

II. Developments in the advanced industrial countries

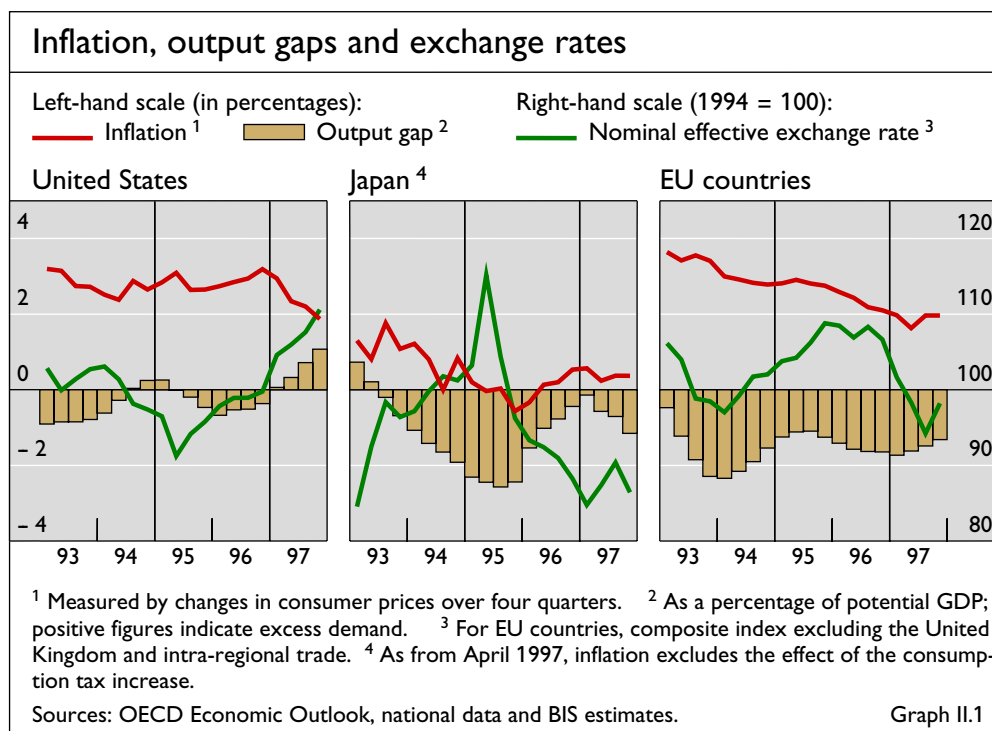
Highlights

Contrary to expectations, the international divergences which have characterised much of the current cyclical recovery widened further last year. In the *United States* real output growth accelerated to almost 4%, even though most forecasters had predicted a gradual slowdown. In contrast, following rapid growth in early 1997, which mainly reflected purchases in advance of a rise in the consumption tax, the *Japanese* economy stagnated as the momentum of private domestic demand was too weak to compensate for the more restrictive fiscal stance. In the *European Union* countries, average growth in 1997 was higher than in 1996 but below most forecasts. Moreover, cyclical divergences within the region increased further, with the *United Kingdom* and several of the smaller countries moving well ahead of the larger continental countries.

These divergences in output growth, allied with an appreciation of the US dollar and the pound sterling against most other major currencies, were also reflected in widening external imbalances. Rapid import growth raised the US current account deficit to 2% of GDP. At the same time, the Japanese surplus, which had narrowed significantly in 1996, started to grow again as the economy stalled. The combined surplus of the EU countries, since 1996 the major counterpart to the US deficit, increased further last year, reaching historical highs in some countries. However, the potential exchange rate impact of larger current account imbalances was mitigated by capital flows. In particular, foreign direct investment rose substantially, driven by cross-border mergers and acquisitions and the continued search for more efficient production structures.

The differences in output growth and in initial cyclical conditions also led to widening divergences in labour and product markets. The US economy entered 1997 with little or no spare capacity and, in the course of the year, the rate of unemployment fell to 4.7%, the lowest rate for 24 years. In Japan, by contrast, the rate of unemployment increased to a new high. Continental Europe saw a further rise in labour market slack, although there were wide divergences between large and small countries; however, in most cases, unemployment was falling towards the end of the year. As a result of sluggish investment spending, the output gap was rather small in most continental countries.

Notwithstanding the cyclical differences, inflation rates converged rather than diverged both between major countries and regions and within the EU area. Indeed, while in 1992 the standard deviation of consumer price inflation in the industrialised countries was about 3¼%, it fell to only 1% last year; in the continental EU countries it dropped even more. One reason for this favourable outcome was that the currencies of the countries most advanced in the cycle tended to appreciate against those of countries still in the early phase of recovery



(Graph II.1). Moreover, despite the late stage of the cycle and contrary to historical patterns, productivity growth in the US business sector accelerated last year while output per hour declined in Japan. Productivity growth also accelerated in *Germany* but, with the resulting decline in unit labour costs mostly absorbed in wider profit margins rather than lower prices, this did not impede the convergence of inflation within the EU area. Finally, convergence was also helped by the continuous fall in computer prices, which had a particularly large dampening influence on US inflation.

This combination of diverging product and labour market conditions and widening external imbalances, in association with converging wage and price developments, raises a number of questions. Some of these have to do with measurement issues, but others with the appropriate setting and coordination of policies.

Developments in the seven major economies

Among the major economies, the three furthest advanced in the business cycle all expanded at a pace well above their potential rates of growth. Whereas both the United States and the United Kingdom entered 1997 with limited or no spare capacity, the recovery in Canada was helped by the availability of unused resources. Another feature distinguishing the English-speaking countries from other major economies was that the expansion was driven by domestic demand whereas the external sector acted as a drag.

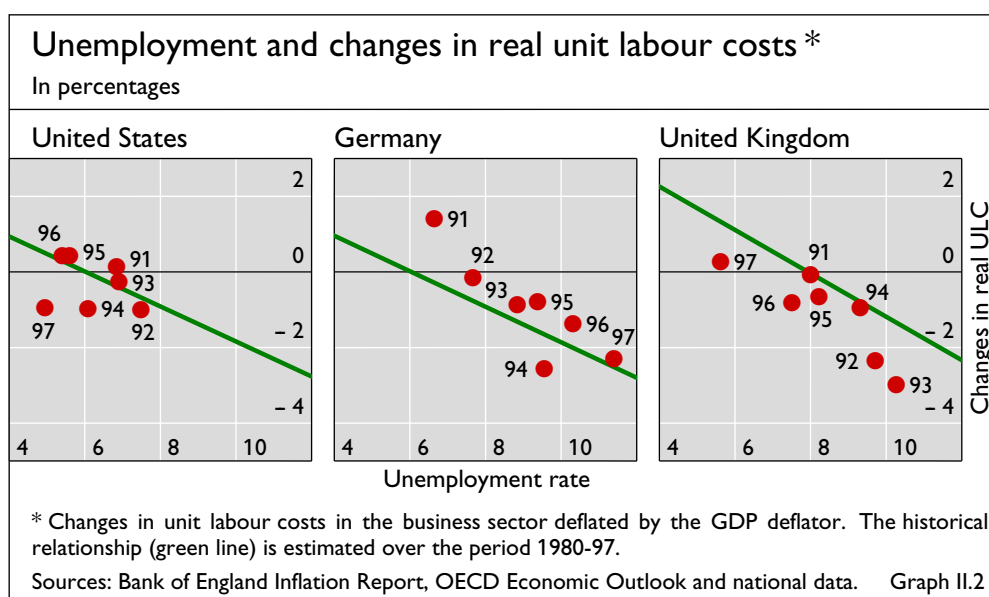
The performance of the *United States* economy last year was exceptional by international as well as historical standards. Despite rapid output and credit growth, macroeconomic imbalances (rising inflation, excess labour demand, unsustainable debt/income ratios, etc.) have been less in evidence than is usual at this stage of the cycle. Strong productivity gains have allowed real wages to

The exceptional performance of the US economy ...

grow along with profits. Consequently, the stance of monetary policy was left largely unchanged (see Chapter IV). However, even though fears of near-term inflationary pressures gradually dissipated, financial markets continued to act as a stabilising factor. Nominal interest rates did not decline by as much as either actual or expected rates of inflation so that real interest rates tended to increase. Another stabilising influence was the appreciation of the dollar, which appears to have had an unusually large dampening effect on import and consumer prices (see below). Despite the real appreciation of the dollar, the volume of merchandise exports grew by nearly 16%, raising the US share of world exports to a 20-year high. Although this performance is attributable in part to lower margins on exported goods, foreign producers seem to have reduced margins on their exports to the United States even more. Thus, terms-of-trade gains provided a further boost to disposable income.

These developments raise the question of whether the level of output at which inflation starts to accelerate has increased compared with historical patterns. Some factors, such as the appreciation of the US dollar and the fall in import prices, are clearly of only a temporary nature, although they may continue to dampen inflation in the near term. Similarly, the acceleration of labour supply growth, as a result of stricter social welfare regulations and the slower growth of employee benefit costs, will only temporarily moderate the rise in labour costs. Other factors, however, could involve more permanent changes. First, the rate of capacity utilisation in manufacturing has remained below earlier peaks suggesting that rapid investment growth has significantly increased output potential; other sectors, where output is more difficult to measure, may have experienced a similar boost to output potential. Second, as in the United Kingdom, there are signs that wage behaviour has changed, possibly lowering the rate of unemployment at which inflation starts to accelerate (Graph II.2). Third, as the distribution of demand has shifted towards sectors where the “split” between real and nominal changes is more difficult to measure, the rate of inflation may be overstated and output growth, although not necessarily output capacity, understated. Fourth, the rapid growth of investment in information

... could point to an improvement in underlying fundamentals ...



The information industry in the US economy ¹			
	1992	1997	1992–97
	as a percentage of the total		annual percentage changes
Real output of information industry	0.8	4.0	40.6
Real investment in information equipment	5.6	20.1	38.7
Real net stock of information equipment ²	1.7 ³	2.6 ³	24.5
Real GDP, excluding information industry	99.2	96.0	2.2
Real GDP, total	100.0	100.0	2.9
GDP deflator, excluding information industry	–	–	3.0
GDP deflator, total	–	–	2.4

¹ Based on 1992 prices. ² Data refer to 1992 and 1995. ³ Net stock of computers and peripheral equipment relative to net stock of private non-residential capital.
Source: US Department of Commerce Survey of Current Business (and special submission). Table II.1

technology may have boosted the level of potential output and contributed to the large productivity gains recorded last year. As shown in Table II.1, the information technology sector has had a significant and positive impact on actual GDP growth and has also helped to dampen inflation over the past five years.

... though the magnitude remains uncertain

Nevertheless, the return on such investment as well as the contribution to output potential and total factor productivity remains uncertain. Even though the growth of technology investment has been very fast, a high obsolescence rate has kept the share of such equipment in the net capital stock of the private sector and thus the contribution to long-run growth rather low. Moreover, given the speed with which technologies are changing and investment has grown, firms may not yet have been able to adapt their organisation and production structures to reap the full benefits of the new technologies installed. Finally, it needs to be kept in mind that measurement errors associated with new technologies and productivity only influence growth potential to the extent that they affect final, and not just intermediate, output.

Strong rebound of demand in Canada ...

Following rather sluggish growth in 1996, domestic demand in *Canada* strengthened significantly last year, reflecting the lagged effects of lower interest rates and higher confidence related to improving labour market conditions. With the general government budget moving into surplus, the restrictive stance of fiscal policy was also relaxed but, more importantly, the risk premium on Canadian bonds disappeared in response to the successful fiscal consolidation. As a result, private fixed investment increased by almost 15% and, with consumer confidence and household spending also strengthening, the household saving rate fell to the lowest level in the postwar period. Considering the buoyancy of the US economy, a relatively favourable competitive position and a large output gap, the resulting deterioration in net export growth in *Canada* was surprisingly large. Real imports expanded by 12½% as the composition of domestic demand shifted towards import-intensive components. Moreover, for the second consecutive year, the growth of exports was far below that of *Canada's* export markets. One reason for this may be that Canadian exporters have increased their margins; the rise in relative export prices has tended to exceed that of relative unit labour costs.

Household consumption also grew strongly in the *United Kingdom*, due in part to buoyant labour market conditions but also reflecting sizable wealth gains from the demutualisation of building societies and insurance companies. Together with higher property prices, wealth and disposable income gains also stimulated residential and non-residential investment. Moreover, as in the United States, disposable income was boosted by terms-of-trade gains, which facilitated a rise in real wages as well as profits without generating inflationary pressures. However, there are also signs that wage behaviour has moderated as the rate of unemployment at which wage earners resist a fall in the share of wages seems to have declined compared with the 1980s (Graph II.2). In contrast to Canada, the drag from net exports remained modest for most of the year, as exporters reacted to the appreciation of the currency by reducing margins to preserve market shares. While the real effective exchange rate, measured by relative unit labour costs, has appreciated by 26% since 1995, the appreciation is only 12% when measured by relative export prices.

... and in the
United Kingdom

Turning to continental Europe, output growth in *Germany* remained slightly below the predicted rate for 1997. In part, this reflected the unexpectedly deep slump in the construction sector whose repercussions on activity were most pronounced in the eastern Länder. Moreover, despite fiscal transfers amounting to 4% of GDP per year since reunification, self-sustaining forces of growth have not yet emerged in the eastern Länder. Per capita income has remained below 60% of that of western Germany and, due to a high level of real unit labour costs, the service sectors in the eastern Länder are not sufficiently competitive and flexible to absorb labour released from the construction sector. As a consequence, the rate of unemployment rose to almost 20% last year.

Uneven recovery in
Germany ...

Labour market conditions also deteriorated in western Germany as employment declined for the third consecutive year against a background of continued efforts by German enterprises to reduce costs and improve efficiency. As a result, the rate of productivity growth accelerated and unit labour costs declined, both in absolute terms and relative to Germany's trading partners. However, despite a consequent improvement in export growth and a rising profit share, the pick-up in business fixed investment was fairly modest, possibly reflecting low, albeit rising, confidence as a reaction to inadequate structural reforms. Low confidence characterised the household sector as well and the expected rebound in household spending did not materialise.

... with falling
labour demand and
sluggish household
spending

Sluggish growth of household spending was also a main cause of the relatively weak expansion in *France* during the first half of 1997. In contrast, the second half saw a shift from net exports to domestic demand as the main engine of growth. In response to lower interest rates, residential investment started to pick up and consumption also strengthened. However, as in Germany, business fixed investment was rather weak despite favourable profit conditions. One reason may have been a redistribution of taxes from labour to capital. In addition, uncertainty about the cost effects of the 35-hour working week to take effect from the year 2000 may have held back investment.

Shift towards
domestic demand
both in France ...

In *Italy*, the recovery that started in late 1996 gained further momentum last year despite certain "headwinds". First, mainly to satisfy the Maastricht criterion both the measured and the structural fiscal deficits were reduced by an

... and in Italy
despite
"headwinds"

unprecedented 4% of GDP, amounting to almost half of the consolidation achieved since 1991. Second, even though nominal short and long-term interest rates declined in response to fiscal consolidation and lower inflation, real rates remained relatively high, which may have held back residential construction and business investment. Third, despite moderate wage growth, exporters were faced with a real appreciation of the lira and appear to have cut margins to maintain market shares. Consequently, household spending was the main source of growth in Italy last year. However, this was mainly the result of special incentives for purchases of automobiles and a further fall in the saving rate.

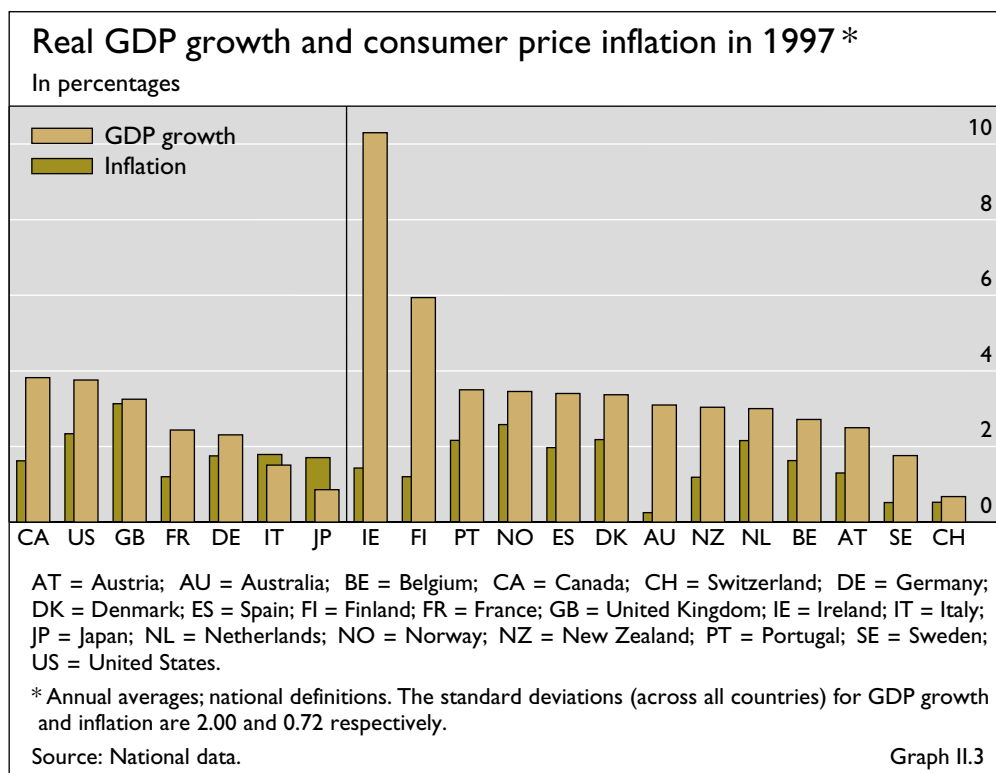
Japan moving to the edge of recession

While growth in *Japan* had been the highest among the major countries in 1996, and output was still expanding briskly during the first quarter of 1997, activity stagnated for the rest of the year. One reason for the slowdown was the marked fiscal tightening from 1st April. With direct and indirect taxes raised, and expenditure on public works sharply cut, the structural deficit was reduced by 1½% of GDP. Moreover, the self-sustaining forces of the private sector turned out to be weaker than initially foreseen, suggesting also that the various fiscal stimuli introduced during 1992–95 may in fact have been more effective than so far assumed. Indeed, as the fiscal stimuli were removed, household spending as well as residential construction and business fixed investment all fell sharply while the level of excess inventories rose. Later in the year, as the economy moved to the edge of, if not into, recession and equity and property prices continued to fall, banks' large stocks of bad loans from the earlier period of volatile asset prices increasingly constrained their ability and willingness to lend. In particular, small and medium-sized companies, which are more dependent on the domestic economy and less able to raise external funds in capital markets than the larger export-oriented enterprises, were severely affected by the tightening of credit standards and led the downturn in business investment spending. Massive liquidity injections by the Bank of Japan and various fiscal measures to strengthen the financial system (see Chapter IV) were only partially successful in alleviating these circumstances. Finally, as labour market conditions weakened and the adverse effects of the crisis in other Asian countries began to be felt, household and business confidence fell. Combined with increasing uncertainty about the health of the financial system, this further exacerbated the deflationary forces in the economy. All in all, domestic demand declined by almost 2% in the course of last year and only a marked rise in net exports prevented an equally large decline in real GDP.

Developments in other industrial countries

Strong performance in smaller European countries

One remarkable feature of developments in the smaller industrial countries last year was that not only did output grow much faster than in the Group of Seven countries but inflation was actually lower (Graph II.3). This was particularly noticeable in Europe, where several smaller countries entered 1997 with relatively low real exchange rates and were able to combine strong domestic demand growth with positive growth of net exports. On balance, smaller countries have also gone further than the larger countries in terms of deregulating labour and product markets and, in several cases, incomes policies



and/or exchange rate commitments have helped to keep inflation low. In addition, the smaller countries seem to have benefited more from the convergence of interest rates than some of the larger ones. However, in a few countries with exceptionally rapid demand growth, the convergence of nominal interest rates seemed clearly at odds with the monetary conditions required to reduce the risk of higher near-term inflation (see Chapter IV).

Buoyant supply-side developments have been particularly evident in *Ireland*, where output growth has averaged more than 9½% per year since 1994. Moreover, despite a widening productivity differential between export-oriented “high-tech” industries and the non-tradable sectors and emerging shortages of skilled labour, nominal wage growth has remained low. Nonetheless, with an expansionary fiscal policy and rapid asset price and domestic credit growth, there is a potential risk of overheating. To reduce this risk, the Irish pound was revalued within the ERM early this year. A similarly buoyant high-tech sector was observed in *Finland* and, allied with a brisk recovery of the forestry sector and growing confidence in the macro policies being pursued, this led to a 6% expansion of GDP last year. Investment spending and exports were particularly strong. Furthermore, households seem to have reduced saving in step with fiscal consolidation and the decline in unemployment associated with the spread of the recovery to the labour-intensive service sectors. However, at just below 13%, the rate of unemployment remains much higher than in most other countries.

Underpinned by the oil and gas sector and a broad incomes policy agreement, the *Norwegian* economy has recorded average output growth of 4½% per year since 1993. Even though short-term interest rates have been kept low to prevent upward pressure on the exchange rate from adversely affecting the competitive position of traditional industries, the average rate of inflation has

Favourable supply-side developments in Ireland ...

... and Finland

Also strong growth in Norway ...

... Iceland and Denmark

been limited to around 2½%. However, with fiscal policy easing, the labour market is tightening and wage growth is accelerating. In *Iceland*, investment in power-related industries and a marked rise in household spending were the main sources of growth last year. Tax-based incomes policies, allied with some appreciation of the exchange rate, prevented higher wage growth from pushing up price inflation. *Denmark* has also enjoyed rapid output growth in recent years, though mainly reflecting buoyant household spending induced by higher house prices and improvements in the labour market. Fiscal consolidation, by helping to narrow the interest differential vis-à-vis Germany, has stimulated interest-sensitive demand components. However, because such components tend to be import-intensive, net exports as well as the external surplus declined.

Broad-based recovery in the Netherlands and Spain ...

Demand growth in the *Netherlands* has been stimulated by wealth gains associated with higher house prices and strong employment growth, the latter a result of supply-promoting labour market policies. It further appears that moderate nominal and real wage growth, together with a rising profit share and low interest rates, has encouraged capital-widening business investment, with a likely positive effect on output potential. Very similar factors seem to have been at work in *Spain*, which last year recorded its best performance this decade. Output growth accelerated to 3½% while inflation fell below the central bank's target of 2½%. In part, this was because lower interest costs helped to offset a rise in real unit labour costs and prevented a profit squeeze. Backed by labour and product market reforms, employment expanded by 3%. Moreover, since Spain entered 1997 in a relatively favourable competitive position, net exports contributed positively to output as well as the external balance. In contrast, the contribution of net exports to growth in *Portugal* fell to a negative 2½% of GDP, even though incomes policies helped to moderate nominal wage increases. Infrastructure investment was a principal source of domestic demand growth but other investment components strengthened too as interest rates declined. *Greece* also recorded a fall in net exports as exchange-rate-based stabilisation policies seem to have received little support in the labour market and relative unit labour costs increased. Partly as a result, the exchange rate became subject to strong downward pressure early this year, a pressure that only eased after *Greece* became a member of the ERM and the drachma was devalued by 12.3% against the ECU.

... while net exports decline in Portugal and Greece

Strengthening economic activity in Belgium, Austria and Sweden ...

The four remaining Western European countries all experienced a strengthening of economic activity last year but growth remained below the European average. Another common feature was that net exports assisted the upturn, whereas there were major differences regarding the role of domestic demand. *Belgium* benefited from buoyant business fixed investment and a recovery in household spending, the latter reflecting real wage growth following the expiration of the real wage freeze. In *Austria*, rapid export growth, notably to Eastern Europe, was a major source of stimulus, while consumption was sluggish as a result of higher taxes and stagnating real disposable income. In *Sweden*, by contrast, consumption growth accelerated. Having regained confidence, households responded to the continued fall in employment, partly due to relatively high wage growth, by reducing saving. Business investment spending was also strong whereas residential investment collapsed following the

termination of temporary tax rebates. In *Switzerland*, the stagnation since 1991 seems to have ended in mid-1997 as exports picked up in response to the depreciation of the exchange rate. Although labour demand and real household disposable income continued to decline, consumption growth was positive because, as in Sweden, households cut back saving. In fact, the household saving rate in Switzerland has fallen from over 10% to about 7% during this decade.

... while Switzerland recovers from prolonged stagnation

Australia, in contrast, has seen a marked improvement in household saving in recent years, possibly reflecting the effects of a gradual build-up in private pension funds. Nonetheless, household consumption and a turnaround in residential investment were among the principal sources of growth in 1997. As interest rates were lowered in step with falling inflation and firms' cash flows improved, business fixed investment also picked up. However, under the influence of falling demand in Asian countries, and weakening commodity markets, net export growth turned negative. In *New Zealand*, output growth slowed during the first half of 1997, reflecting the lagged effects of tighter monetary policy and a consequent appreciation of the exchange rate. Monetary conditions have subsequently been eased in response to declining inflation and fears of larger repercussions from the crisis in Asia.

Asian crisis affects growth in Australia and New Zealand

The macroeconomic policy mix

The developments discussed above have been strongly influenced by an ongoing shift in the mix of fiscal and monetary policies, which was taken a significant step further last year. Fiscal policy was tightened considerably in virtually all countries. Indeed, for the industrial countries as a group, structural deficits were cut by more than 1% of GDP. With the exception of Japan, all countries recorded surpluses on their primary balances. Against this background, monetary policy was generally eased in 1997 and in several countries depreciating exchange rates reinforced the relaxation of monetary conditions.

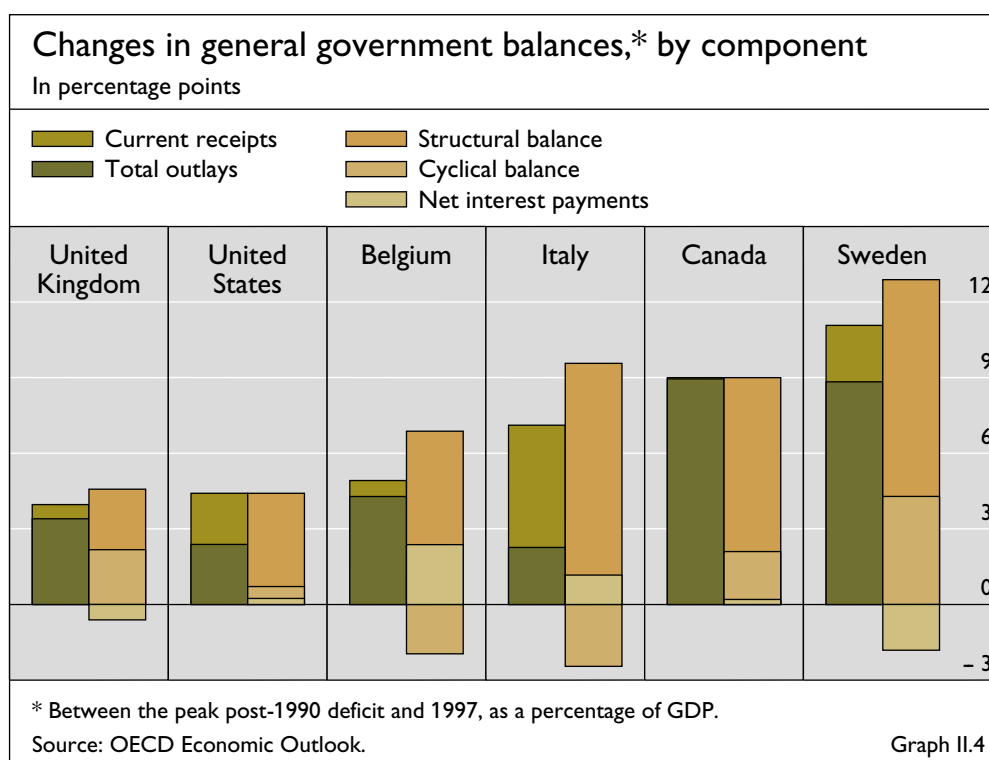
Ongoing shift in the policy mix

Seen in a slightly longer perspective, fiscal deficits have been reduced by over 3% of GDP since their peak in 1992–93 and in some countries by substantially more. For instance, the general government borrowing requirement has been reduced by more than 11% of GDP in Sweden and by 7–10% in Italy, Canada, Finland and Greece. The United Kingdom has also seen a marked strengthening of the budget balance. To consolidate the gains, the UK Government recently proposed a “Code for Fiscal Stability” which would limit future deficits to government investment and strengthen accountability.

Significant fiscal consolidation ...

Determined consolidation policies have been followed in all countries and discretionary measures account for a major part of the deficit reductions achieved. Nonetheless, there are some differences with respect to the sources of fiscal improvements. As Graph II.4 shows, expenditure cuts have figured prominently in most cases. However, the improvement in Italy is mostly due to higher taxes and in the United States it is evenly split between higher taxes and lower expenditure. Except in Italy and Belgium, net interest payments have fallen only little or have actually increased, suggesting that fixed rate securities account for a sizable part of governments' debt financing but also reflecting the influence of large deficits in some countries.

... mostly reflecting expenditure cuts



Widespread decline in household saving ...

In spite of the fiscal consolidation achieved, the rise in total domestic saving has been relatively small. In fact, in several countries household saving rates have declined in step with lower fiscal deficits (Graph II.5), most notably in Canada and Sweden. As discussed below, one reason for this decline might be the marked rise in equity prices and resulting wealth gains seen in recent years. The shift in the distribution of factor income in favour of profits may also have raised company saving at the expense of household saving (Table II.2).

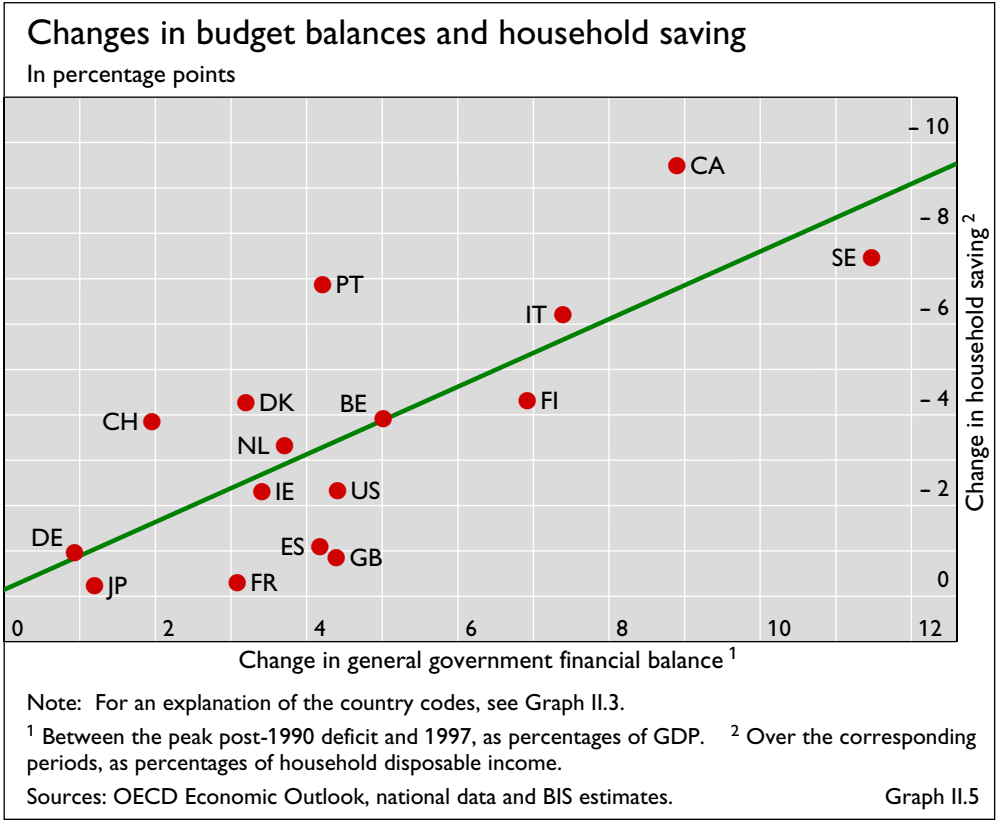
... raises concerns about the burden of future pension and health care obligations

The failure of domestic saving to rise in step with fiscal consolidation may also have prevented a more substantial decline in long-term interest rates. Another reason for continued high real interest rates is probably that government debt/GDP ratios have remained high (Graph II.6) and have actually increased in countries with relatively slow GDP growth this decade. With the ageing of populations in the industrial countries and the approaching retirement of the

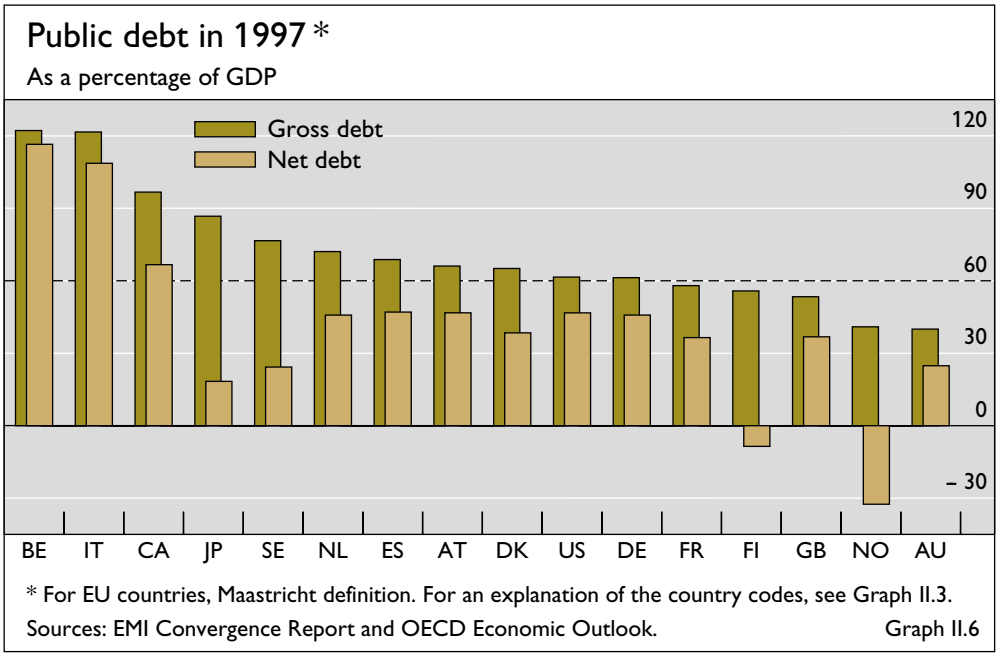
Developments in domestic saving in selected countries										
	United States		Canada		Italy		Sweden		Denmark	
	1992*	1997	1992*	1997	1991*	1997	1993*	1997	1993*	1997
as a percentage of GDP										
Domestic saving	14.5	17.2	14.3	18.7	18.5	20.7	11.2	17.4	20.0	20.6
Public saving	-1.1	2.8	-4.7	2.4	-5.2	0.7	-7.6	0.9	-0.7	2.1
Private saving	15.6	14.3	19.0	16.3	23.7	19.9	18.8	16.5	20.8	18.4
Households	4.6	2.8	7.6	1.1	15.9	10.7	4.9	0.4	4.6	1.8
Enterprises	11.0	11.5	11.4	15.1	7.8	9.2	13.9	16.1	16.2	16.6

* Year of peak post-1990 general government deficit.
Sources: National data and BIS estimates.

Table II.2



“baby boom” generations, these developments prompt additional longer-term concerns. Rising pension and health care obligations mean that fiscal balances could deteriorate sharply in future decades. The prospects of such a deterioration, combined with high government debt, imply that medium-term fiscal sustainability is not yet assured. More importantly, irrespective of any reform to reduce the fiscal burden of ageing, supporting the baby boom generations in retirement without adversely affecting the living standards of future



workers will require higher output growth per hour worked. Since this is unlikely without higher saving and investment rates, the relatively tepid response of national saving to fiscal consolidation so far is worrisome, particularly given the contemporaneous moves in some countries to reduce the supply of labour input by cutting weekly working hours and the general failure to remove disincentives to continued labour participation by older workers.

Changes in financial wealth and spending

Equity-induced wealth gains ...

A potential explanation for the relatively modest rise in national saving during a period of substantial fiscal consolidation could be the large wealth gains recorded by households in recent years, due in particular to higher equity prices. If household plans for spending and saving depend in part on net wealth, then increases in asset values will tend to reduce saving rates. As discussed in Chapter V, most of the industrial countries have seen strong equity price gains in recent years as stock markets have continued to reach new highs.

... boost household spending in the United States and United Kingdom ...

Table II.3 presents real equity price movements and their possible impact on consumption growth for four countries during 1995–97. Over this period, the United States enjoyed the sharpest equity price gains, and it is also the country in which households have placed the largest proportion of their financial wealth in equities. In consequence, the estimated impact on consumption growth is substantial. For each of the last three years, the contribution of equity price gains to consumption growth may have steadily increased from about ½ percentage point to nearly 1 percentage point, thus accounting for about one-quarter of total consumption growth over the period. Similar wealth gains substantially boosted consumption growth in the United Kingdom during 1996–97, possibly accounting for some 10% of the total growth in household spending.

... but have only modest effects elsewhere

In contrast, share prices have had only a modest impact on consumption growth in Germany, largely because only 6% of household financial wealth is held in equities. Although the equity share is equally low in Japan, the fact that equity price movements are positively correlated with changes in property prices and consumer confidence may explain the relatively large impact found for Japan.

Changes in real stock prices and household consumption in selected countries							
	Real stock prices			Estimated impact on real consumption ¹			Memo item ²
	1995	1996	1997	1995	1996	1997	1997
	annual percentage changes ³						in %
United States	26.6	17.8	28.4	0.43	0.51	0.84	28.0
Japan	-4.2	5.1	-20.5	-0.51	0.90	-0.65	6.0
Germany	0.5	16.9	32.7	-0.13	0.02	-0.13	6.0
United Kingdom	12.4	9.0	16.1	-0.19	0.58	0.45	20.0

¹ Based on a regression of quarterly consumption growth on its own lagged value, the lagged term spread and four lags of changes in equity prices. ² Proportion of household financial wealth held in equities. ³ Fourth quarter to fourth quarter.

Sources: National data and BIS estimates.

Table II.3

According to the estimates, the 20% decline in real equity prices last year, allied with the record low level of consumer confidence, could account for a considerable part of the fall in real household spending.

In addition to household spending, there are other channels through which equity price movements may influence real economic activity. For instance, higher equity prices lower the cost of corporate investment and therefore stimulate investment spending. Rising share prices can also increase tax receipts, and thus help to reduce government budget deficits. This may have played a role in the United States, where surging tax revenues have led to a sizable decrease in the federal government budget deficit. Finally, higher equity prices allow employers with defined benefit pension plans to reduce their contributions to employee pensions, thus slowing the growth of labour costs and boosting corporate profits.

Additional influences of equity price changes

Labour markets

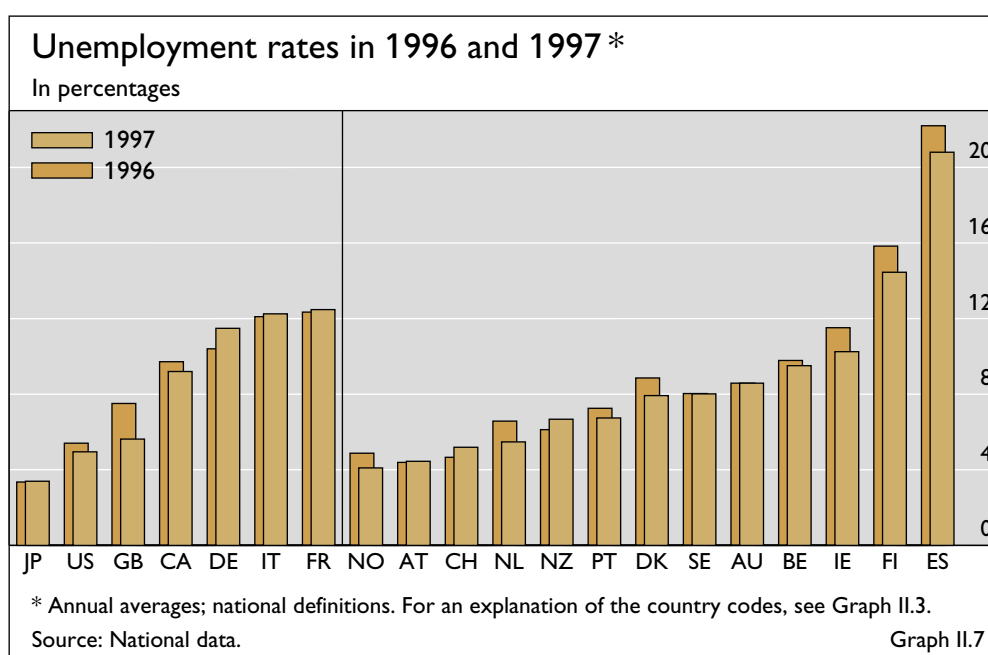
The international divergences in labour market conditions discussed in previous Annual Reports were observed again last year and, in some respects, widened further (Graph II.7). In the United States and the United Kingdom, rates of unemployment fell well below levels that, in the past, have led to inflationary pressures. Unemployment also declined significantly in Canada, Denmark, Finland, Ireland, the Netherlands, Norway, Portugal and Spain. In some other European countries unemployment rates reached postwar highs, before starting to fall towards the end of 1997, a trend that has continued this year.

Divergences widen further ...

Cyclical differences have been one important factor behind these developments. Unemployment has generally fallen most in those countries that are furthest advanced in the current cycle or in which output expansion has been well above potential rates of growth. However, structural factors and policies have also played a role. For instance, in the United Kingdom and Denmark, unemployment has fallen by far more than employment growth would suggest as various policy measures have reduced labour supply. In contrast, unemployment

... reflecting cyclical differences ...

... and structural policies



Developments in aggregate and manufacturing employment						
	Real GDP	Total employment	Manufacturing employment	Relative prices ¹	Manufacturing/total employment	
	1980–97				1980–90	1990–97
	annual percentage changes				cumulative changes ²	
United States	2.6	1.6	–0.5	–1.7	–4.4	–1.7
Japan	3.1	1.0	0.3	–2.0	–0.6	–2.1
Canada	2.4	1.4	–0.1	–0.9	–2.1	–1.6
Australia	3.0	1.7	–0.5	–0.3	–5.0	–1.4
EU countries	2.1	0.2	–1.4	–1.0	–3.4	–2.9
Germany	2.1	0.2	–1.7	–0.4	–2.3	–5.4
France	1.9	0.2	–1.8	–0.4	–4.3	–2.8
Italy	1.8	–0.2	–0.9	–2.8	–3.6	0.5
United Kingdom	2.3	0.3	–2.0	–1.4	–6.1	–2.9

¹ Ratio of manufacturing to non-manufacturing prices; for the United States, 1980–93; for Canada, 1980–92; for the United Kingdom, 1980–94; for other countries and most EU countries, 1980–95.
² In percentage points.
Sources: OECD Economic Outlook, OECD Labour Force Statistics, OECD National Accounts, national data and BIS estimates. Table II.4

has increased in France, reflecting a policy-induced rise in participation rates. Unemployment has also risen in Germany, owing to the aforementioned slump in the construction sector and firms' efforts to lower costs. In fact, over the last two years, productivity growth in the German business sector has averaged 3½% and unit labour costs have fallen.

It is frequently argued that an additional reason for the poor labour market performance of the industrial countries as a group is “deindustrialisation”, in part induced by growing competition and imports of manufactured goods from low-wage countries. While it is true that the share of manufacturing in total employment has fallen significantly over the last two decades (Table II.4), empirical studies suggest that, with broadly equal growth rates of real demand for manufactured goods and services, the decline can mainly be attributed to a higher rate of productivity growth in manufacturing than in services. This has resulted in a fall in the relative price of manufactured goods. For individual countries, changes in net trade have moderated (Japan) or exacerbated (the United States) the fall in the share of manufacturing employment. While there is little evidence that trade with emerging market countries has had any direct effect on manufacturing employment, it cannot be excluded that competitive pressures have contributed to the high rate of productivity growth in that sector.

The underlying causes of these trends and the cumulative declines in the share of manufacturing employment have been broadly the same in Europe and North America. Nonetheless, the composition of the decline has varied across countries, due to different trends in total employment. In North America, manufacturing employment has been largely stable and the falling employment share mainly reflects the rapid growth of employment in services. In contrast, manufacturing employment has fallen sharply against a stagnating trend of total

The falling share of manufacturing employment reflects ...

... underlying trends in total employment ...

employment in the EU countries, suggesting that labour market rigidities have constrained the ability of the service sectors to absorb redundant workers from manufacturing. One particular source of rigidity, documented in previous Annual Reports, appears to have been the low flexibility of relative wages, notably in countries with high minimum wages and/or generous unemployment benefit systems. Moreover, in some countries (Germany in particular), enterprises seem to have preferred outsourcing or investing abroad to expanding capacity at home.

... and labour market rigidities

Import prices and inflation

Despite the differences in labour market slack, the trend in inflation has been remarkably similar across the industrialised economies. Virtually everywhere, inflation rates have declined during the 1990s, reducing average inflation and its variation across countries. Although the trend in unit labour cost growth has been similar, it has not converged to the same degree as price inflation.

Convergence of price inflation ...

Among the factors that could explain the convergence of inflation rates are changes in exchange rates and associated movements in import prices, as well as the extent to which these changes are passed through to domestic prices. The countries furthest advanced in the business cycle, such as the United States and the United Kingdom, have seen their currencies appreciate and their import prices decline. This has contributed to redistributing demand across the industrialised economies, reducing imbalances that otherwise could have exacerbated inflationary pressures. Moreover, global overcapacity in certain sectors has further depressed import prices and lessened the risk of inflationary pressures in the industrialised economies generally.

... helped by exchange rates and import prices

Because goods are more tradable than services, the impact of import prices on domestic inflation will be more readily apparent in changes in producer and consumer goods prices than in overall consumer price indices. As can be seen in Table II.5, the decline in import prices over the last two years has been pronounced in the United States. In addition, the pass-through into producer and

Pronounced influence of import prices in the United States ...

Changes in import price and domestic inflation					
	Import prices	Producer prices		Consumer goods prices	
	Actual	Actual	Impact ¹	Actual	Impact ^{1, 2}
	annual percentage changes, 1995 Q4–1997 Q4				
United States	-4.1	1.1	-1.2	1.8	-0.9
Japan	6.5	1.1	1.2	1.0	0.4
Germany	2.2	0.4	0.3	1.1	0.2
France	1.7	-1.2	0.8	1.4	0.0
United Kingdom	-4.2	1.5	-0.3	2.6	-0.3
Canada	0.8	0.4	0.3	1.6	-0.5 ³
Belgium	3.1	2.3	2.3	1.9	0.4
Netherlands	4.6	2.1	0.0	2.0	0.0

¹ The impact of import prices (PM) on producer prices (PPI) and of producer prices on consumer goods prices (CPI) is estimated from regressions on quarterly data over 1988–97. ² Impact estimated by the effect of PPI on CPI times the impact of PM on PPI. ³ Impact estimated from the effects of, respectively, US CPI on Canadian CPI and US PM on US CPI.

Sources: National data and BIS estimates. Table II.5

consumer goods prices seems larger in the United States than in other countries, probably reflecting the high degree of competition in US markets. Indeed, without the fall in import prices, the annual rise in producer prices could have been about 1¼ percentage points higher and that of consumer goods prices almost 1 point higher. Thus, the fall in import prices may have dampened overall CPI inflation by about ½ percentage point in each of the past two years.

... and in the United Kingdom but less in Canada

Although the United Kingdom has experienced a similar decline in import prices, the pass-through to domestic prices seems to have been somewhat less. Even so, without the import price decline, the annual rate of producer and consumer goods price inflation would have been about ¼ percentage point higher. In contrast, Canadian import prices rose slightly, with the pass-through explaining most of the increase in producer prices. However, consumer prices in Canada appear to be more heavily influenced by US consumer prices than by Canadian import prices. Consequently, the deceleration in US consumer price inflation associated with the US import price decline may have reduced the annual rate of Canadian consumer goods price inflation by about ½ percentage point and the overall CPI by about ¼ percentage point.

Moderate pass-through in countries with rising import prices

Turning to countries that have experienced significantly higher import prices over the last two years, the greatest increase was in Japan, primarily because of the depreciation of the yen. Although the effect on domestic producer and consumer goods prices has been relatively small, the increase in import prices may have raised producer price inflation by 1¼ percentage points and consumer goods price inflation by almost ½ point.

In Germany and France, the import price increase has been much smaller than in Japan. Still, because the pass-through is relatively large in Germany, higher import price inflation may have raised consumer goods price inflation by about ¼ percentage point, whereas little of the import price rise was reflected in French consumer prices. In Belgium, where a very high proportion of producer goods is imported, higher import prices account for most of the rise in producer prices. However, the effect on consumer goods prices is much smaller, around ½ percentage point. An even lower pass-through is found for the Netherlands, where virtually none of the rise in import prices appears to have fed through to consumer goods price inflation.

Significant overall convergence ...

To summarise, it appears that import prices have been an important influence in the convergence of inflation rates across the industrialised countries during the last two years. If there had been no change in import prices, producer and consumer goods price inflation would have ranged from 2 to 3% in the United States and the United Kingdom and from zero to 1% in Germany and Japan. This is a considerably wider spread than that actually observed over the last two years. Also, import prices seem to have a greater effect in the United States than they do in other, ostensibly more open economies. In the circumstances of the last two years, this has reinforced the favourable and convergent redistribution of inflationary pressures.

... with likely implications for future inflation

Although there are many uncertainties about the course of inflation in the years ahead, import price developments could remain an important influence on domestic inflation. Over the long term, the trend towards greater competition within the industrialised economies may mean that there will be a greater pass-

through of import price changes. This appears already to be the case in the United States, where competitive forces seem stronger than elsewhere. Moreover, in the near term, the global excess capacity in certain sectors can be expected to exert downward pressure on the prices of imported goods. Therefore, even if their exchange rates remain unchanged, the industrial countries may still see import prices falling. This would help to reduce the risk of rising inflationary pressures in the countries most advanced in the business cycle.

Foreign trade, current account balances and foreign direct investment

Foreign trade

Following a slowdown in 1996, the growth of world trade accelerated to more than twice the estimated rate of growth of total output last year (Table II.6). The expansion was particularly pronounced in the emerging market countries as higher import demand in Latin America and Eastern Europe more than offset the slowdown in Asia. Trade growth also accelerated in the industrial countries, reflecting a particularly strong rise in the United States, but also faster growth in Europe.

Marked expansion
of world trade ...

As discussed above, the fall in international goods and import prices was one factor contributing to the low rates of inflation seen last year. In fact, world prices for manufactured goods, measured in SDRs, fell by 4½%, a reason for the moderate terms-of-trade deterioration in the industrial countries. Oil prices also declined, particularly towards the end of 1997 and early this year, when a rise in OPEC production quotas combined with lower oil demand in Asia and an unusually mild winter in Europe and the United States to reduce real oil prices to a level only slightly above that existing prior to the first oil crisis. Prices for non-oil commodities also declined towards the end of 1997 but increased slightly for the year as a whole.

... with falling
goods prices

World trade and output				
	1980–89	1995	1996	1997
	annual percentage changes			
World output	3.3	3.6	4.1	4.1
World trade, volume	4.3	9.5	6.7	9.5
Industrial countries	5.0	8.8	6.1	9.0
Emerging market countries	2.0	11.2	9.6	11.9
Trade prices (in SDRs)	2.6	2.2	3.1	-0.8
Manufactures	3.3	4.1	1.2	-4.4
Oil	..	1.9	24.3	-0.9
Non-oil primary commodities	0.6	2.1	3.1	1.2
Terms of trade, industrial countries	0.3	0.1	-0.1	-0.7

Source: IMF World Economic Outlook. Table II.6

Current account balances in the industrial countries

Owing to cyclical divergences and the tendency for the currencies of the countries most advanced in the business cycle to appreciate, external imbalances (measured in absolute terms) widened significantly last year. Most of this can be attributed to the growing US deficit and the increasing surpluses in Japan and the EU countries.

Divergent current account balances in the United States and Japan ...

Despite the appreciation of the dollar, real US exports of goods rose by nearly 16% and, for the second consecutive year, US exporters gained market shares. Nevertheless, because of the booming domestic economy and increased import penetration, the trade deficit widened to about US\$ 200 billion. In addition, with the appreciation of the dollar and the growing external debt, the investment income balance moved into deficit (Table II.7). In contrast, Japan's investment income surplus rose, while the stagnation in the domestic economy, allied with the depreciation of the yen, led to a turnaround in the trade and current account balances and a partial reversal of previous losses in market share.

... and a further rise in the surplus of the EU countries

A similar trend to that seen in Japan could be observed in the EU countries, where the aggregate surplus rose to about US\$ 125 billion, of which France and Italy accounted for about two-thirds. For Italy, in particular, which became a net international creditor last year, the improvement this decade can to a large extent be attributed to substantial fiscal consolidation, a depreciation of the exchange rate and the fact that the Italian economy has been lagging the European business cycle. Elsewhere in Europe, Switzerland's traditional surplus declined somewhat

Foreign trade indicators and the current account balance								
	Real effective exchange rate ¹	Export performance ^{2,3}	Volume of imports ³	Terms of trade ³	Trade balance	Net investment income	Current account balance	
	1997	1996–97, cumulative changes				1997		
	index, 1995=100	in percentages		in billions of US\$		in billions of US\$	as a % of GDP	
United States	114	7.9	25.9	0.2	-23.1	-18.8	-166	-2.1
Japan	77	-10.2	5.0	-9.7	-27.7	11.2	97	2.3
Germany	90	0.4	11.8	-2.3	10.7	-6.2	-1	0.0
France	93	1.7	9.2	-1.4	16.9	10.3	40	2.9
Italy	118	-5.7	7.4	1.3	2.3	5.2	37	3.2
United Kingdom	130	-3.1	14.4	1.8	-3.0	3.2	7	0.6
Canada	107	-9.1	23.7	3.7	-6.9	0.5	-12	-2.0
Australia	119	8.6	15.5	0.9	6.0	-0.4	-13	-3.4
Belgium	97	-6.3	10.9	1.3	-1.2	-0.2	13	5.5
Netherlands	92	-2.0	13.6	-0.5	-4.2	1.4	21	6.0
Norway	109	5.7	19.3	12.0	3.7	0.7	9	5.5
Switzerland	88	-9.5	9.6	-0.6	-1.2	0.7	21	8.3
EU countries	102	-0.7	12.2	-0.9	28.6	10.1	124	1.6

¹ In terms of relative unit labour costs; for EU countries, composite index excluding intra-regional trade. ² Growth of export volumes less growth of export markets. ³ Goods only.

Sources: OECD Economic Outlook, national data and BIS.

Table II.7

due to lower earnings on net investment, while Norway's oil-based surplus remained largely unchanged despite the fall in oil prices towards the end of 1997.

As for other industrial countries, Australia managed to reduce its deficit despite the fall in commodity prices and exports to Asian countries. Although less reliant on exports to Asia, New Zealand's current account deficit increased to over 7% of GDP, implying a substantial saving deficit for the private sector since the general government surplus declined only a little. The external balance of Canada moved back into deficit owing to the rise in import penetration and poor export performance mentioned earlier. As in New Zealand, the counterpart to the external imbalance was a growing saving deficit for the private sector, notably the household sector. Finally, Turkey's external deficit was limited to 1% of GDP as the nominal exchange rate was allowed to depreciate in line with the growing inflation differential vis-à-vis other OECD countries.

Deterioration
in New Zealand
and Canada

Salient features of recent trends in foreign direct investment

The growth of foreign direct investment (FDI) outflows from and inflows to the industrialised countries since the early 1980s has been very high, far outpacing the expansion of foreign trade and real GDP (Table II.8). Growth, however, has not been very stable. In fact, most of the expansion took place during 1981–89, when outflows from Japan, induced by the appreciation of the yen and comparatively low prices of foreign equities, provided a major stimulus to global investment activities. During the next seven years, real outflows grew by less than 1% per year and inflows declined. However, according to preliminary figures, these trends were significantly reversed last year, as booming equity markets and low interest rates led to a record level of cross-border mergers and acquisitions. Under the influence of a stronger dollar and buoyant profit growth, the United States led the rise in FDI outflows, but US inflows actually increased even more, since the attraction of the high-growth economy more than offset the effect of an appreciating currency. Outflows from Germany also reached a historical high. However, for the second consecutive year, inflows into Germany declined. Led by France and the United Kingdom, other EU countries experienced marked increases in both outflows and inflows.

Strong but unstable
growth of FDI ...

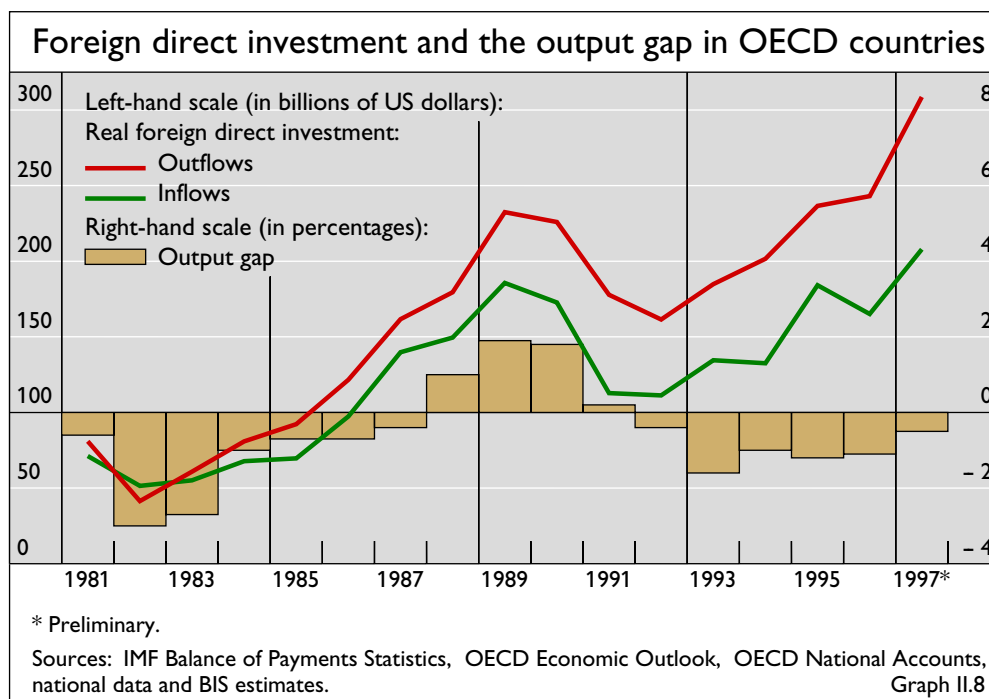
... with a marked
pick-up last year

As shown in Graph II.8, short-term movements in FDI flows are highly procyclical, mainly reflecting the influence of reinvestment of retained earnings. Virtually all of the fall in real outflows between 1989 and 1992 can be attributed to the rise in the OECD output gap. Moreover, the subsequent slow recoveries

FDI affected by
cyclical changes ...

Comparative trends of foreign direct investment ¹							
	Outflows	Inflows	Outward stocks	Inward stocks	GDP	Exports	Investment ²
	annual percentage changes, in constant prices ³						
1981–89	14.1	12.7	11.9	14.2	3.0	4.5	3.4
1989–96	0.6	-1.7	12.5	10.8	1.9	5.5	2.0

¹ In industrial countries. ² Gross fixed domestic investment. ³ Except for outward and inward stocks (current prices and exchange rates).
Sources: IMF Balance of Payments Statistics, OECD International Direct Investment Statistics, OECD National Accounts, UN World Investment Report, national data and BIS estimates. Table II.8



... exchange rates ...

in continental Europe and Japan largely explain the continued low level of inflows. Exchange rate movements can also exert a significant influence by affecting countries' relative cost positions as well as their "bidding power" with respect to mergers and acquisitions. As mentioned above, the appreciation of the yen was a major factor behind the rise in Japan's share of global outward stocks in the 1980s, while the recent recovery of US outflows can be ascribed to the stronger US dollar and the advanced stage of the business cycle.

... and changes in interest rates

In addition, since FDIs are essentially financial flows which may or may not be related to investment in real capital, measured outflows tend to be affected by movements in interest rates and equity prices in both source and host countries. This was evident for US outflows in the early 1980s, when a more restrictive monetary policy and higher interest rates encouraged US firms to finance their capital expansions abroad by borrowing in the host countries rather than by capital outflows defined as FDI. In contrast, the recent recovery of US outflows can, in part, be attributed to the fall in US interest rates and to higher equity prices which have substantially strengthened the ability of US enterprises to merge with or acquire firms abroad.

Increasing role of emerging market countries ...

Apart from cyclical and other short-term influences, changes in FDI flows and stocks over the last 15 years also reflect the growing number of countries, sectors and firms involved. Although the shares of inward and outward stocks are still dominated by the industrial countries, the participation of emerging market countries has grown considerably. China, in particular, has become a major host country and, by the end of 1996, emerging market countries as a group accounted for about 30% of global inward stocks. Furthermore, even though these countries hold only 10% of outward stocks, the fact that their share of outflows has been close to 14% during the 1990s indicates that they are also becoming more active as source countries (Graph II.9). While the financial crisis

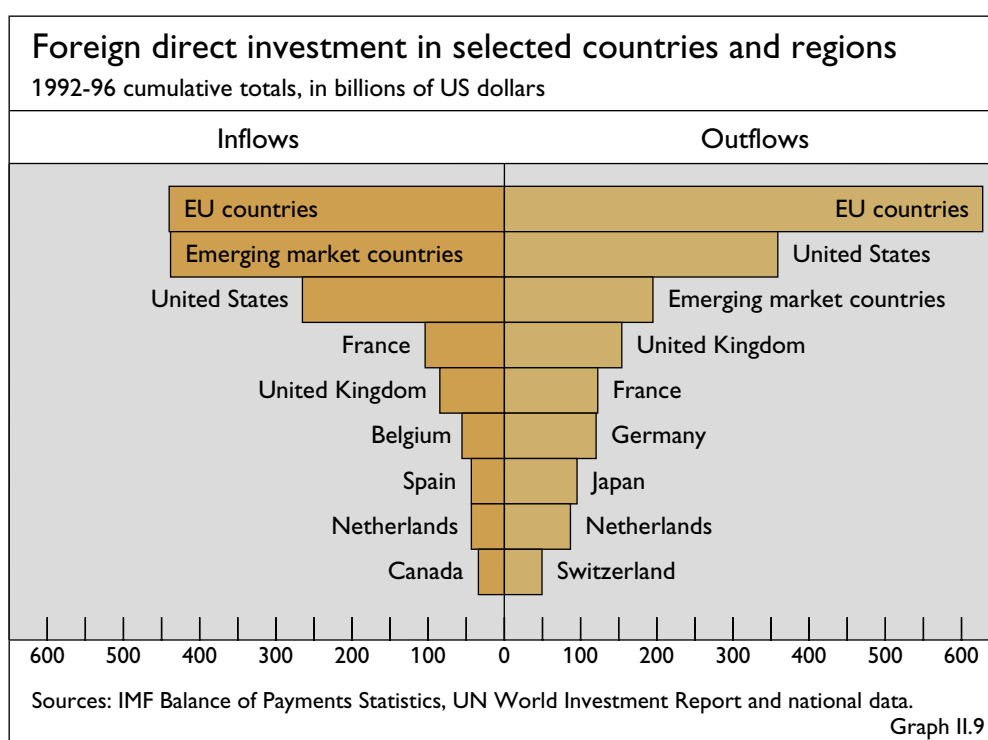
in Asia seems to have slowed outflows from emerging market countries, preliminary figures for inflows point to a new historical high in 1997. Moreover, given the marked decline in Asian equity prices, the deregulation of inflows and the improvement in corporate governance contained in the reform policies adopted in several countries affected by the crisis, FDI inflows may fall only marginally this year.

Within the group of industrial countries, relative positions have also changed. In addition to the increase in outflows from Japan in the 1980s, the share of EU countries has risen substantially, notably since the adoption of the Single European Act in 1986. Indeed, the rise in the share of EU countries in global flows and stocks has been driven, not only by growing inflows from non-member countries, but also by larger flows within the EU area itself. Apparently, the effects of liberalising capital account transactions and the integration of markets have more than outweighed the expected fall in investment flows associated with the removal of trade barriers. In contrast, the US share of global outflows and outward stocks has fallen sharply compared with the late 1970s, even allowing for the recent recovery. In fact, the late 1970s seem to have marked a peak in the internationalisation of US production, which coincides with a downward turning-point for US manufacturing. Because manufacturing is far more international than other sectors, its declining role in the US economy, allied with an earlier start to this process than in most other countries, imparted a downward trend to US outflows.

... but also shifts within industrial countries

The last decade has also witnessed a marked rise in the number of sectors and firms involved in FDI activities. Even though the dominant position of large multinational firms is one of the defining features of recent trends, medium-sized enterprises now take a more international approach to their output and

More sectors and firms involved



employment decisions as well. Overall, it is the expansion in the number of countries, sectors and firms involved that has prevented the declining share of manufacturing from causing either stagnation or a trend fall in FDI flows.

Globalisation in a historical perspective

In order to identify the motives underlying FDI flows and their possible effects on employment and output in the countries involved, it is useful to view recent developments in a longer perspective. While the growth of trade and FDI since 1982 has been impressive, it merely returns the degree of globalisation and internationalisation to that existing prior to 1914 and, by some measures, not even that. For instance, measured by foreign trade relative to GDP, Japan is less open now than before 1914. Moreover, while FDI outflows now equal 5–6% of domestic investment in the industrial countries, UK outflows during the first decade of this century were of about the same size as UK domestic investment.

Shift from horizontal to vertical production structures

Yet, in some respects, international integration and FDI activities are more important today than before the First World War, as the underlying forces and motives have changed substantially, with implications for firms' production and employment decisions. Although earlier FDI outflows were partly motivated by firms' interest in gaining access to raw materials, they mostly reflected attempts to get around artificial and natural barriers to trade. Such outflows favour a *horizontal* production structure as similar plants are set up in different countries and affiliate sales are aimed at markets which cannot be reached by exports. In contrast, more recent trends in FDI activities have been driven by liberalisation and deregulation and, above all, by technological progress, which has added new dimensions to the process of integration. By enabling firms to "slice up the value-added chain", the sharp decline in communication costs has created new and more efficient ways of organising production and distribution at a global level. Moreover, by allowing firms to arbitrage on factor-price differentials, this favours a *vertical* production structure generating stronger interactions between production and employment in affiliates and parent companies.

FDIs complement or strengthen foreign trade ...

Nonetheless, for most countries the evidence suggests that FDI outflows and affiliate production continue to complement rather than substitute for exports. Manufacturing affiliates tend to use intermediate goods imported from the source countries while service affiliates improve the distribution of final goods produced in the source countries. It further appears that outflows and imports are complements and that inflows are associated with higher imports, notably in emerging market countries.

... and reduce exposure to external shocks

There is also evidence that globalisation not only helps firms to achieve a more efficient production structure but also allows them to reduce exposure to foreign shocks and spread risks more evenly. Firms with production facilities in several countries can reduce their vulnerability to exchange rate movements by redistributing output in accordance with changes in relative costs. Moreover, assuming that affiliate sales are proportional to outward FDI stocks, the geographical distribution of exports may give a misleading impression of firms' external exposure (Table II.9). Therefore, the overall exposure to the fall in domestic demand in Asia may be much lower than would be implied by exports alone. As the table shows, the exposure of the United States, Germany and Japan seems lower than is suggested by export shares. In contrast, the shares of Asia in UK exports and affiliate sales are more or less equal.

Geographical distribution of exports and foreign direct investment*								
	United States		Japan		Germany		United Kingdom	
	Ex-ports	FDI	Ex-ports	FDI	Ex-ports	FDI	Ex-ports	FDI
	in percentages							
Industrial countries	56.5	69.9	46.9	62.5	75.5	86.4	77.6	82.0
EU countries	20.5	43.7	15.3	17.5	58.2	57.0	56.9	43.3
Non-European countries	34.3	20.8	30.5	43.3	11.1	24.3	17.5	36.9
Asia	19.2	8.4	44.2	32.1	8.0	3.0	8.6	8.1
Latin America	17.5	18.1	4.5	4.8	2.5	5.9	1.8	6.6

* Exports of goods in 1996 and outward stock of direct investment at end-1996; for Germany, 1995 data.
Sources: OECD Statistics of Foreign Trade and national data. Table II.9

At the same time, the globalisation of production is not without risks. Thus the rise in technology-driven FDI flows amid attempts by multinationals to maintain or expand market shares could generate excess capacities to the extent that multinationals as well as local companies are attracted to the same sectors by low costs and high prospective rates of return. This has been evident in several Asian countries where inflows of foreign capital have raised already high investment/GDP ratios even further (see Chapter III). Moreover, firms with production facilities in several countries can only reduce their exposure to exchange rate movements by allowing a lower rate of capacity utilisation than firms with most of their output produced at home.

Globalisation
subject to risks and
costs