger export growth to other Nordic countries and an early restoration of fiscal balance. Household spending also strengthened, stimulated by relatively large real wage and employment gains, low interest rates and growing real wealth associated with a recovering property market. Business investment, however, weakened, possibly responding to a falling profit share. In *Sweden,* on the other hand, vigorous investment and a resumption of export growth were both instrumental in reversing the decline in overall GDP growth towards the end of 1995, despite a large nominal appreciation and a 15% deterioration in the competitive position of Swedish enterprises. Consumption, however, remained sluggish even though households reduced their saving rate in response to continuing weak growth of real disposable income.

… but some wage pressures in Greece, Denmark and Sweden

Low growth in Belgium and Austria and stagnation in Switzerland

Lower household saving to partly compensate for stagnating real income growth was also a typical feature of developments in Belgium, Austria and Switzerland last year. Moreover, export growth weakened as the result of exchange rate movements and the general slowdown in continental Europe. With exports accounting for 75% of GDP, the latter influence was particularly pronounced in *Belgium* where the output gap widened to 3%. In *Austria*, output growth recovered only slowly from the downturn in late 1995, as fiscal tightening reinforced the unfavourable effects of an earlier exchange rate appreciation on total demand. In *Switzerland*, the stagnation since 1990 continued last year and the output gap widened to almost 4%, the highest in the OECD area. A number of forces seem to have contributed to this unprecedented weakness: fiscal retrenchment, a 20% effective appreciation of the exchange rate between 1992

and 1995, restructuring and downsizing to improve the competitiveness of Swiss enterprises and lagged effects (both real and financial) of an earlier building boom. As in the past, companies' restructuring efforts generated a marked rise in capital deepening which, however, was largely met through imports.

Developments in other industrial countries

Delayed recovery in Canada …

In *Canada*, the slow growth of 1995 continued into the first half of last year as government consumption declined and firms ran down a large overhang of inventories. However, in response to a substantial easing of financial conditions, output growth accelerated in the second half. Rising unemployment, mainly reflecting continuing cuts in public sector employment (to almost 10% below the 1993 level) helped to contain inflation and also contributed to an improvement of the competitive position. Since import growth was moderate and lower international interest rates reduced the foreign debt service burden, Canada registered its smallest current account deficit for more than a decade.

… along with expansion in Australia

Australia is one of the few countries where output growth last year exceeded predictions. In part, this resulted from a recovery of agricultural output and exports following the 1994–95 drought, but it was also due to an unexpectedly strong expansion of investment in machinery and equipment and higher exports of manufactured goods. Consumption growth was a further source of strength whereas residential investment declined despite lower mortgage rates. In contrast to developments in Canada, the second half of last year saw a substantial weakening of activity, though with large differences between sectors and demand components. While several investment projects amplified growth in the primary sectors and in business fixed investment, the implementation of a more restrictive fiscal policy from mid-1996 already seems to have had a significant effect on household spending. In *New Zealand*, the downturn of 1995 deepened further last year, mainly due to the impact of higher interest rates on investment as well as house prices and a continued appreciation of the exchange rate (some 30% in real effective terms in just four years), with a consequent weakening of net export growth.

Macroeconomic policies and other factors affecting demand

Change in policy mix affecting demand patterns

Various factors influenced the slowdown in demand generally observed in 1996. Many countries changed their policy mix towards further fiscal tightening and monetary easing. Given the different lags with which monetary and fiscal policies affect aggregate demand, this shift is likely to have restrained growth early in the year but provided a net stimulus towards the end of 1996 and early this year. Inventory corrections also tended to restrain growth during the first half and business fixed investment remained particularly weak in continental Europe despite lower interest rates and generally higher profits; uncertainty with respect to future demand prospects as well government policies may have played an additional role. Residential investment was also sluggish in continental Europe but it supported growth in North America and the United Kingdom. The influence on spending of the real wealth gains associated with the recent rise in the prices

of financial assets is particularly difficult to judge. In several countries, lower household saving rates would suggest that wealth gains helped to cushion the effects of declining real incomes. However, it also appears that households and firms responded more cautiously to wealth gains than in the 1980s.

Macroeconomic policies

Fiscal restraint in 1996 …

As discussed in Chapter IV, monetary policies were eased slightly in some countries in 1996. Moreover, for several European countries and Japan, a partial reversal of earlier exchange rate appreciations was an additional source of stimulus. In contrast, with Japan and Germany as the major exceptions, fiscal policies have exerted a contractionary effect as structural deficits have been reduced significantly over the last two years (Table II.2). Even though automatic stabilisers were commonly allowed to absorb part of the slowdown in growth, the fact that actual budget deficits rose only in three countries (Japan, Germany and Switzerland) serves as a further indicator of the determined efforts to strengthen fiscal balances. The first signs of reversal in the relentless rise in public sector debt ratios also emerged in 1996 although, so far, only the most highly indebted countries have achieved any significant reduction in their debt burden. When unfunded pension liabilities are taken into account, most countries still remain far removed from the medium-term target of fiscal sustainability.

General government financial balances and debt

As a percentage of actual or potential GDP

Countries	Net financial balances				Structural balances				Gross financial liabilities			
	1990	1994	1995	1996[1]	1990	1994	1995	1996[1]	1990	1994	1995	1996[1]
United States	– 2.7	– 2.3	–2.0	–1.6	– 3.3	– 2.5	–2.0	–1.7	55.6	63.7	64.3	65.0
Japan	2.9	– 2.3	–3.7	–4.4	1.7	– 1.3	–1.8	–2.9	65.1	73.2	80.7	88.0
Germany	– 2.0	– 2.4	–3.5	–3.9	– 3.1	– 2.2	–3.3	–3.5	43.8	50.4	58.1	60.5
France	– 1.6	– 5.6	–4.8	–4.1	– 2.3	– 4.1	–3.5	–2.4	35.4	48.4	52.8	56.5
Italy	–11.0	– 9.0	–7.0	–6.8	–11.7	– 8.3	–6.8	–6.1	98.0	125.5	124.9	124.5
United Kingdom	– 1.2	– 6.8	–5.5	–4.8	– 3.1	– 5.7	–4.7	–3.9	35.3	50.3	53.9	56.0
Canada	– 4.1	– 5.3	–4.1	–1.8	– 4.8	– 4.1	–2.9	–1.1	72.5	97.2	99.6	100.0
Australia[2]	0.6	– 4.0	–2.0	–0.7	0.5	– 3.7	–2.1	–0.7	21.3	42.7	43.5	43.5
Austria	– 2.2	– 4.4	–5.3	–3.9	– 3.2	– 4.2	–5.8	–3.7	58.3	65.1	69.3	70.0
Belgium	– 5.6	– 5.1	–4.1	–3.4	– 6.7	– 3.7	–2.8	–1.5	129.7	134.8	133.5	130.0
Denmark	– 1.5	– 3.5	–1.9	–1.7	– 1.2	– 2.4	–0.9	–0.3	59.6	76.0	71.9	70.5
Finland	5.4	– 6.2	–5.1	–2.5	2.7	– 2.6	–3.5	–1.5	14.5	59.5	59.2	59.0
Greece	–16.1	–12.1	–9.1	–7.5	–16.2	–11.0	–8.0	–7.1	90.2	110.4	111.8	112.0
Ireland	– 2.3	– 2.0	–2.3	–1.0	– 2.4	0.3	–2.1	–1.8	95.2	87.9	81.6	73.0
Netherlands	– 5.1	– 3.4	–4.0	–2.4	– 6.5	– 3.4	–3.9	–2.4	78.8	77.6	80.0	78.5
New Zealand[2]	– 2.3	2.2	3.7	3.2	– 6.7	2.2	3.2	3.2	62.4	56.7	50.8	46.5
Norway[3]	2.6	0.3	3.3	6.3	– 0.7	– 4.8	–2.0	0.8	31.6	43.7	42.8	40.0
Portugal	– 5.5	– 5.7	–4.9	–3.8	– 7.3	– 4.6	–3.7	–2.6	65.5	71.5	74.0	72.5
Spain	– 4.1	– 6.3	–6.6	–4.5	– 6.8	– 4.7	–5.2	–3.2	45.1	63.0	65.8	70.0
Sweden	4.2	–10.3	–7.7	–3.6	1.5	– 8.3	–7.2	–3.1	43.5	79.0	78.5	76.5
Switzerland	0.0	– 2.9	–1.8	–2.2	– 1.0	– 2.3	–0.7	–1.4	31.2	45.7	47.0	48.5

[1] Preliminary. [2] Debt data refer to financial years ending 30th June. [3] Structural balance excluding oil sector production and revenue.

Sources: European Commission European Economy, OECD Economic Outlook and national data. Table II.2

… but further consolidation necessary

Looking ahead, there is clearly a need to reduce structural deficits over the medium term, given the ageing of populations and the growing burden of unfunded pension and other social benefit schemes. The obvious risk in further tightening, particularly if conducted simultaneously by many countries, would be of a slowdown of demand and a further widening of actual as opposed to structural deficits, even allowing for offsetting influences (see Chapter IV). As stressed in last year's Annual Report, policies to reduce structural unemployment by removing various obstacles to firms' increasing their demand for labour could play an important complementary role to fiscal restraint. If unemployed workers on state-financed benefits find jobs and spend more, the fiscal framework would gain in obvious ways. Moreover the associated increase in output potential would allow less demand restraint without posing a risk to maintaining low inflation. Such a combination of structural and fiscal reform should be given a particularly high priority in Europe where structural unemployment now exceeds 9% of the labour force in eight EU countries and the introduction of a single currency will remove a potential channel of adjustment to economic shocks.

Other factors affecting demand

Inventory corrections restrain demand

Changes in inventories had a major impact on both the pattern and level of output growth last year, despite the increasing use of computer-based systems to keep inventories in line with actual and expected demand. During the first half, inventory corrections reduced output by ½% in the G-7 countries, with particularly large reductions in France and Canada. Conversely, in the second half inventories had a positive effect although, in some cases, the renewed build-up of stocks may have been involuntary. Lower-than-expected growth of business fixed investment also contributed to the disappointing output performance in continental Europe, whereas in the United States, Japan, the United Kingdom and Canada, capital spending on machinery and equipment was, or progressively became, a source of strength. Developments in residential construction provide a similar contrast, with relatively high growth in the aforementioned four countries and low or negative growth rates dominating in continental Europe.

Large real wealth gains with uncertain spending effects

A remarkable feature of developments in recent years has been the sharp rise in bond and equity prices in many countries (see Chapter IV). Whether the associated increases in private sector wealth, as measured by total returns on bonds and equities (Table II.3), have affected private spending remains an open question. The saving rate did decline substantially in France, Denmark, Ireland and the Netherlands last year and also in Italy, Canada, Austria, Sweden and Switzerland. In the latter five cases, and in a number of other countries as well, the obvious interpretation is that wealth gains enabled households to cushion the effects of weak or negative real disposable income growth. While in France, temporary fiscal measures to boost consumption seem more likely to have been the main cause of the fall in the saving rate, the marked change in the household saving rate in the Netherlands last year seems to reflect the parallel rise in equity and house prices and the use of additional mortgages to finance current consumption. Similar developments may have taken place in Denmark and Ireland.

Evaluating wealth effects on spending is more difficult for the United States and the United Kingdom. In those countries households hold a major share of their financial assets in equities but the propensity to save actually rose slightly in both countries. In the United Kingdom, the acceleration of consumption growth could still be seen as indicating a response to the substantial improvement in net financial wealth, as well as a series of windfall payments by building societies. However, the parallel rise in the saving rate points to a more cautious response than in the 1980s when property prices were also rising sharply.

More cautious response in the United Kingdom …

Developments in the United States are also indicative of a behavioural change. According to historical estimates, spending increases by about 5% of a rise in household financial wealth within the same year. However, this seems to overstate the impact of recent gains since it would imply that as much as three-quarters of the actual rise in consumption over the last two years would be attributable to higher equity prices. The fact that consumption growth was not even stronger may indicate that some households have preferred debt reduction to more consumption or that wealth gains have been increasingly isolated in retirement funds. At the same time, aggregate changes in consumption may reflect offsetting behaviour among different income groups. High-income households which gained most from the rise in equity prices have rather low debt ratios and thus little incentive to reduce debt. In contrast, low and medium-income households tend to have higher debt/income ratios and may have used wealth gains to repay debt. In addition, this group could have been more affected by the recent tightening of credit standards for households.

… and the United States

It is also relevant to note that, except in Australia and some of the smaller European countries, the recent boom in equity and bond prices has generally not

Moderate changes in property prices

Equity and bond returns, saving rate and consumption

In percentages or percentage points

Countries	Equities[1]	Bonds[1]	Saving rate[2]	Consumption[2]
	1995–96			
Sweden	65.2	49.3	–1.5	0.8
United States	60.1	23.8	0.2	0.1
Netherlands	57.5	29.9	–1.0	0.8
Switzerland	47.7	20.7	–0.8	–0.5
Ireland	47.3	22.0	–1.7	2.3
Canada	46.0	36.4	–2.3	1.0
United Kingdom	40.4	25.4	0.7	1.1
Denmark	38.0	35.4	–2.3	0.4
Germany	34.9	26.0	0.1	–0.8
France	34.6	32.3	–1.8	0.5
Australia	34.1	38.4	0.8	–0.9
Austria	8.6	28.1	–1.4	–0.5
Italy	8.4	53.0	–1.2	–1.1
Japan	–2.6	23.0	–1.2	0.9

[1] Cumulative return. [2] Change in, respectively, the household saving rate and the growth of real private consumption.

Sources: Goldman Sachs, The International Economics Analyst, OECD Economic Outlook and national data. Table II.3

Nominal and inflation-adjusted real estate prices

Countries and cities	Nominal prices				Inflation-adjusted prices			
	1993	1994	1995	1996	1993	1994	1995	1996
	indices, 1992 = 100							
	Residential property prices							
United States	102	104	106	110	99	99	98	99
Japan[1]	95	94	91	90	94	92	90	88
Germany[2]	99	101	100	100	95	94	92	90
France	98	97	97	98	96	93	91	91
United Kingdom	97	99	99	102	96	95	92	93
Canada	102	105	100	100	100	103	96	94
Netherlands	103	106	110	111	101	100	102	101
Australia	102	110	113	118	100	106	104	106
Switzerland	98	97	94	83	95	93	88	78
Belgium	107	115	120	125	104	109	113	114
Sweden	89	93	93	94	85	87	85	85
Denmark	99	109	118	130	97	106	112	121
Norway	101	111	120	130	99	107	113	120
Finland	93	99	95	101	91	96	91	96
Ireland	101	105	113	126	99	101	106	116
	Commercial property prices: major cities							
New York	110	120	120	130	107	114	110	116
Tokyo[1]	82	69	57	50	81	68	56	49
Frankfurt	88	77	75	75	85	72	69	68
Paris	88	83	74	69	86	79	70	64
Milan	85	72	72	66	81	67	63	56
London	106	133	141	150	104	127	131	136
Toronto[3]	81	72	65	63	80	70	63	60
Madrid	63	64	67	73	61	59	58	62
Amsterdam	93	101	111	118	90	96	103	107
Sydney	90	109	117	119	89	105	108	106
Zurich	85	82	78	72	82	78	73	67
Brussels	86	81	81	86	84	77	76	79
Stockholm	81	106	137	145	77	99	125	131
Copenhagen	91	91	97	106	90	88	92	98
Oslo	102	110	119	127	99	106	112	118
Helsinki	97	109	114	116	95	105	109	111

[1] Land prices. [2] Four major cities. [3] Price index for offices in Ontario.

Sources: Frank Russell Canada Limited, Jones Lang Wootton, Ministère de l'Équipement, du Logement, des Transports et du Tourisme, National Association of Realtors, OPAK (Oslo), Sadolin & Albæk (Copenhagen), Wüest & Partner (Zurich), various private real estate associations and national data. Table II.4

been accompanied by rising property prices (Table II.4). Moreover, in real terms commercial property prices remain mostly below their 1985–86 levels although, in some countries, signs have emerged that the previous excess supply of commercial buildings has been eliminated and that price declines have come to an end.

Recent trends in wage and price inflation

Further decline in price inflation …

Average inflation in the industrial countries edged down further last year, even though the two-year decline in unit labour costs in manufacturing was partially reversed and energy and food prices rose more quickly. The improvement in inflation performance was particularly noticeable in Italy, Australia, Sweden, New Zealand and Spain, though in some cases this was partly the result of special factors or reflected a return to lower rates following adverse price level shifts (Table II.5). In Italy, the reduction in inflation can mainly be attributed to monetary policy and a consequent appreciation of the exchange rate since nominal wages actually grew faster in response to past price increases. Similarly in Sweden, the appreciation of the exchange rate served as a major offset to the acceleration of wages and unit labour costs. While a softening of manufactured goods prices in international markets was an important element in keeping inflation low, there are also signs, notably in the United States, that more intensive competition has made it increasingly difficult for firms to pass on higher costs into prices. By contrast, in countries with less competitive output markets and a more regulated services sector, mark-ups on costs have remained the typical form of price

… owing to restrained goods markets …

Consumer prices and unit labour costs

Countries	Consumer prices					Unit labour costs[1]				
	1980–89	1993	1994	1995	1996	1980–89	1993	1994	1995	1996
	annual percentage changes									
United States	5.5	3.0	2.6	2.8	2.9	2.9	0.3	−1.2	0.3	−0.4
Japan	2.5	1.2	0.7	−0.1	0.1	1.0	5.4	−0.2	−2.3	−2.0
Germany[2]	2.9	4.5	2.7	1.8	1.5	2.4	3.4	−6.1	−1.1	−0.9
France	7.3	2.1	1.7	1.8	2.0	4.6	3.6	−4.8	−0.2	1.3
Italy	11.2	4.2	3.9	5.4	3.8	8.4	3.3	−3.5	−0.5	5.0
United Kingdom	7.4	1.6	2.5	3.4	2.4	6.0	−0.4	0.0	3.1	4.1
Canada	6.5	1.8	0.2	2.2	1.6	4.9	−2.5	−2.4	0.2	3.4
Belgium	4.9	2.8	2.4	1.5	2.1	1.7	0.7	−1.5	−0.2	−0.2
Netherlands	2.8	2.6	2.8	1.9	2.1	0.5	1.6	−4.4	−1.2	−0.2
Sweden	7.9	4.6	2.2	2.5	0.5	6.6	−6.3	−2.2	−0.4	5.2
Switzerland	3.3	3.3	0.9	1.8	0.8	1.8	1.2	−2.3	−1.6	−0.7
Group of Ten[3]	*5.4*	*2.7*	*2.2*	*2.3*	*2.2*	*3.3*	*1.7*	*−2.0*	*−0.3*	*0.4*
Australia	8.4	1.8	1.9	4.6	2.6	6.7	0.0	−0.3	5.1	0.6
Austria	3.8	3.6	3.0	2.2	1.9	1.6	0.4	−3.6	−1.7	0.3
Denmark	6.8	1.3	2.0	2.1	2.1	5.5	−4.1	2.1	4.5	2.5
Finland	7.2	2.2	1.1	1.0	0.6	4.8	−6.3	−4.9	4.3	0.5
New Zealand	11.8	1.3	1.8	3.8	2.3	8.1	0.1	0.7	3.0	3.2
Norway	8.3	2.3	1.4	2.5	1.3	6.7	1.3	1.6	3.6	3.8
Portugal	17.5	6.5	5.2	4.1	3.1	16.8	7.3	3.6	3.3	3.1
Spain	10.2	4.6	4.7	4.7	3.6	7.9	1.2	−4.9	1.0	6.7
All countries[3]	*5.7*	*2.8*	*2.3*	*2.4*	*2.2*	*3.6*	*1.6*	*−2.0*	*−0.1*	*0.6*

[1] In the manufacturing sector; definitions of series differ across countries. [2] Prior to 1993, western Germany only. [3] Calculated using weights based on 1990 GDP and PPP exchange rates.

Sources: OECD Economic Outlook, national data and BIS estimates. Table II.5

determination, even though the highest mark-ups seem to have been reduced somewhat.

Profit margins and profit shares generally increased further last year. This could still be observed in the United States despite the advanced phase of the business cycle. In Japan, low interest rates and the sharp depreciation of the yen helped to reverse a three-year decline in profits. However, in some countries, including Italy, Canada, Denmark and Sweden, profit shares appear to have weakened. This could foreshadow upward pressures on prices in the future if firms attempt to restore margins.

… and continuing wage moderation in most countries

Even though unit labour costs stopped falling last year, wage moderation has continued to be one of the main reasons for the favourable inflation performance. The reasons for this vary across countries, though the influence of persistent slack in labour markets is generally pervasive. While this is not true in the United States, a series of one-time reductions in non-wage labour costs, allied with employee uncertainty with respect to future job prospects, has led to the same outcome. In the Netherlands, a social consensus approach has been instrumental in creating a general acceptance of real wage moderation as a principal condition for employment growth. In several other countries, tripartite agreements between governments, employers and employees still play a role in setting wages. For example, in some of the Nordic countries, a promise of low wage growth has variously required tax concessions or a commitment by the monetary authorities to keep the exchange rate stable. In Belgium, the Government imposed a real wage freeze when wage growth threatened to exceed that of its main trading partners, while in Australia the acceleration of nominal wage growth last year followed the expiration of an earlier incomes policy agreement (the Accord).

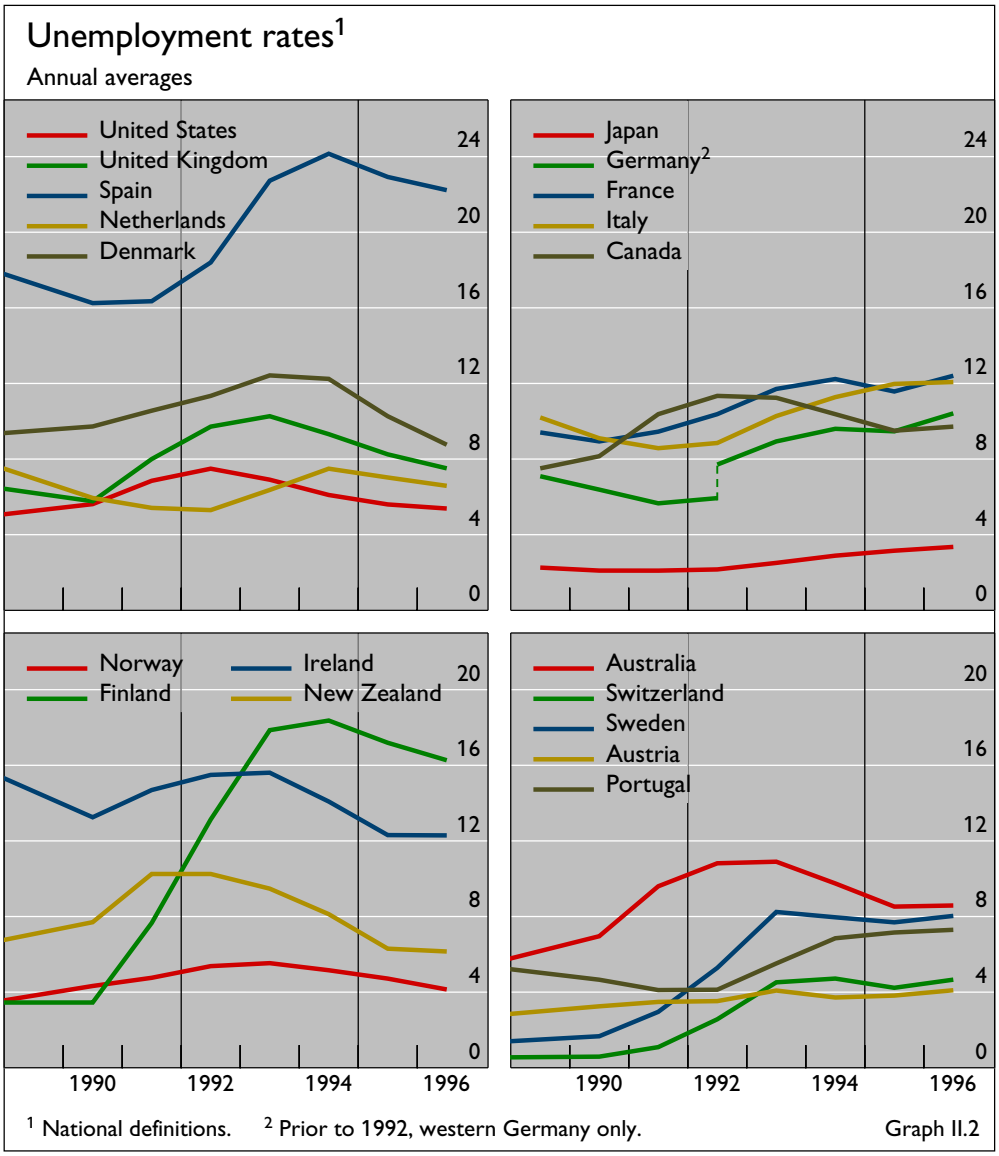
Developments in labour markets

Divergent labour market trends reflecting …

With output expanding at less than the potential rate of growth last year, the number of unemployed in the industrial countries rose to 35 million (of which about one-half are in the EU countries), equivalent to 7¾% of the labour force. Despite sizable differences between regions and countries, high unemployment thus remained a major policy problem. While the unemployment rate declined to around 5½% in the United States in 1996, it rose to 11½% in EU countries. Unemployment also increased in Canada and Switzerland but fell in New Zealand and Norway. Within the European Union, there were also several countries that managed to lower unemployment, including the United Kingdom, Denmark, the Netherlands and Ireland. By contrast, in the major continental European countries, the rate of unemployment worsened to over 12%, the highest level since the 1930s (Graph II.2).

… cyclical factors …

What explains these differences in performance? One obvious factor is the stage of the business cycle and the growth of output. Indeed, most of the countries with rising unemployment are lagging in the current business cycle and their recovery has, in any event, been fragile, with growth averaging only 1¾% during the last two years. Conversely, countries with falling unemployment are generally well advanced in the cycle. Growth in these countries averaged nearly



3% during 1995–96, with Norway, Ireland, the United States and the United Kingdom all showing improvements in labour markets which were primarily demand-driven.

Developments in employment and non-employment

… but above all structural reforms …

It is, however, generally recognised that the long-term rise in unemployment in continental Europe, as well as in Canada and Australia, mainly reflects structural problems. While it is less clear which specific structural measures are needed to deal with the problem, country experiences may still be instructive. The United Kingdom, the Netherlands, Denmark and Portugal do seem to have benefited from structural reforms, even if their reform policies differed and the benefits have taken many years to emerge.

Policies which enhance the influence of market forces and remove disincentives to work are rightly seen as means of lowering unemployment. Over the last decade or more, the United Kingdom has gone further down this road

than most other European countries by curtailing the power of trade unions, decentralising the wage bargaining process, tightening eligibility rules for social benefits while lowering benefit rates, and virtually abolishing minimum wages. Partly as a result, the United Kingdom has witnessed a much faster reduction in unemployment than in the last recovery, when unemployment continued rising. Moreover, real earnings per hour have increased less than in the 1980s in spite of the current relatively low rate of unemployment. However, to assess fully the UK experience it is important to add that the fall in unemployment seems to have been entirely the result of a growing proportion of "non-active" persons (i.e. persons who either leave or do not join the labour force). Employment, measured as a share of the total population, has been stagnant in the 1990s. A more equal regional distribution of unemployment has probably helped to contain wage pressures.

… in the United Kingdom …

Unemployment in the United Kingdom has also been reduced by the continuing increase in the proportion of part-time workers, a response to both deregulation and a shift of demand from industry to services. The Netherlands has gone even further in this respect (see below) and the share of part-time workers in total employment has risen to over 37%, compared with 24% in the United Kingdom. The UK and Dutch voluntary approach to working hours seems to have been more successful than compulsory cuts in weekly working hours. In Germany, for instance, the reduction in average annual working hours to a level 10% below that of the United Kingdom, seems to have had only a marginal effect on the total number of persons employed. In part, this is because wages did not fall commensurately and employers have taken compensatory steps to raise output per hour. It is also the case that more than 40% of all jobs in Germany are still in industry which is less suitable for part-time work than services.

… the Netherlands and Denmark …

The experiences of Denmark and the Netherlands provide additional policy lessons. A key policy change dating back to the early 1980s has been a greater emphasis on real wage moderation. In Denmark, wage indexation was eliminated while the Netherlands initiated policies to promote real wage moderation in sectoral settlements. More recently, in addition to measures encouraging part-time and/or temporary work, the major policy initiatives in the Netherlands have included a marked cut in employers' social security taxes, enhanced product market competition, and schemes allowing older or disabled workers to leave the labour force, albeit at recently reduced benefit rates. In Denmark, the reduction in unemployment has also been facilitated by a relatively competitive product market dominated by small to medium-sized firms and a traditionally low burden of non-wage labour costs. Yet additional support has been provided by active labour market measures and decentralisation of the wage bargaining system. Lay-off costs are also very low although, as compensation, unemployed workers are entitled to rather high unemployment benefits for up to five years. However, as in the Netherlands and the United Kingdom, it must be added that an important reason for Denmark's success in reducing unemployment has also been a rising number of non-active persons.

… as well as in Portugal

With an unemployment rate of just over 7%, Portugal compares favourably with most other EU countries and, in particular, with neighbouring Spain. The principal policy changes in Portugal also date from the 1980s when, faced with

the problem of absorbing a sharp rise in the labour force, the Government implemented a wide range of market-oriented policies. These were instrumental in lowering unemployment to only 4¼% early this decade while, at the same time, inflation was being reduced from 20% to 7%. A gradual approach to disinflation is likely to have eased the adjustment burden, but the process was further helped by a high degree of real and relative wage flexibility and comparatively low unemployment benefits. Portugal also continues to have the highest number of average annual working hours among EU countries. In addition, a series of tripartite agreements, supported by a high degree of consensus, seems to have contained nominal wage pressures in recent years.

Employment, foreign trade and foreign direct investment

Fears of trade-induced job losses …

Fears are often expressed that trade leads to jobs being "siphoned" out of the industrial countries, and that the wages of less skilled workers tend to be depressed by the rising share of emerging market countries in world exports of manufactured goods. Because capital is more mobile than labour, such trends may have been exacerbated by the outsourcing of production through foreign direct investment in emerging market economies. If these allegations were true, the repercussions would be likely to differ between countries depending on institutional and other factors, not least relative wage flexibility. If relative wages are rigid, the main effect would be felt in higher unemployment, notably among those with less skills. In contrast, with flexible relative wages, employment should remain constant, while the dispersion of earnings widens. This issue is returned to below.

… are not confirmed by the evidence and …

While there is some evidence that growing trade with emerging market countries has had adverse effects on unskilled workers in some sectors (notably textiles, clothing and footwear), the general consensus among economists is that the overall impact on both employment and relative wages has been small (Graph II.3, right-hand panel). Even in the United States, where the NAFTA agreement with Canada and Mexico caused fears of job losses, a recent study points to a small net gain after three years. Indeed, adjusting for the impact on US exports of the 1995 recession in Mexico, the number of job gains in the United States resulting from the NAFTA would have been twice the number of job losses.

… there are obvious reasons for this

For several reasons, this consensus is not very surprising. First, although imports from the emerging market countries have grown rapidly, they still amount to only a small share of total output in the industrial countries (in most cases less than 4%) and relative wages are still largely determined by national factors rather than in a world market. Second, while emerging market countries have substantially increased their exports to the industrial world, their imports have risen even more; as a group, the industrial countries have a significant trade surplus with emerging market countries. Third, most unskilled and low-income workers are found in the wholesale and retail trade sectors which, so far, have been little exposed to international competition. A final and central reason is that trade is not about job losses and gains; it is about resource allocation and long-run real income growth.

Against this background, it would appear that technological changes favouring skilled workers have been the main cause of changes in relative

The employment effects of technological changes …

employment and wages. A US study has found that 30–50% of the rise in the demand for skilled workers can be attributed to the spread of computer technology. Moreover, survey evidence for Canada suggests that, even if the wider use of computer-based technologies has increased overall employment, it has reduced firms' demand for unskilled workers. Even so, this does not exhaust possible international influences. Skill-biased technological changes could, in part, be induced by international competitive pressures or by the threat of such competition. In addition, direct trade is not the only channel by which international competition is felt; an equally important channel is foreign direct investment and the outsourcing of output and of work primarily done by the unskilled.

… and of foreign direct investment

It is frequently argued, notably in Europe, that foreign direct investment outflows from industrial countries tend to be accompanied by a parallel loss of jobs. Econometric evidence for Germany, the United Kingdom and Sweden suggests that relatively high domestic labour costs tend to increase foreign direct investment outflows and job growth abroad, while reducing the demand for labour in the parent countries. By way of example, Swedish companies have expanded employment abroad by 19% this decade when employment in Sweden fell steeply. Swiss multinational firms' employment abroad has doubled during the last ten years, whereas total employment in Switzerland has actually declined slightly (Table II.6). Similarly, German companies abroad have increased their workforce by over 50% since 1985, whereas total employment in Germany has grown by only 4½%. Furthermore, investment by German car manufacturers in eastern Germany and in Eastern Europe, has often been directly accompanied by employment cuts in western Germany. Among the cited motives have been lower wage costs outside Germany, together with the possibility of implementing new and more efficient production methods without being constrained by existing labour market agreements.

Need for cautious interpretation

However, for several reasons, concerns based on these observations can be overstated. As discussed below, the bulk of foreign direct investment represents flows between industrial countries which have, in most cases, been motivated by factors other than differences in labour costs. A growing share of foreign direct

Employment and foreign direct investment

Countries	1985		1985–95		1995		
	FDI/GDP	EMF/EMD	dFDI/dGFI	dEMF	FDI/GDP	EMF/EMD	FDI/EMF
United States	5.5	6.0	7.5	8.4[1]	9.8	5.7[1]	89,250[1]
Germany[2]	8.1	6.8	14.6	49.4	11.5	9.4	92,700
Switzerland	23.0	21.1[3]	12.8	98.2[3]	45.4	38.0	99,300

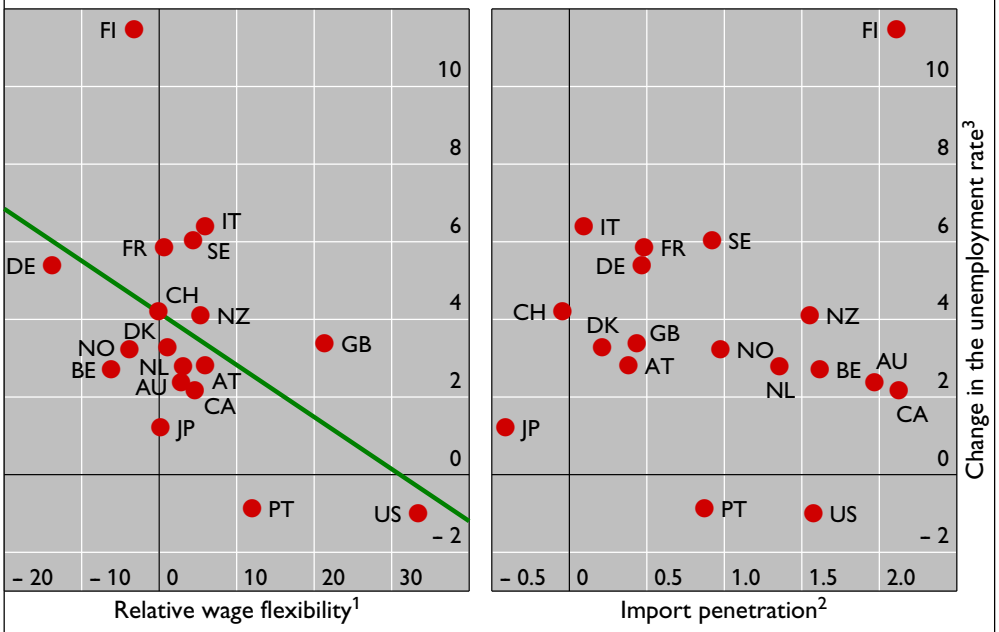
Note: FDI = stock of foreign direct investment; EMF = employment abroad; EMD = total domestic employment; dFDI = cumulated FDI outflows; dGFI = cumulated domestic non-residential gross fixed investment (for the United States, excluding government investment; for Switzerland, including residential investment); dEMF = cumulated percentage growth of EMF; FDI/EMF is expressed in US dollars.

[1] 1985–94 and 1994 respectively. [2] Western Germany only. [3] 1986 and 1986–95 respectively.

Sources: OECD International Direct Investment Statistics, US Department of Commerce Survey of Current Business, Deutsche Bundesbank and Swiss National Bank. Table II.6

Relative wage flexibility, import penetration and unemployment

In percentage points



AT = Austria; AU = Australia; BE = Belgium; CA = Canada; CH = Switzerland; DE = Germany; DK= Denmark; FI = Finland; FR = France; GB = United Kingdom; IT = Italy; JP = Japan; NZ = New Zealand; NL = Netherlands; NO = Norway; PT = Portugal; SE = Sweden; US = United States.

[1] Change in earnings dispersion (defined as the ratio of the highest decile to the lowest) between the 1980s and 1990s. [2] Change in non-oil goods imports from emerging market countries (as a percentage of GDP) between 1979 and 1995. [3] Between 1979-80 and 1995-96.

Sources: OECD Employment Outlook, OECD National Accounts, OECD Trade Series A and national data. Graph II.3

investment is also directed to the services sector, frequently to facilitate the sale and distribution of exports from the home country. What is more, funds invested abroad are not necessarily "lost" to the domestic economy as foreign investment projects are commonly financed in the host country itself, or from retained earnings, and not by funds from the parent company. Finally, goods produced by foreign affiliates are mainly for local or third markets, and in many cases complement rather than replace exports from the home country. For instance, the setting-up of German car plants in Eastern Europe has also been prompted by high import duties on automobiles and by firms' expectations of rapidly growing demand in the new markets.

Employment and relative wage flexibility

Relative wage flexibility helps to reduce unemployment …

Another factor frequently mentioned as having contributed to high and persistent unemployment in continental Europe is the absence of the relative wage flexibility needed to adapt to technological and other changes. Indeed, from Graph II.3 (left-hand panel), a trade-off between wage inequality and unemployment seems to exist, with a widening wage dispersion and falling unemployment in the United States standing in marked contrast to narrowing wage differentials and rising unemployment in Germany and France.

… but needs for flexibility differ

However, country-specific experiences should also be taken into account in assessing the policy implications. For instance, countries with apprentice systems

and other arrangements that ease the transition from school to work tend to have a more equal distribution of skills. This may enable workers to accommodate new technologies with less change in relative wages than is required elsewhere. Moreover, the experience of Denmark and the Netherlands demonstrates that it is possible to decentralise wage bargaining systems and reduce unemployment with rather stable relative wages. It is also noticeable that unemployment rates for the unskilled are not particularly low in countries with widening wage differentials such as the United States and the United Kingdom. In sum, greater wage flexibility is important but may not be a sufficient condition to ensure lower unemployment and more jobs for the unskilled.

Wage dispersions and social equity

On the other hand, the notion that greater relative wage flexibility is inconsistent with maintaining social equity also appears overly simplistic. When income is measured per household rather than as earnings per worker, one striking feature of recent developments is that countries with the largest widening of earnings differentials have actually witnessed some reduction in the inequality of household income. The main reason for this is that unemployment has been lower than in countries which have prevented labour markets from adapting to shifts in labour demand.

Concluding remarks

Significant progress has been made towards liberalising labour markets and removing disincentives to work, but much remains to be done. For instance, when taking account of unemployment-related subsidies and social benefits, unemployed workers can still face marginal tax rates of up to 80–90% should they accept a job. Progress in reforming social benefit schemes to reduce non-wage labour costs has also been slow as employees seem to more readily accept real wage moderation than changes in social benefits. Indeed, strikes today are more frequently about preserving entitlements than about future wage gains.

It is generally recognised that comprehensive reforms are more effective than piecemeal reforms and that both require supportive macroeconomic policies to yield positive results. It is, however, often overlooked that a key condition for effective labour market reforms is liberalisation and deregulation of product markets. In particular, given that globalisation frequently generates a need to shift resources from tradable to non-tradable sectors, deregulation of the services sector is of principal importance in preventing employment from falling. However, in several cases, high minimum wages relative to labour productivity or concerns about equity prevent the services sector from absorbing redundant resources. In this context, many countries also seem to disregard the fact that, while a wider dispersion of earnings may widen inequalities among individuals and households, faster employment growth tends to be the most equitable and effective way of improving the prospects for low-income households.

A final point to note is that, in some countries, success in reducing structural unemployment has been achieved in part by encouraging the unemployed (or even the employed) to leave the labour force. Such measures may well increase individual welfare in the short run, but they run a grave risk of aggravating future problems, given the ageing of the population and the associated need to finance pension liabilities.

World trade, current accounts and foreign direct investment

Developments in world trade and prices

Slower growth in world trade …

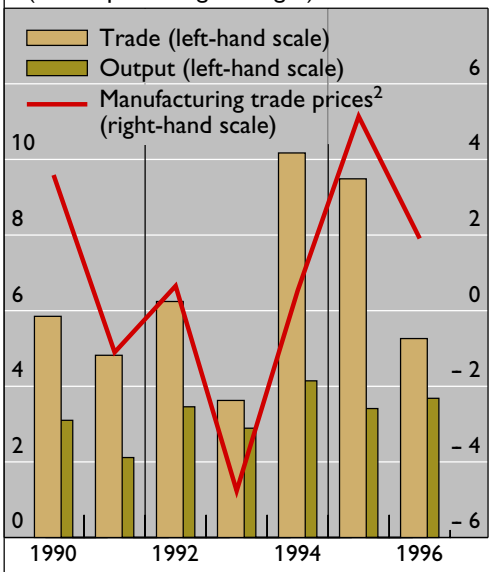
The growth of world trade decelerated last year, despite a slight pick-up in world GDP growth (Graph II.4). One reason for the slowdown was that trade between the industrial countries increased at only half the rate of 1995. In addition, more restrictive macroeconomic policies in some of the fast-growing Asian countries reduced their imports from industrial countries while their exports were severely affected by worldwide overcapacity problems in the electronics industry as well as by other factors (Chapter III). In contrast, with domestic demand growth accelerating in the Latin American countries, their import demand also expanded, which benefited exporters in the United States and Canada in particular. Moreover, the effects on trade of the slowdown in Western Europe were partly offset by a marked rise in import demand in Eastern European countries. Germany appears to have gained most from this development, and trade with Eastern Europe now accounts for almost 10% of its total trade. These changes in the regional composition of growth, together with exchange rate movements and cyclical differences, also led to some small changes in the major countries' share of world trade. The United States consolidated its leading position while the trade shares of Japan, Germany and France declined slightly.

… but slightly faster rise in prices

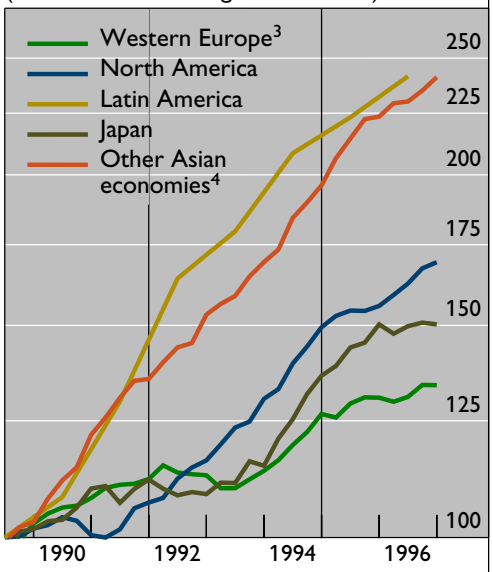
World trade prices (in SDRs) increased somewhat faster last year but this was almost entirely because of higher prices for oil and agricultural raw materials and inputs. Prices for manufactured goods increased at a lower rate than in 1995 and actually declined when measured in US dollars. This development may to

Indicators of world trade

World trade volumes and prices[1]
(annual percentage changes)



Import volumes
(1989 = 100; semi-logarithmic scale)



[1] Excluding Eastern Europe and the former Soviet Union. Output growth as measured by percentage changes in real GDP. [2] In SDR terms. [3] Belgium, France, Germany, Italy, the Netherlands, Spain, Sweden, Switzerland and the United Kingdom. [4] Hong Kong, Indonesia, Korea, Malaysia, Singapore, Taiwan and Thailand.

Sources: IMF, OECD, national data and BIS estimates. Graph II.4

some extent be the result of more intense competition in world markets, though it mainly seems to reflect the unexpected slowdown in demand growth in both 1995 and 1996. Non-oil commodity prices rose at a slightly faster rate than in 1995. Nonetheless, the terms of trade of the non-oil developing countries deteriorated while those of the industrialised countries rose moderately.

Developments in current account positions

Deterioration of the US external position …

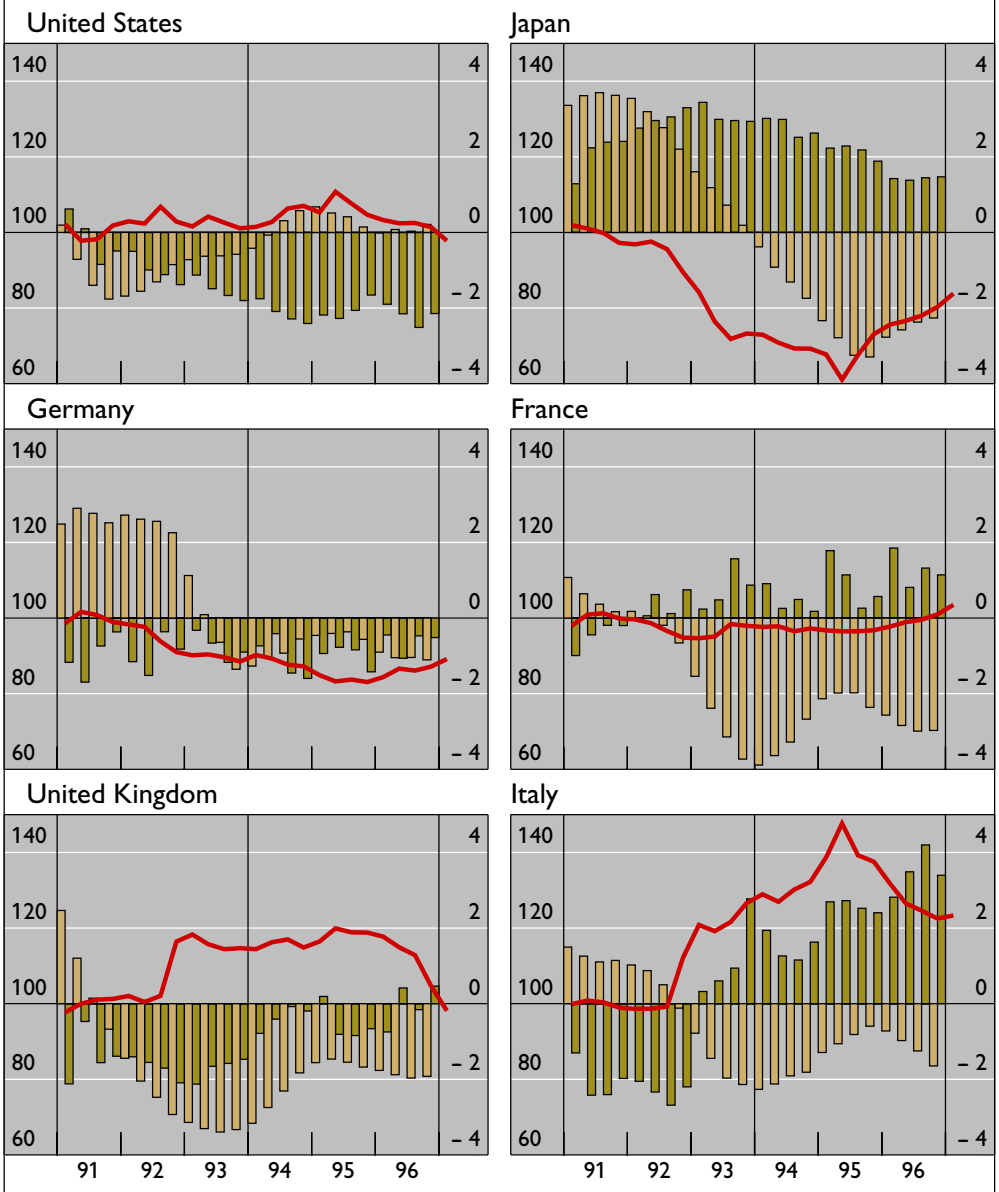
As in earlier years, divergent cyclical positions and the lagged effects of exchange rate movements had an important impact on changes in current account positions, not only in the United States and Japan, but also in Western Europe (Graph II.5). Reflecting the relatively advanced stage of the US business cycle and the strengthening of the dollar, the US current account deficit rose almost to the record level of 1987 (Table II.7) although, relative to GDP, the deficit was only slightly higher than in 1995. The deterioration was mainly accounted for by the continued surge in imports and a widening of the trade deficit to an historical peak. Because the US economy was virtually at full capacity in 1996, implying that stronger demand for US exports could not have been met without rising domestic inflation or macro-restraint, the underlying cause of the deteriorating external position seems to have been the high rate of domestic absorption.

Current account balances of the industrial countries

Countries and areas	Current account balance			of which					
				Trade balance			Balance on investment income		
	1992	1994	1996	1992	1994	1996	1992	1994	1996
	in billions of US dollars								
Industrial countries	−46.0	− 7.8	− 1.8	26.9	83.8	79.7	−15.7	−22.9	−11.4
United States	−62.6	−148.4	−165.1	−96.1	−166.1	−187.7	11.2	− 4.2	− 8.4
Japan	112.6	130.2	65.9	124.7	144.2	83.6	36.4	40.9	53.6
Western Europe	−62.9	46.0	115.8	−10.1	96.8	158.4	−34.3	−23.9	−17.1
of which:									
France	4.9	5.9	19.8	2.4	6.6	14.3	− 7.4	− 9.9	− 6.5
Germany	−19.7	− 21.7	− 14.6	28.7	51.7	72.6	16.8	6.7	− 3.8
Italy	−28.7	15.2	42.0	3.0	35.6	60.7	−21.9	−16.6	−15.6
United Kingdom	−18.4	− 3.5	0.0	−23.0	− 16.6	− 19.0	5.5	13.3	16.1
Belgium-Luxembourg	6.5	12.6	15.4	4.9	7.7	10.0	1.0	3.4	7.8
Finland	− 4.9	1.3	4.4	3.8	7.5	11.1	− 5.5	− 4.3	− 4.0
Netherlands	7.3	18.0	20.3	12.3	18.8	21.8	− 0.4	3.3	4.1
Norway	4.8	3.0	10.9	8.3	6.8	13.8	− 3.4	− 1.7	− 1.7
Spain	−21.5	− 6.9	2.9	−30.4	− 14.8	− 13.8	− 6.0	− 8.2	− 5.9
Sweden	− 8.8	0.7	5.7	5.9	8.7	17.4	− 9.9	− 5.8	− 8.0
Switzerland	15.1	17.8	20.3	− 1.0	1.6	0.8	13.7	12.9	16.9
Turkey	− 1.0	2.6	− 5.0	− 8.2	− 4.2	− 19.2	− 2.6	− 3.3	0.5
Other industrial countries	−33.1	− 35.5	− 18.3	8.4	9.0	25.4	−29.0	−35.8	−39.5
Australia	−10.1	− 16.9	− 14.7	1.7	− 3.3	− 0.5	−10.2	−12.2	−14.7
Canada	−21.6	− 16.3	− 1.2	5.1	10.9	25.3	−16.6	−20.1	−20.5
New Zealand	− 1.4	− 2.4	− 2.4	1.6	1.3	0.6	− 2.2	− 3.5	− 4.3

Sources: IMF Balance of Payments Statistics, OECD Economic Outlook, national data and BIS estimates. Table II.7

Competitiveness, cyclical positions and current account balances



* Measured as the real effective exchange rate (in terms of relative unit labour costs); an increase indicates an improvement.

Sources: OECD Economic Outlook, national data and BIS calculations. Graph II.5

… with Japan's surplus stabilising …

While changes in the US external position can be related primarily to cyclical forces, the fall in the Japanese current account surplus to the lowest level since 1990 reflected a number of different forces, including "J-curve" effects. Changes in trade volumes were not the cause of the decline; indeed, the growth of imports in 1996 slowed substantially more than that of exports. Rather, because the terms of trade deteriorated by over 9%, owing to higher oil prices and the depreciation of the yen, the trade surplus actually fell by US$ 50 billion. At the same time, the investment income balance improved, partly as a result of the high proportion

of US securities in foreign assets, and this limited the decrease in the current account surplus. With the rate of export growth strengthening in response to the depreciation of the yen, and given a prospective fiscal tightening, Japan's surplus appears unlikely to shrink much further.

… and Western Europe seeing a record surplus …

In contrast to the experience of the United States and Japan, Western Europe saw a further improvement in its aggregate current account position last year. Indeed, at more than US$ 100 billion, the surplus is the highest ever recorded even though Germany is still running a deficit. Western Europe has now replaced Japan as the main counterpart to the US deficit. With respect to contributions by country, the largest improvements have been recorded by France and Italy which together account for over 70% of the overall rise since 1994. The current account positions of Spain and Sweden have also strengthened, whereas that of Turkey has weakened substantially; at almost 4% of GDP, Turkey's current account deficit is approaching the level which triggered problems in 1993.

… due to lower domestic absorption

In terms of underlying forces, a large part of the current external strength of Western Europe as a whole can be attributed to its relatively weak cyclical position. The reduction of fiscal imbalances, together with a rise in private sector net saving, has reduced internal demand growth while strengthening the external position. An additional factor has been a growing export surplus with Eastern Europe, whereas the recent depreciation of most European currencies only began to affect the trade accounts towards the end of 1996.

Effects of fiscal restraint also in Canada …

Among other industrial countries, the principal change last year was the marked reduction in Canada's current account deficit to the lowest level since 1984. The improvement can be ascribed mainly to the trade account which was favourably influenced by fiscal restraint, a cyclically induced decline in import growth and a slight terms-of-trade gain as commodity prices rose. However, the better external position of Canada is not entirely cyclical as wage moderation and relatively high productivity growth have helped to improve the competitive position of Canadian enterprises. In New Zealand, a tight fiscal stance has also helped to prevent the current account deficit from rising in spite of a marked appreciation of the currency (30% since 1992). Australia's current account deficit fell somewhat last year, primarily reflecting a strong recovery of exports after the 1995 drought and increasing terms of trade. The external improvement was matched by a rise in government saving and a higher household saving rate. Nonetheless, at just over 3%, the latter remained one of the lowest among the industrial countries.

… and New Zealand

Foreign direct investment (FDI)

Marked rise in foreign direct investment …

Although increases in international trade typically exceed output growth, trade is no longer the sole form of interaction between countries. In fact, a main feature of this decade has been the growing role of multinational firms. Intra-firm trade now accounts for one-third of global trade in goods and services, and foreign sales by their foreign affiliates are higher than total direct trade (Table II.8). Furthermore, following a resumption of the growth of foreign direct investment flows, the expansion of FDI stocks abroad has, by far, outpaced that of domestic capital stocks and even the growth of foreign trade. Although not without

Diversification of international transactions

	World	United States	Japan	Germany
FDI stocks (a)	2,500	712	298	248
Affiliate sales (b)	5,355	1,636	626	532
Intra-firm exports (c)	1,646	163	86	208
Total exports (d)	4,940	448	374	623
b/(d-c)	1.6	5.7	2.2	1.3
c/d	0.33	0.36	0.23	0.33

Note: FDI stocks refer to end-1995, the other items to 1992. FDI, sales and exports are expressed in billions of US dollars.

Sources: OECD International Direct Investment Statistics and UN World Investment Report.

Table II.8

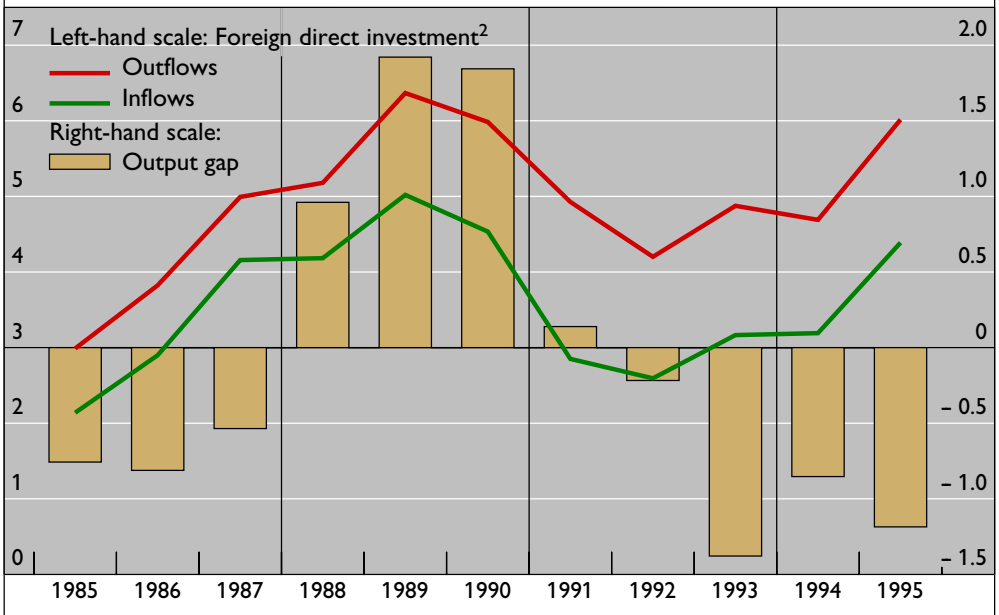
associated drawbacks, this increasing diversification of international transactions has probably helped to reduce the exposure to specific shocks of both countries and firms.

… reflecting cyclical factors …

Taking a longer perspective, the growth of FDI has trended upwards, if not always smoothly (Graph II.6). Indeed, there is a distinct and dual cyclical pattern, with developments in both parent and host countries having an influence. Strong growth in the investing countries provides cash flow to finance FDI while strong growth in host countries attracts investment. In some periods, this dual influence may give rise to asymmetries. For instance, with the United States leading the business cycle in the industrial world during the 1990s, it has again become the largest foreign investor. In contrast, investment outflows from Japan, which is just

Foreign direct investment and the output gap in OECD countries[1]

In percentages



[1] Excluding Greece, Ireland, Mexico, the Czech Republic, Hungary, Poland and Korea. [2] As a percentage of total fixed investment.

Sources: OECD Economic Outlook and OECD International Direct Investment Statistics. Graph II.6

emerging from recession, are still only half their 1990 peak. Outflows from continental European countries have also remained low during most of this decade of sluggish growth, although they increased markedly in 1994–95 in response to buoyant trends in the United States and in the emerging market countries. The continued slow growth in continental Europe has, however, kept investment inflows to a relatively low level.

… but above all several underlying trends

The strong upward trend in FDI which underlies these cyclical swings has been driven by several factors. These include technological progress which has lowered the costs of international communication and transport, growing international competition in both goods and services, the partial or complete removal of regulations on capital flows in general and on FDI in particular, and the trend towards privatising state enterprises in many countries. Despite these changes, the regional pattern of FDI stocks has remained remarkably stable. Thus, even though emerging market countries (in Latin America and Asia as well as in Eastern Europe) receive a rising share of investment outflows, a dominant part still reflects FDI among industrial countries and particularly among EU countries. Moreover, because of the long slump in FDI outflows to emerging market countries in the 1980s, especially to Latin America, the distribution of FDI stocks is even more dominated by investment in industrial countries (Table II.9).

Implications for sectoral distribution

In contrast, the sectoral distribution of FDI has changed significantly over the last 25 years, reflecting not only sectoral shifts seen in the parent economies but also changes in underlying investment motives. Traditionally, the principal motive for FDI was to gain access to a secure source of primary materials. However, since the 1970s, the share of FDI going to the primary sectors has fallen by one-half. Attempts to overcome restrictions on direct trade have also been a major factor and these efforts generated large foreign investment in the secondary sectors. More recently, motives have shifted again in step with the

Foreign direct investment abroad

In percentages

	United States	United Kingdom	Japan	Germany	Nether-lands	Switzer-land	OECD
Position at end-1995							
As a percentage of OECD FDI	29.4	12.5	12.3	10.3	6.4	5.9	100.0
As a percentage of GDP	9.8	27.9	6.3	10.3	39.3	45.4	10.9
Distribution by region (1994)							
North America[1]	12.1	34.3	43.7	23.0	28.2	24.5	24.6
European Union	42.0	34.7	18.1	50.5	45.9	45.4	40.0
Latin America and Asia[2]	23.2	15.6	27.7	10.1	12.5	17.8	17.8
Distribution by sector (1994)							
Primary	11.8	19.9	5.0	1.2	1.7	..	9.0
Secondary	35.0	38.9	27.8	32.9	49.8	47.8	37.0
Tertiary	53.2	41.2	65.5	65.8	48.4	52.2	53.8
of which: Financial[3]	*36.5*	*27.5*	*18.9*	*23.8*	*36.0*	*22.0*	*29.2*

[1] United States and Canada. [2] Excluding Japan. [3] Banking and other financial and business services.

Sources: OECD International Direct Investment Statistics and national data. Table II.9

Location and sales of US and Japanese foreign affiliates

In percentages

Destination	US affiliates located in		Japanese affiliates located in	
	EU and Asia	other NAFTA	EU and US	other Asia
Home country	6	26	4	16
Local markets	64	71	79	66
Third markets	30	3	17	18

Source: OECD Economic Outlook, December 1996. Table II.10

general trend towards globalisation and this has led to a further change in the sectoral distribution of FDI towards the tertiary sectors, with the latter often dominated by financial services broadly defined.

Different motives …

Within these broad trends there have also been significant differences between the forces and motives underlying FDI outflows from individual countries. Depending on whether the production structures of the host countries are complementary to, or competing with, those of the investing countries, these idiosyncratic forces have influenced trade patterns in several ways. As illustrated by the experiences of the United States and Japan (Table II.10), US FDI has mostly been undertaken to serve local and third markets. The main exception to this is FDI in Canada and Mexico where inter-industry and inter-firm links have led to complementarities in production structures and significant sales back into the United States. In the case of Mexico, lower costs have also contributed to the high share of sales in the US market. Overall, Japanese affiliates sell an even higher share in local and third markets. However, since 1990 the proportion of FDI outflows from Japan going to Asia has grown from about 10 to over 23% and Japanese affiliates are increasingly exporting back into Japan. According to preliminary estimates, this change in the pattern of FDI, together with deregulation in Japan, has already begun to affect Japanese foreign trade in manufactured goods. Thus, compared with the 1980s, the income elasticity of Japanese exports has declined as demand can be met by Japanese affiliates abroad. In contrast, FDI outflows seem to have significantly increased Japan's import propensity, as seen from the rapid growth of imports of manufactured goods from Japanese affiliates in Asia. Taken together, these estimates suggest that the previous tendency for Japan to accumulate large trade surpluses in a worldwide cyclical upturn may have been substantially reduced. Moreover, even though the net impact of recent changes on price elasticities is difficult to judge, it could be that smaller exchange rate movements will now be required to keep the Japanese trade account broadly balanced.

… have influenced trade patterns