

CHAPTER 2

THE GLOBAL CONTEXT AND THE SITUATION IN THE WESTERN MARKET ECONOMIES

2.1 The global context

(i) The broad pattern

Uncertainties in international financial markets have continued to prevail after the decision of the Brazilian government on 15 January 1999 to abandon the exchange rate peg and to float the domestic currency, the real, which has since depreciated sharply. The Brazilian crisis is the latest episode in a succession of contagion effects from the Asian crisis which were also an important factor in the Russian crisis which unfolded in mid-1998.⁴⁶ Basically, all these crises have to do with a major reappraisal of risk exposure by international investors, which has been mirrored in a sudden and large-scale redirection of short-term capital flows from emerging markets to safe havens in industrialized countries. Reduced net capital inflows, or even net capital outflows, have been associated with a considerable rise in the costs of borrowing, often tantamount to a “credit crunch” for emerging markets. High short-term interest rates required to check capital flight and defend established fixed or quasi-fixed exchange rates, in turn, have had considerable domestic economic costs, often triggering a vicious circle, in which the ensuing recessionary tendencies reinforced the selling pressure on the currency.

The adjustment policies implemented in emerging markets to cope with these changes have led to a steep fall in their domestic absorption, which, in turn, has had a deflationary effect on world economic activity. These deflationary effects have also led to a considerable fall in commodity prices since the Asian crisis which adversely affected real incomes in those countries for which commodity exports are a major source of foreign exchange. These adverse effects have only been partly offset by the potential stimulus of falling interest rates – associated with the retreat of capital flows to “safe havens” – and the gains in real income, ensuing from the fall in commodity prices, in western Europe and North America.

The cumulative effects of these successive crises on world economic activity has been considerable. Real GDP in the world economy rose by only 2¼ per cent in 1998, a marked slowdown from the growth rate of 4.2 per cent the previous year. This was the lowest growth rate of world output since 1991 (chart 2.1.1). This outcome reflects in the main the deepening recession in Japan and the sharp contractions of economic activity in several other east Asian countries, developments which have been mutually reinforcing as a result of the strong regional trade links. But there was also a marked deceleration in economic growth in other parts of the world economy, viz. Latin America, the Middle East and the transition economies, which contrasts with continuing robust growth in western Europe and, especially, in North America for the year as a whole.

It not only proved very difficult to anticipate correctly the deflationary effects of the Asian crisis but, with hindsight, the choice of the traditional policy response seems to have been inappropriate.⁴⁷ In any case, the much deeper than expected economic crisis in Japan and in the east Asian emerging markets and its adverse spillover effects to other regions has been the major factor in the successive and significant lowering of growth forecasts for the world economy in 1998 and beyond (chart 2.1.2).

The slowdown in world output growth has also led to a marked weakening of the rate of expansion of world trade. World merchandise imports rose in volume by only 3¼ per cent in 1998, down from some 10 per cent in 1997.⁴⁸ Import demand in the developing countries was depressed on account of the domestic adjustment measures required to cope with reduced capital inflows and a significant deterioration in their terms of trade. These adverse effects on world trade were amplified by the steep fall in import demand in Japan and a slowdown in import growth in North America and western Europe.

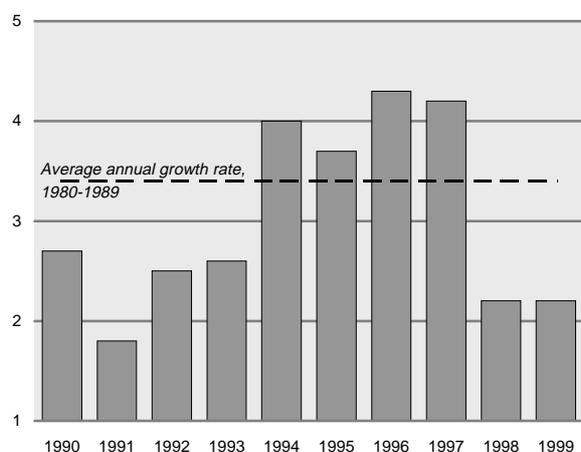
⁴⁷ UNCTAD, *Trade and Development Report*, 1998 (United Nations publication, Sales No. E.98.II.D.6), p. 69.

⁴⁸ IMF, *World Economic Outlook and International Capital Markets. Interim Assessment* (Washington, D.C.), December 1998, p. 164, table 5.

⁴⁶ UN/ECE, *Economic Survey of Europe*, 1998 No. 3.

CHART 2.1.1

Changes in world output, 1990-1999^a
(Percentage change over previous year)

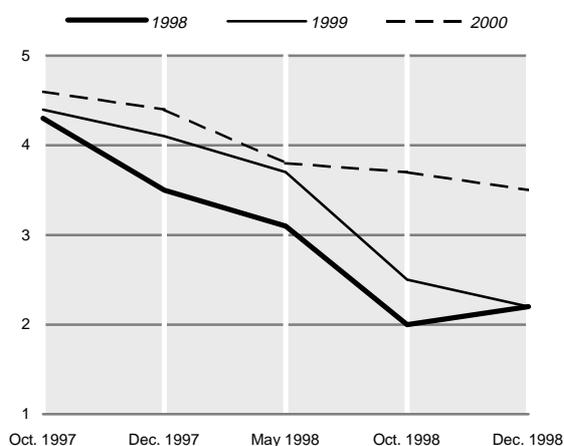


Source: IMF, *World Economic Outlook and International Capital Markets, Interim Assessment* (Washington, D.C.), December 1998, p. 160, table 1.

^a Real GDP. Data for 1998 and 1999 forecasts.

CHART 2.1.2

Changing forecasts of world output growth, 1998-2000
(Annual percentage change)



Source: IMF, *World Economic Outlook and International Capital Markets, Interim Assessment* (Washington, D.C.), December 1998, p. 7, table 1.1.

Note: The dates refer to the issue dates of the IMF, *World Economic Outlook*.

World trade prices in dollar terms fell by some 4.5 per cent in 1998, following a decline of more than 6 per cent in 1997. The terms of trade of industrialized countries improved by some 1 per cent in 1998, while those of developing countries deteriorated by 5 per cent. Since 1990, the terms of trade of developing countries have fallen by a cumulative 12 per cent.⁴⁹

⁴⁹ Ibid.

TABLE 2.1.1

World commodity prices, 1995-1998
(Percentage change over previous year)

	Weights ^a	1995	1996	1997	1998
Food and beverages	9.9	1.6	-1.6	5.6	-12.3
Industrial raw materials	29.5	16.3	-12.1	-1.8	-14.5
Energy	60.5	8.3	15.4	-3.9	-29.0
Crude oil	55.5	8.6	17.1	-3.6	-31.1
Total	100.0	9.6	3.3	-1.4	-22.3
Total, excluding energy	39.5	12.0	-9.8	1.3	-13.8

Source: Hamburg Institute for Economic Research (HWWA).

Note: Growth rates calculated on the basis of current dollar prices.

^a Weights refer to average commodity shares in total imports of western industrialized countries in 1989-1991.

The sharp fall in *international commodity prices* in 1998 was the main factor behind these differential changes in the terms of trade. Oil prices declined by some 30 per cent to their lowest level in more than 20 years.⁵⁰ Non-oil commodities fell at about half that rate (table 2.1.1). These price developments are largely due to the direct and indirect effects of the Asian crisis, including the deep recession in Japan, on the demand for commodities.⁵¹ This shortfall of demand amplified an already existing oversupply in a number of commodity markets, notably for oil, which was reflected in rising stocks. Oil demand was also dampened by the mild winter of 1997/98 in the Northern Hemisphere and the economic downturn in the CIS in 1998. Some OPEC countries stepped up oil production in an unsuccessful attempt to offset the impact of falling oil prices on revenues.⁵² In the markets for several other commodities, producers also appear to have expanded output in response to the appreciation of the dollar vis-à-vis domestic currencies. Commodity producers, in general, have been reluctant to cut back output to limit or reverse the fall in prices; instead, they have preferred to build up stocks which has led to a large overhang. The completion of new plants has also added to the downward pressure on metal prices.

Seen in a longer-term perspective, recent developments continue the tendency for commodity prices to fall in real terms, i.e. relative to changes in the prices of manufactured goods exported by developed market economies (chart 2.1.3). This reflects a combination of supply and demand factors, *inter alia*,

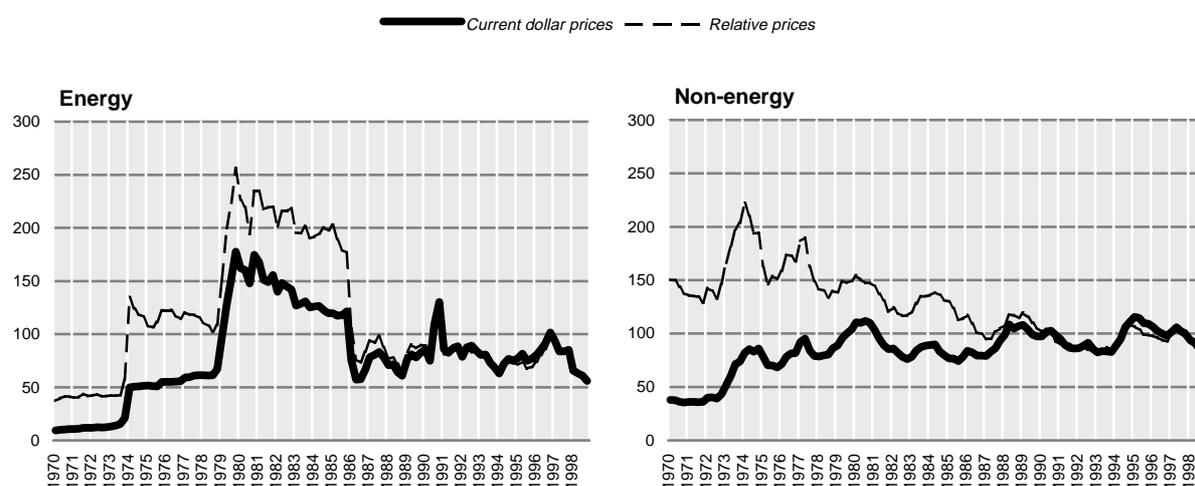
⁵⁰ The average price of the OPEC crude oil basket fell to \$12.44 in 1998, its lowest level since 1977, when it was \$12.40.

⁵¹ Net imports of commodities into East Asia rose strongly during the period of rapid economic growth since the mid-1980s with the result that the region's share of global raw material consumption was larger than its corresponding share in world output. But with the onset of recession, commodity consumption has been falling.

⁵² Economic and Social Commission for Western Asia, *Preliminary Overview of Economic Developments in the ESCWA Region in 1998* (United Nations document E/ESCWA/ED/1998/6), p. 8.

CHART 2.1.3

Changes in international energy and non-energy commodity prices, 1970-1998
(Indices, 1990=100, quarterly average)



Source: United Nations, *International Trade Statistics Yearbook*, various issues and *Monthly Bulletin of Statistics*, January 1999; Hamburg Institute for Economic Research (HWWA).

Note: Data are annual averages. Relative prices are nominal prices divided by the United Nations unit value index of exports manufacture from developed countries.

reduced raw material and energy intensity of production, substitution by other materials and the fall in production costs of commodities themselves.⁵³ These long-term factors will continue to exert downward pressure on commodity prices in the future, underlying the cyclical movements of prices.

(ii) Lingering instability in financial markets

The Russian devaluation and debt default in mid-August 1998 triggered severe tensions in international financial markets.⁵⁴ These tensions were reflected in a sharp rise in the risk aversion of international investors vis-à-vis emerging markets, a feature which had occurred, albeit less pronounced, already in the aftermath of the Asian crisis. The Russian crisis accelerated the flight to quality (i.e. to financial instruments in industrialized countries) and this was mirrored in significant downward pressure on long-term interest rates in the western market economies.⁵⁵ At the same time there was a substantial widening of yield spreads between bonds issued in emerging markets and comparable

benchmark government bonds in the United States and other western countries. This effectively prevented new borrowing by the former countries in the international bond markets in September and October 1998.⁵⁶ But the general sense of uncertainty which had afflicted financial markets also became visible in a perceptible widening of interest rate differentials between private sector corporate bonds and government bonds within the industrialized countries themselves. In the United States, the yield difference between triple-A rated corporate bonds and 10-year treasuries rose from some 1.1 percentage points to 1.84 percentage points between June and October 1998. This combined with a marked increase in investors' preference for more liquid instruments and concerns about the possible risks of a credit crunch if banks were to tighten lending standards.

These tensions in financial markets receded in the autumn after the decision of the United States Federal Reserve to lower interest rates in three consecutive steps between end-September and mid-November 1998 and an easing of monetary policy in western Europe, which reflected the need for convergence of short-term interest rates among the prospective member countries of the euro area prior to the start of EMU on 1 January 1999.

Nevertheless, as yet there has been no return to the status quo ante. Although yield spreads on emerging market bonds have fallen again, they remain significantly above the levels prevailing in the months before the Russian crisis. And in the United States, the differential between yields on triple-A corporate bonds and 10-year

⁵³ Technological change in production methods and the larger scale of operations have caused productivity to increase and costs to fall over the past two decades. This has been especially the case for oil exploration and extraction and for metal mining, smelting and refining, which have also benefited from the deregulation of energy markets in some producing countries. At the same time, advances in agronomic and genetic research have led to higher yields in agriculture.

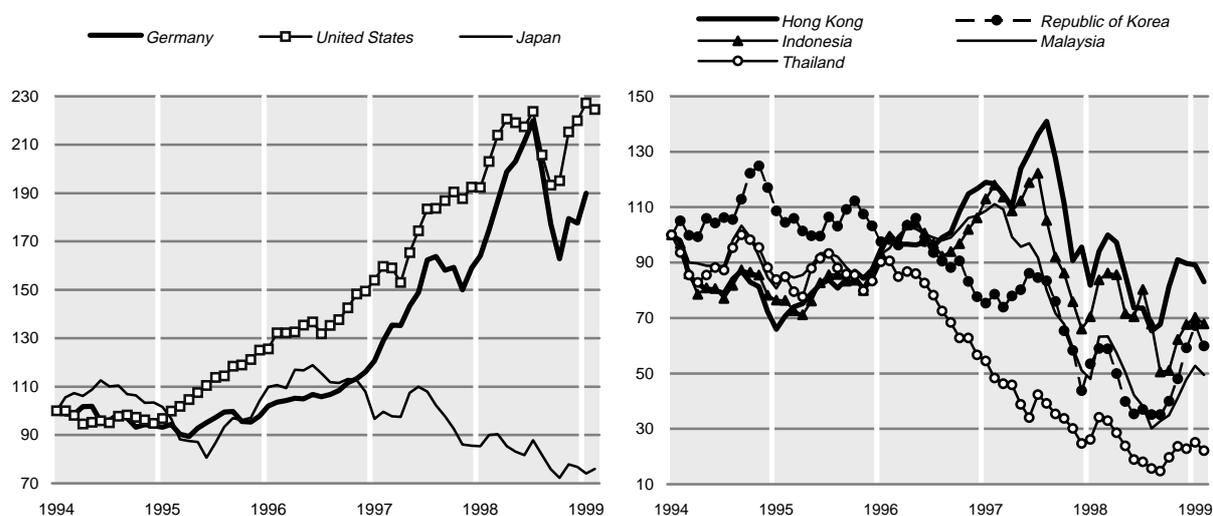
⁵⁴ UN/ECE, *Economic Survey of Europe, 1998 No. 3*, pp. 15-18.

⁵⁵ The general sense of enlarged risk and uncertainty engulfing investors was probably also related to the near failure of a large United States hedge fund, which was averted by a rescue operation organized by the United States monetary authorities. To this was added the shock that Russia was not considered, as widely believed, to be "too big to fail".

⁵⁶ Institute of International Finance, Inc., *Capital Flows to Emerging Market Economies* (Washington, D.C.), 27 January 1999.

CHART 2.1.4

International share prices, January 1994-February 1999
(Indices, January 1994=100)



Source: Reuters News Service.

Note: National currency basis; data are monthly averages. Germany: CDAX; Japan: Nikkei 225; United States: New York Stock Exchange Composite; Hong Kong: Hang Seng; Indonesia: Jakarta Composite; Malaysia: Kuala Lumpur Composite; Republic of Korea: Korea Composite Exchange; Thailand: Bangkok SET.

treasuries was still 1.5 percentage points at the end of January 1999, about half a percentage point more than during the months before the Russian crisis. In contrast, United States share prices, which fell sharply in August and September 1998, have more than recovered their losses. Share prices also recovered in western European markets (chart 2.1.4).

The increasing risk aversion of international investors towards emerging markets is reflected in the sharp drop of net private credit flows to some \$38.5 billion in 1998, down from \$119 billion in 1997 and \$196 billion in 1996. There was also a sharp fall in portfolio investment. But foreign direct investment has remained relatively stable, a reflection both of the longer time horizon of investment decisions pertaining to fixed assets and also of the favourable asset prices prevailing in emerging markets, notably in East Asia. In the event, total net private capital flows to emerging market economies fell to \$152 billion in 1998, a decline by nearly \$90 billion from their level in 1997.⁵⁷

(iii) The crisis in Brazil

Brazil had introduced a new currency, the real, in July 1994 as part of a wider plan (the Plano Real) to achieve price stability following a long period of extremely high inflation during the 1980s and early 1990s. The main element of the monetary policy strategy was to peg the exchange rate of the real to the dollar in order to anchor the domestic wage-price process.

Inflation did, indeed, fall to quite low levels and it is against this background that the government strongly resisted speculative attacks on the currency which occurred as part of the contagion effects of the Asian crisis in the autumn of 1997 by tightening monetary policy. But the combination of a large budget deficit and a large current account deficit, together with evidence that the real was overvalued,⁵⁸ made the currency vulnerable to speculative attack. The trigger for this was the Russian crisis, which led to massive capital outflows and associated selling of the currency. In response, official interest rates were raised to nearly 50 per cent and the government announced fiscal austerity measures. But the high interest rates created a vicious circle by depressing domestic activity and, given the strong reliance on variable interest rates for financing the budget deficit, by significantly raising the cost of domestic debt servicing. The immediate consequence was a further deterioration in the public finances.

Against the background of lingering instability in the international financial markets in the second half of 1998, there were concerns that a disorderly devaluation of the real would have significant adverse contagion effects on other countries of Latin America, with concomitant risks to other regions as well. An emergency support package of \$41.5 billion was agreed with the IMF in mid-November 1998 to support domestic policies designed to defend the exchange rate policy and to curb the budget deficit. But when domestic political

⁵⁷ Ibid. For an analysis of recent changes in net capital flows into the transition economies see chap. 3.7.

⁵⁸ The cumulative inflation in Brazil was significantly higher than in the United States since the onset of the Plano Real.

support for the fiscal retrenchment programme faltered, capital outflows resumed on a massive scale in January 1999 and the attempt to defend the exchange rate threatened to exhaust the stock of foreign reserves. The key official interest rate was raised to 39 per cent to arrest these outflows. On 13 January 1999, the government attempted a controlled devaluation by widening the fluctuation band for the exchange rate which immediately fell to its new floor. In the face of persistent strong selling pressure the authorities decided on 15 January 1999 to float the real. By the end of February 1999 the Brazilian currency had depreciated by some 40 per cent against the dollar.

In early March 1999, the Brazilian government concluded the renegotiation of the support package agreed with the IMF in November 1998. The basic policy strategy is to keep inflation in check and to avoid an extended wage-price spiral. This will also depend on the extent of the currency depreciation. As in the Asian emerging markets, high real interest rates are expected to arrest and reverse capital outflows, with concomitant positive effects on the exchange rate. The earlier tightening of monetary and fiscal policy has now pushed the economy into recession. Current forecasts are for real GDP to fall by some 3-4 per cent in 1999 compared with 1998, but this may prove to be too optimistic. The contagion effects on other emerging markets have so far been much more limited compared with those that followed the Russian devaluation and default. This probably reflects the fact that the currency depreciation had been widely anticipated and that the exposure of investors to emerging markets, notably as regards highly leveraged investments, had already been substantially reduced in the final months of 1998.

The large currency depreciation has significantly improved price competitiveness of Brazilian firms and this could lead to tensions within Mercosur, the free trade zone which, besides Brazil, includes Argentina, Paraguay and Uruguay. In fact, foreign trade and investment links can constitute an important channel for contagion.⁵⁹ But Mercosur is a relatively closed trade area,⁶⁰ which accounts only for some 3 per cent of United States and extra-EU exports. This means that the trade effects will be largely felt inside Mercosur. The main impact will be on Argentina, the third largest economy in Latin America, which relies strongly on the Brazilian market for its exports. Argentina has raised interest rates to defend its own currency, the peso, which is pegged to the dollar in the framework of a currency board.⁶¹

Overall economic developments in *Latin America* in 1998 were strongly affected by the repercussions of the Asian crisis on international capital flows and commodity prices. Monetary policy was tightened significantly to prevent capital outflows and the associated loss of international reserves. On current trends a recession in 1999 cannot be excluded.⁶²

This episode can be seen as a confirmation of lessons for the ECE transition economies already drawn from the Asian crisis.⁶³ Strong dependence on short-term foreign capital can lead to an inherently unstable economic situation once foreign investors start pulling out. The increase of official interest rates, even to very high levels, is then no guarantee for arresting capital outflows, in fact, it may even make matters worse, given the adverse consequence of tight policies for domestic activity levels. Any official exchange rate peg, moreover, must be backed not only by an adequate level of foreign reserves but, more importantly, by credible economic policies designed to prevent the emergence of major domestic and external imbalance. Otherwise, governments simply sow the seeds for a speculative attack on the currency with attendant risks of a serious overshooting of the ensuing depreciation. More generally, when significant imbalances begin to emerge, governments must design credible adjustment policies and be seen to implement them in order to maintain or restore investor confidence. Governments should also be prepared for contagion effects if a financial crisis occurs in another country in the region or beyond. This holds independently of the state of the so-called "fundamentals" given that international investors in times of crisis often fail to differentiate between national markets.

(iv) Recent developments in East Asia

In *Japan*, the economic situation deteriorated significantly in the course of 1998. Real GDP fell in the four consecutive quarters⁶⁴ since the final quarter of 1997 and for 1998 as a whole a decline by some 2¾ per cent is estimated, the worst recession since 1974, when there was a decline of nearly 1 per cent. The unemployment rate rose above 4 per cent, a postwar record. Deflationary tendencies are discernible, *inter alia*, in a very large and rising output gap, falling wholesale and producer prices as well as asset prices, a severe crisis in the banking sector, a credit crunch for small- and medium-sized enterprises, and depressed business profits. Private households' spending behaviour has become very cautious on account of the worsening outlook for jobs

⁵⁹ R. Glick and A. Rose, "Contagion and trade: why are currency crises regional?", *NBER Working Paper*, No. 6806 (Cambridge, MA), November 1998.

⁶⁰ The degree of openness (measured as the arithmetic average of the sum of merchandise exports and imports as a proportion of total GDP) is only about 8 per cent compared to some 35 per cent of the aggregate of five Asian economies most affected by the recent crises.

⁶¹ There has even been a proposal by the government to "dollarize" the economy, i.e. to introduce the United States currency as legal tender.

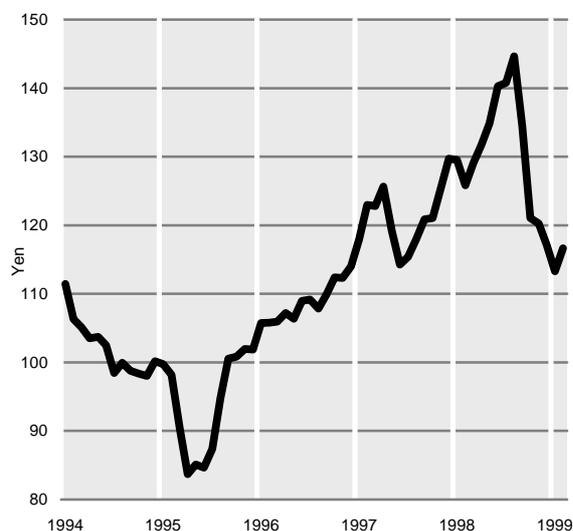
⁶² Economic Commission for Latin America and the Caribbean, *Preliminary Overview of the Economies of Latin America and the Caribbean 1998* (United Nations publication, Sales No. E.98.II.G.15).

⁶³ UN/ECE, *Economic Survey of Europe, 1998 No. 1*, pp. 73-75.

⁶⁴ At the time of writing, national accounts data were available only for the first three quarters of 1998. But forecasts are for a further fall in real GDP in the fourth quarter of 1998. This would then be the fifth consecutive quarterly decline in aggregate output.

CHART 2.1.5

The exchange rate of the yen against the dollar,
January 1994-February 1999
(Monthly averages)



Source: United States Federal Reserve.

and incomes and concerns about the pension system. As a result, the savings propensity rose markedly in 1998. Weak domestic demand has translated into a marked fall in imports. Exports to western Europe and North America rose strongly but this was more than offset by the continuing weak demand from other countries in the region. The current account surplus rose to some \$140 billion or 3.3 per cent of GDP in 1998.

The sharp appreciation of the yen between the beginning of August 1998 and mid-January 1999 has raised concerns about its adverse impact on export growth, the mainstay of economic activity in the current malaise. The Bank of Japan intervened in early January 1999 to arrest the strengthening of the yen against the dollar, which has since been partly reversed (chart 2.1.5). The appreciation of the yen has probably offset to a large degree the potential effects of the new fiscal stimulus package adopted in April 1998. In any case, significant positive effects of this package were hardly discernible until late 1998, when there were signs of a strengthening in public investment. A further package of fiscal measures, which envisages additional public works spending as well as income and corporate tax reductions, was adopted in November. Given the persistence of recessionary forces, the successive fiscal stimulus packages have propelled the budget deficit and government debt to high levels. Gross general government debt rose to about 100 per cent of GDP in 1998, compared with some 75 per cent in 1995.

Official interest rates in Japan are at very low levels. The discount rate has been at a historic low of 0.5 per cent since September 1995. The overnight lending

rate was reduced to 0.25 per cent in September 1998. The effects of this monetary easing, if any, were probably offset by the appreciation of the yen. There was a further lowering of the lending rate to 0.15 per cent in mid-February 1999 and in early March, the bank pushed it down to 0.02 per cent. This move led to a fall in long-term interest rates as investors shifted funds from the money market to the bond market. But, since for some time there has been no evidence that the monetary transmission mechanism is still effective, there have been demands for an outright monetization of government debt by the Bank of Japan, a demand which it has so far resisted.

Reform of the banking sector is underway, but small- and medium-sized companies continue to be faced with the restrictive lending policy of banks ("credit crunch"). Public funds were made available in the autumn of 1998 to enable banks to tackle the bad loans problem, but although they have made large write-offs, the volume of bad loans did not change significantly in the first half of 1998, as new firms became insolvent.

In the *five Asian economies* most affected by the crisis in the region (Indonesia, Malaysia, Philippines, Republic of Korea and Thailand) there was a sharp fall in output in 1998, except in the Philippines, where the recession was rather shallow (table 2.1.2). The current account balances of these countries have moved from deficit in 1997 into surplus in 1998, reflecting the domestic adjustment process to the net outflow of private capital from the region. Falling import demand has played a major role in this reversal of the current account balance. Export values have remained depressed with, in some countries, a strong recovery in export volumes offset by falling dollar prices. National currencies have tended to appreciate against the dollar in 1998, thus partly reversing the earlier sharp depreciations. Exchange rate pressures were also reduced on account of the strong appreciation of the yen against the dollar in the second half of 1998. This provided scope for lowering domestic interest rates, which was supported in some countries (Indonesia, Republic of Korea, Thailand) by a more accommodative stance of fiscal policy. Equity prices have also edged upwards but displayed considerable volatility in view of the turbulence in international financial markets (chart 2.1.4). The recession is expected to bottom out in 1999 reflecting the more conducive stance of economic policy and improved prospects for export earnings, but this will also depend on the extent of the cyclical slowdown expected in western Europe and North America.

Among other Asian emerging market economies, Hong Kong moved into deep recession in 1998, while the forces for growth have weakened significantly in Singapore, driving the economy to the brink of recession. In contrast, the Taiwan economy has displayed a striking resilience to the recession in the region, although the financial sector has started to experience some difficulties (table 2.1.2).

TABLE 2.1.2

Annual changes in real GDP in east Asian countries, 1996-1999
(Percentage change over preceding year)

	1996	1997	1998	1999
Asean-4	7.1	4.6	-8.9	-1.2
Indonesia	8.0	4.6	-13.7	-3.9
Malaysia	8.6	7.7	-6.4	0.2
Philippines	5.8	9.7	-0.5	1.5
Thailand	5.5	-0.4	-7.9	0.7
NIEs	6.3	6.0	-2.0	0.1
Hong Kong	4.6	5.3	-5.0	-1.5
Republic of Korea	7.1	5.5	-6.1	-2.2
Singapore	6.9	7.8	1.3	-
Taiwan Province of China	5.7	6.8	4.8	4.4
China	9.7	8.8	7.8	7.3
Japan	5.0	1.4	-2.6	-0.5
Total above	7.4	5.6	0.8	2.7

Source: Consensus Economics Inc., *Consensus Forecasts*, February 1999 (internet website).

Note: Growth rates of regional aggregates have been calculated by the ECE secretariat as weighted averages of growth rates of individual countries. Weights were derived from 1996 GDP data converted from national currency units into dollars using purchasing power parities.

In *China*, the pace of economic expansion slowed down further in 1998, although the growth rate of real GDP remained very high by international standards. Despite the significant adverse trade effects of the east Asian crisis and the associated repercussions on domestic employment and income levels, the official target of an increase in real GDP by 8 per cent was broadly met. Strong overall growth, however, contrasts with sluggish consumer demand and falling consumer and producer prices in 1998. It appears that a large part of output is simply being added to already large inventories, which may not be saleable. In fact, to counter the slowdown in economic growth and reverse deflationary tendencies the stance of monetary policy was eased and the government boosted expenditure on public investment projects. These measures appear to have been effective in supporting economic growth in the second half of 1998.

A matter of concern has been the signs of crisis in the so-called International Trust and Investment Corporations (ITICs), which have been channelling funds borrowed abroad to domestic projects. In October 1998, a large ITIC was declared bankrupt after defaulting on its foreign loans. The government announced in early 1999 that most of the ITICs will have to be restructured. International banks have reacted to the prospect that their loans might not be repaid with a credit squeeze on Chinese corporate borrowers, refusing to extend new loans and calling in some existing loans. A matter of dispute remains the reliability of macroeconomic statistics published by the Chinese Statistical Office and to what degree output growth is overstated.⁶⁵ Faced with a deteriorating domestic

economic environment, the authorities have maintained their commitment not to devalue the renminbi, which has fluctuated within an unchanged narrow band against the dollar since May 1994. But the domestic economic costs of this exchange rate policy have been increasing and its sustainability will depend strongly on a recovery not only of demand in the neighbouring Asian economies and sustained import growth in western markets but also on the restoration of domestic consumer and investor confidence. Growth prospects for 1999 could also be affected by potential adverse spillover effects of the crisis in Brazil, which so far, however, have failed to occur.

2.2 The economic situation in western Europe and North America

(i) General economic developments

In the western market economies, the contractionary effects of the crisis in Asia and other parts of the world economy were increasingly restraining export growth in the second half of 1998. In western Europe, this weakening of exports was not offset by a strengthening of domestic demand; instead, the growth of domestic demand also slowed down. Real GDP rose by only 0.6 per cent between the second and third quarters of 1998 and was only 2.5 per cent above its level in the third quarter of 1997 (chart 2.2.1). Partial data suggest that economic growth decelerated further in the final quarter of 1998: real GDP in the four major economies combined stagnated between the third and fourth quarters, masking falling aggregate output levels in Germany and Italy. Rough estimates suggest that economic growth in western Europe as a whole was only about one quarter of a percentage point in the final quarter of 1998. This stands in sharp relief to developments in the United States. Propelled by buoyant domestic demand, real GDP rose by 1.5 per cent between the third and last quarters. These relative changes have led to an increasing divergence in the cyclical positions of western Europe and the United States, a tendency which appears to have continued in early 1999. For 1998 as a whole, real GDP in western Europe is currently estimated to have increased by 2.7 per cent, down from 2.9 per cent in 1997. Within this aggregate, there was a slight increase in the average annual growth rate in the European Union and the euro area to 2.8 per cent in 1998 (table 2.2.1). In the United States, real GDP rose by 3.9 per cent in 1998, the same as in 1997.

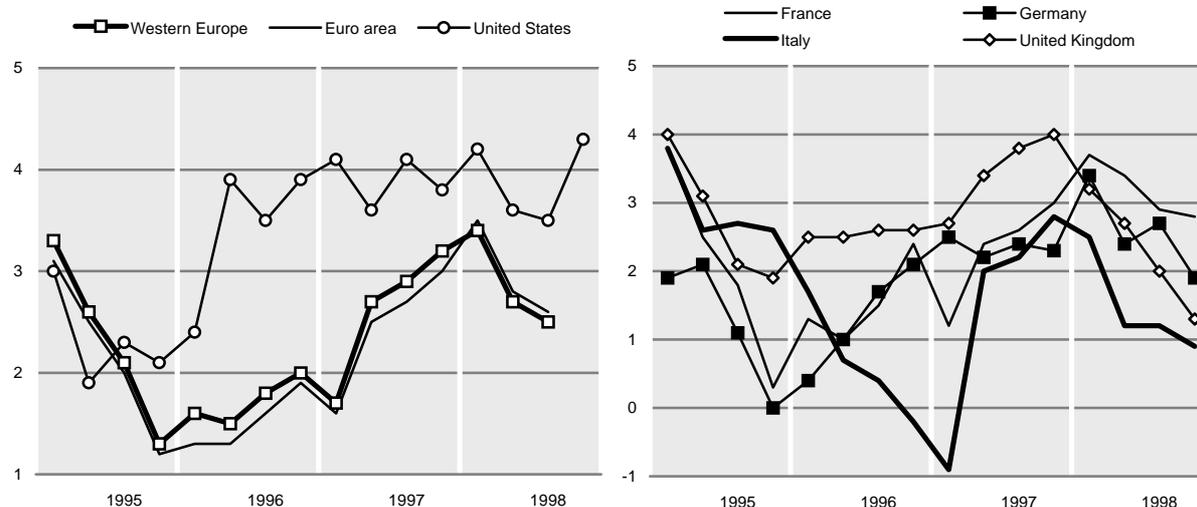
(a) Western Europe

Against a background of deteriorating prospects for sales and profits, industrial confidence in western Europe has fallen sharply since mid-1998, a feature which contrasts with a further rise of consumer confidence to very high levels (chart 2.2.2). Industrial and consumer confidence have been highly correlated in the past, and the recent divergence between the two is therefore quite

⁶⁵ See IMF, *World Economic Outlook* ..., op. cit., pp. 147-150, box 4.1, which tries to reconcile strong output growth with low increases in electricity production and falling freight traffic in 1998.

CHART 2.2.1

Quarterly changes in real GDP, 1995-1998
(Percentage change over same quarter of preceding year)



Source: National statistics.

Note: Data are seasonally adjusted. Euro area excludes Ireland and Luxembourg. Western Europe: euro area plus Denmark, Norway, Sweden, Switzerland and the United Kingdom.

striking. To some extent the relative optimism of consumers may reflect the prevailing low interest rates and the gains in financial wealth of private households, which have supported the purchase of consumer durables (notably cars) and favourable financing of residential investments. There could be considerable myopia, however, on the part of consumers. Thus, the effects of the recent deterioration in the short-run economic outlook will become visible in the labour markets only with a lag in the course of 1999. It is also striking that, on balance, households perceived an improvement in the general economic situation between September 1998 and February 1999,⁶⁶ although forecasts of economic growth were being steadily revised downwards since last autumn.

Manufacturing production turned increasingly sluggish in the course of 1998, a marked contrast to its buoyancy in 1997 (chart 2.2.3). This reflected to a large degree the adverse effects of the spreading crisis in emerging markets, including the transition economies, on net exports of manufactures. These effects then spilled over via weaker activity levels and depressed demand for imported intermediate goods and raw materials between west European countries themselves. As a result, manufacturing output in western Europe is estimated to have fallen between the third and fourth quarters of 1998. In view of the significant statistical carry-over effect from the end of last year, output rose, nevertheless, by some 3.5 per cent for the year as whole.

This average includes considerably stronger growth rates in Finland (8.5 per cent), Ireland (16.5) and Spain (6¼). In view of the sharp slowdown in output growth, capacity utilization rates fell in the second half of 1998 and in January 1999 they were nearly 2 percentage points lower than in August 1998 (chart 2.2.3).

Among the major components of demand, private consumption held up relatively well in 1998, and although the underlying tendency was for a slight weakening in the course of the year (chart 2.2.4), it was the mainstay of domestic demand. Aggregate households' disposable incomes in 1998 were supported by continued moderate growth in average earnings and by stronger gains in employment than in 1997. In several countries, consumers' expenditure was also supported by falling saving ratios. In addition, real disposable incomes were boosted by falling inflation and the sharp fall in oil prices.

Quarterly changes in real fixed capital formation have been rather volatile since the second half of 1997, but the momentum which has normally accompanied earlier cyclical upswings has been lacking. The rise in capacity utilization rates until mid-1998 stimulated business investment, as did favourable financing conditions and improved profitability. But with the deteriorating economic outlook, many firms appear to have postponed or scaled down their investment plans. The main focus of business investment has continued to be rationalization and modernization. Expenditure on machinery and equipment rose in real terms by some 8 per cent in 1998 (compared with 1997). In contrast, construction investment remained sluggish with

⁶⁶ European Commission, *Business and Consumer Surveys, First Results: February 1999* (Brussels), 4 March 1999.

TABLE 2.2.1

Real GDP in the developed market economies, 1996-1999
(Percentage change over previous year)

	1996	1997	1998	1999 ^a
Western Europe	2.0	2.9	2.7	1.9
4 major countries	1.5	2.3	2.4	1.5
France	1.6	2.3	3.1	2.2
Germany	1.3	2.2	2.8	1.5
Italy	0.9	1.5	1.4	1.8
United Kingdom	2.6	3.5	2.3	0.5
17 smaller countries	3.1	3.9	3.3	2.5
Austria	2.0	2.5	3.3	2.1
Belgium	1.3	3.0	2.8	2.0
Cyprus	2.0	2.5	5.0	4.0
Denmark	3.3	3.1	2.4	1.6
Finland	4.1	5.6	4.9	3.0
Greece	2.4	3.2	3.0	3.2
Iceland	5.5	5.0	5.6	4.3
Ireland	7.4	9.8	8.5	6.3
Israel	4.7	2.7	2.0	1.7
Luxembourg	3.0	4.8	4.7	3.4
Malta	3.8	4.4	7.6	7.5
Netherlands	3.1	3.6	3.7	2.3
Norway	5.5	3.4	2.0	1.0
Portugal	3.2	3.7	3.5	3.0
Spain	2.4	3.5	3.8	3.4
Sweden	1.3	1.8	2.9	2.0
Switzerland	-	1.7	2.1	1.5
Turkey	7.0	7.5	2.4	1.8
North America	3.3	3.9	3.8	3.0
Canada	1.2	3.8	3.0	2.7
United States	3.4	3.9	3.9	3.0
Total above	2.7	3.4	3.3	2.4
Japan	5.0	1.4	-2.9	-0.5
Total above, including Japan	3.0	3.1	2.3	2.0
Memorandum items:				
European Union	1.8	2.6	2.8	1.9
Euro area	1.6	2.5	2.8	2.1

Source: National statistics and national economic reports.

Note: All aggregates exclude Israel. Growth rates of regional aggregates have been calculated as weighted averages of growth rates in individual countries. Weights were derived from 1991 GDP data converted from national currency units into dollars using purchasing power parities.

^a Forecasts.

persistent excess capacities in many countries. Falling mortgage interest rates stimulated households' residential investment and there was also a stronger growth of investment in industrial buildings. On average, however, construction investment rose only by some 1¼ per cent in 1998. Altogether, total real gross fixed capital formation increased by 4.7 per cent in 1998, up from about 3.4 per cent in 1997 (table 2.2.2).

Changes in stockbuilding tended to support domestic activity in 1998, although there was a weakening in stock accumulation in the second half of the year. For the year as a whole, stockbuilding contributed half a percentage point to the overall growth of GDP.

Growth in real exports of goods and services slowed down significantly in 1998 from the very high rates of 1997, a reflection of the fall in demand from Asia, Russia and the OPEC countries. But also demand from central and eastern Europe weakened. This general shortfall of demand was increasingly less offset by rising demand in the other west European economies, which was reflected in a weakening of their import growth. In addition there were competitive pressures from the recovery of export growth in Asia, which tended to crowd out producers from western Europe in their domestic markets and abroad.

On average, the changes in real net exports of goods and services subtracted somewhat more than half a percentage point from the growth in total domestic demand of 3.4 per cent to yield an increase in real GDP in western Europe of 2.7 per cent.

Developments in the *labour markets* were relatively positive in 1998. The rise in aggregate output was associated with an increase in total employment in western Europe by some 1¼ per cent in 1998 (table 2.2.3). This was the largest annual increase since 1990 (chart 2.2.5), but the weakening of cyclical growth forces in the course of 1998 increasingly weakened the demand for labour.

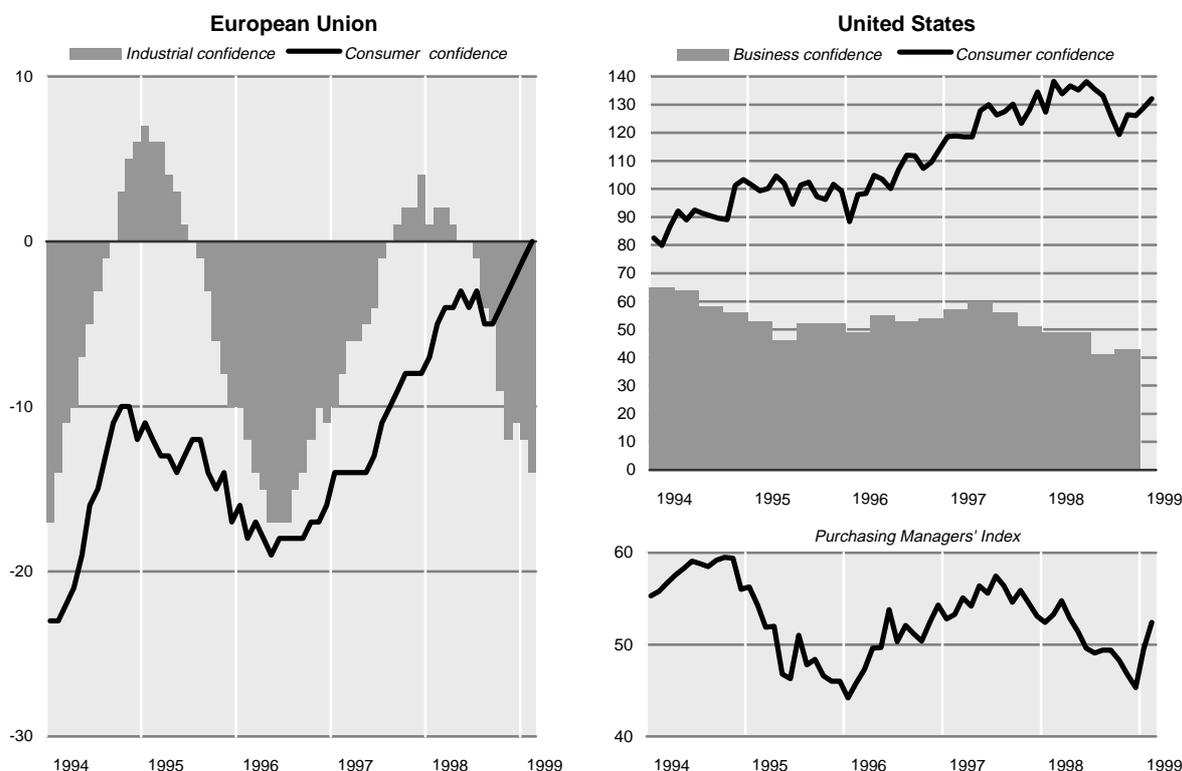
Employment growth continued quite strongly in the smaller economies in 1998, also a reflection of rapid output growth in the past few years. In contrast, changes in employment were more divergent among the four major economies, where the average increase was small (about half a percentage point). There was, however, a strong upturn in the demand for labour in France, in fact the largest annual increase in employment in this decade. This reflected the combined effect of robust economic growth and special labour market measures aimed at providing jobs for young persons in the public sector.⁶⁷ Employment growth also remained relatively strong in the United Kingdom, but weakened in the course of the year in response to the cyclical downturn. In Germany, the fall in employment since 1991 petered out into broad stagnation in 1998. There was, however, a rise in manufacturing employment in the course of 1998 but this levelled off in the final months of the year as output growth weakened. Employment in eastern Germany continues to be supported by special job creation programmes. In Italy, sluggish economic activity produced only a slight rise in employment.

Increased employment was also reflected in a further small decline in the average unemployment rate to 9.2 per cent in 1998, down from 9.9 per cent in 1997 (table 2.2.4 and chart 2.2.6). Some offset to the falls in unemployment was due to the growth in the labour force, which was also influenced in many countries by the increased incentives for "discouraged workers" to seek

⁶⁷ This accounted for about one third of all the additional jobs created in 1998 and was reflected in a decline of youth unemployment.

CHART 2.2.2

Business cycle indicators for the European Union and the United States, January 1994-February 1999



Source: Data for the European Union: Commission of the European Communities, *European Economy*, Supplement B (Luxembourg), monthly and direct communications. Data for the United States: consumer and business confidence: the Conference Board, New York (internet website), and direct communications. Purchasing Managers' Index: website of the National Association of Purchasing Management, Arizona, and direct communications.

Note: European Union data show net balances between the percentages of respondents giving positive and negative answers to specific questions. For details see any edition of the source. United States: consumer confidence is measured in index form with base year 1985=100. Business confidence is compiled on the basis of answers to specific questions, with the following scale applying: 100 = substantially good; 75 = moderately good (+); 50 = moderately good (-); 25 = moderately bad; (0) = bad. The Purchasing Managers' Index (PMI) is a composite index pertaining to the business situation in manufacturing industry. An index value above (below) 50 per cent indicates that manufacturing industry is generally expanding (contracting). A PMI above (below) 44.5 per cent, over a period of time, indicates that overall economic activity, as measured by real GDP, is generally expanding (contracting).

jobs again against a background of tighter labour markets. On the other hand, special labour market measures also played a role in reducing unemployment in France and Germany. Given the modest recent declines, the average unemployment rate has remained close to its peak of the past two decades in France, Germany and Italy. This contrasts with the sharp fall of the unemployment rate in the United Kingdom since the start of the cyclical upswing in 1993, to 6.3 per cent in 1998, the lowest rate in the past two decades. Unemployment rates have fallen significantly in many of the smaller economies and to relatively low levels in 1998 (table 2.2.4).

The negative social and economic consequences of persistently high unemployment rates in most of western Europe has increased the pressure on governments to strengthen their *labour market policies*. At the "Jobs Summit" of November 1997 the European Union launched the *Luxembourg process*, which aims at reorienting policies towards a more preventive and active approach to the problem. Guidelines were agreed, which

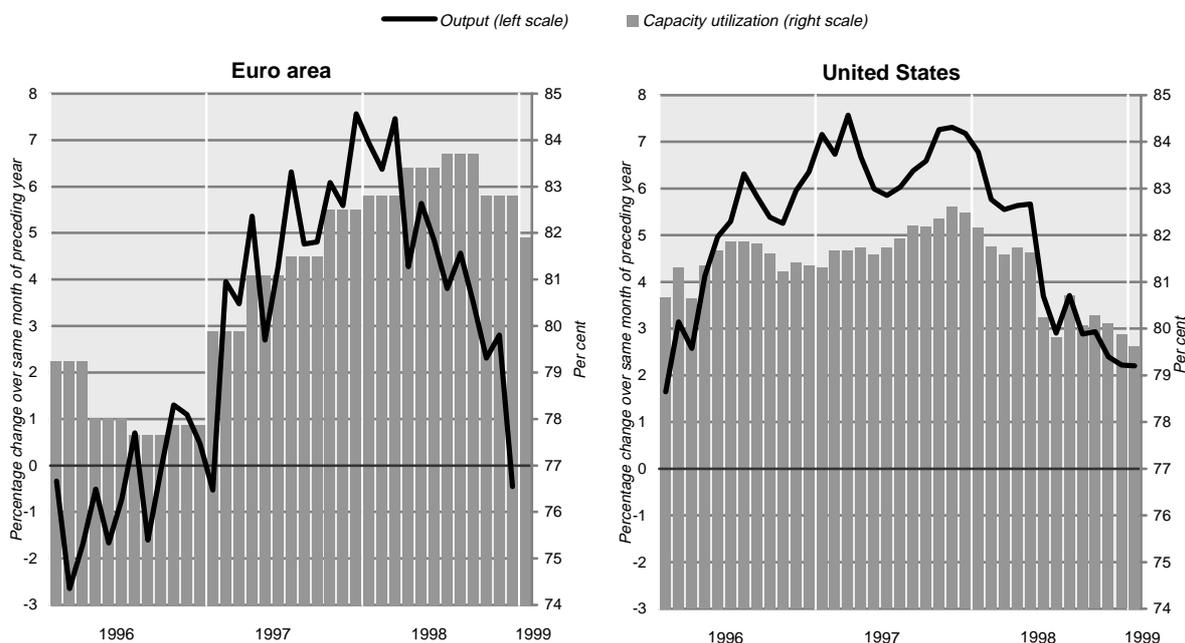
should be translated into National Action Plans for employment. The 1999 version of these guidelines reaffirms the tenets of the strategy and puts the accent on active measures (e.g. changes in benefits and taxes so as to provide incentives for unemployed or inactive people to seek and take up work and training opportunities and to reduce recourse to early retirement schemes) and on lifelong learning (especially in the area of information and communication technologies). However this process is still incipient and the shift in the focus of policies is likely to take place only in the medium term.⁶⁸

Consumer price inflation in western Europe continued the declining trend established at the beginning of the decade and in 1998 reached its lowest level in almost 40 years (see chart 2.2.7). The main factor

⁶⁸ European Commission, *European Commission Adopts 1999 Employment Guidelines*, IP/98/887 and *European Commission Adopts 1998 Joint Employment Report*, IP/98/889 (Brussels), 14 October 1998.

CHART 2.2.3

Manufacturing output and capacity utilization in the euro area and the United States, January 1996-January 1999



Source: Eurostat; OECD, *Main Economic Indicators* (Paris), various issues.

Note: Data are monthly and seasonally adjusted. Capacity utilization rates for the euro area refer to January, April, July and October of each year. Data for the euro area excludes Austria.

underpinning the latest fall in inflation rates was the steep decline in the prices of international commodities (section 2.1 above). Labour cost pressures have remained largely absent. Prices of international manufactures fell against the background of excess capacities in several sectors (e.g. steel, automobiles, textiles, information processing equipment) and fierce price competition in the wake of the Asian crisis and the marked slowdown in world output growth.⁶⁹

Falling commodity prices depressed not only the prices of industrial raw materials (a major component of producer price indices) but they also exerted downward pressure on the energy and food prices paid by final consumers. The pass-through of falling non-fuel commodity prices contributed to lower average price increases faced by private households. *Producer prices* actually fell not only in many west European countries⁷⁰ but also in North America and Japan in 1998. In western Europe, their fall was accentuated by the depreciation of the dollar in the second half of the year, which put additional downward pressure on import prices in domestic currencies. Consumer price inflation averaged only 1.6 per cent in 1998 (table 2.2.5), with virtual

stability in the monthly price indices in the second half of the year. Core inflation (i.e. excluding food and energy prices) has been stable at an annual rate of some 2 per cent since early 1997. The differential changes in producer and consumer prices (chart 2.2.7) reflect not only differences in the composition of the indices but also the fact that consumer prices also include services. There is evidence that service suppliers have been more successful in raising their prices in recent years than goods suppliers,⁷¹ who have been facing intensified import competition.

An alternative measure of inflation in the euro area is the Harmonized Index of Consumer Prices (HICP), which has a less comprehensive coverage than the traditional national indices. The HICP rose by 1.2 per cent in the euro area in 1998, down from 1.6 per cent in 1997. The general tendency is for the annual inflation rate in the individual countries according to HICP to be slightly lower than the rates based on the national definitions (table 2.2.5). Outside the euro area, there is a considerable difference (some 2 percentage points) between these two measures in the United Kingdom.

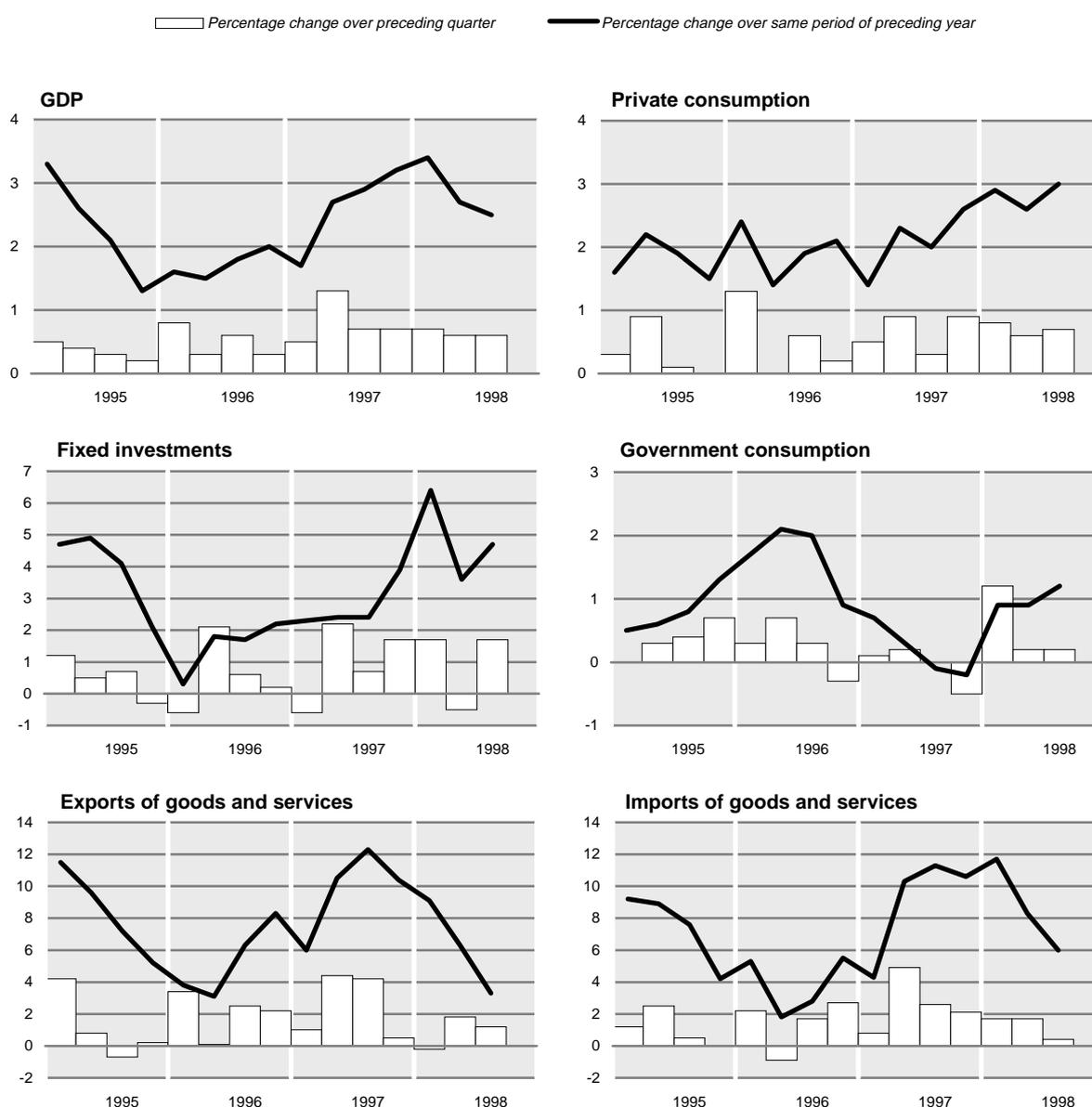
⁶⁹ International trade prices of manufactures (in dollars) fell by 2.5 per cent in 1998 compared with a fall of 8.1 per cent in 1997.

⁷⁰ Average annual producer price indices fell in 10 out of 17 countries in 1998. The fall in prices was even more pervasive, in 14 out of 17 countries, in the final months of 1998.

⁷¹ In the United Kingdom, for instance, 27 per cent of goods' prices included in the retail price index fell in 1998, as compared with just 14 per cent of service prices. The difference between producer price and consumer price changes may also partly reflect past increases in the cost of labour or bought-in services, which together account for a large portion of manufacturers' total costs. Bank of England, *Inflation Report* (London), February 1999, pp. 35-36.

CHART 2.2.4

Quarterly changes in real GDP and major demand components in western Europe, 1995-1998



Source: National statistics.

Note: Data are seasonally adjusted. Data cover 14 countries, i.e. 12 member states of the EU (except Greece, Ireland and Luxembourg) plus Norway and Switzerland.

Inflation differentials between countries of the euro area had narrowed significantly in early 1997, but since then the gap between the highest and lowest rates has tended to rise again (chart 2.2.8). While the average increase in the HICP continued to be pulled down by the further decline of inflation in countries such as Austria, Finland, France and Germany, this was partly offset by somewhat stronger inflation in a number of other countries (Portugal, Ireland, the Netherlands) in the course of the year.

The continued moderate growth in labour costs in most western European countries was to a large extent

offset by gains in productivity. GDP per person employed, a crude measure of productivity, rose by 1.6 per cent in 1998, less than the 2.5 per cent gain in 1997. This limited the average increase of *unit labour costs* to just 0.6 per cent. In several countries (Germany, Italy, Spain, Netherlands, Switzerland) unit labour costs even fell slightly. The major exceptions to this general pattern were Denmark, Norway and the United Kingdom, where unit labour costs rose by some 4 per cent in 1998.

Among the four major economies, there was a marked strengthening in the average yearly rate of GDP growth in France and Germany. The pace of economic

TABLE 2.2.2

Major components of demand in the ECE market economies, 1997-1998
(Percentage change over preceding year)

	Private consumption		Government consumption		Gross fixed investment		Stock building ^a		Total domestic demand		Exports		Imports		Net exports ^a	
	1997	1998	1997	1998	1997	1998	1997	1998	1997	1998	1997	1998	1997	1998	1997	1998
Western Europe	2.3	2.7	0.3	1.3	3.4	4.7	0.4	0.6	2.6	3.4	10.2	4.8	9.7	7.4	0.2	-0.7
4 major countries	1.8	2.4	-0.1	1.2	1.6	4.1	0.6	0.8	2.0	3.3	9.5	3.9	8.8	7.1	0.3	-0.9
France	0.9	3.4	1.2	1.5	0.1	4.6	0.1	0.6	0.9	3.8	12.6	5.7	8.1	8.2	1.4	-0.7
Germany	0.5	1.9	-0.7	0.6	0.1	1.6	1.2	1.5	1.4	3.1	11.1	5.4	8.1	6.6	0.8	-0.3
Italy	2.6	1.9	-0.8	1.4	0.8	3.5	0.7	0.5	2.4	2.6	5.0	1.3	9.9	6.1	-0.9	-1.1
United Kingdom	3.9	2.6	-	1.5	6.6	8.0	0.2	0.2	3.8	3.5	8.7	2.7	9.5	7.8	-0.3	-1.7
17 smaller countries	3.4	3.2	1.1	1.5	6.9	5.8	-	0.3	3.9	3.8	11.5	6.5	11.4	7.8	0.1	-0.5
Austria	0.7	1.8	-3.9	1.5	2.8	4.8	1.4	0.3	1.8	2.8	10.1	7.5	8.7	6.8	0.7	0.4
Belgium	2.1	2.8	0.8	1.1	5.4	4.8	-0.3	0.1	2.2	3.0	7.1	5.1	6.3	5.5	0.9	-0.1
Cyprus	2.4	7.0	3.4	7.7	-8.4	0.6	0.4	0.1	0.7	5.6	2.1	-2.0	1.3	3.6	0.3	-3.0
Denmark	3.6	3.4	1.1	2.2	10.6	5.0	0.1	0.3	4.5	3.8	5.5	1.2	9.8	4.8	-1.3	-1.3
Finland	2.2	5.1	2.9	0.4	14.2	8.2	0.7	-	5.4	4.6	14.2	6.6	11.4	8.1	2.0	0.2
Greece	2.5	1.9	-0.4	0.8	9.6	8.0	-0.2	-0.2	3.5	3.0	5.3	5.5	5.4	4.5	-0.8	-0.4
Iceland	6.0	10.3	1.5	3.0	11.2	28.2	-0.2	0.2	5.8	12.4	5.6	5.7	8.0	25.0	-0.6	-6.6
Ireland	6.3	8.3	4.8	3.0	10.9	13.0	0.4	-0.6	7.3	7.6	16.9	19.5	15.6	21.3	3.7	2.2
Israel	4.1	3.3	1.9	2.3	-2.3	-3.3	-0.9	-1.0	1.4	0.9	7.6	6.0	2.8	2.1	1.1	1.0
Luxembourg	2.5	2.6	1.7	2.8	14.1	6.5	-0.7	-	4.7	3.7	6.0	7.5	6.1	7.0	0.8	1.5
Malta	2.4	2.9	-1.2	-4.6	-7.6	-4.1	2.1	5.3	1.6	5.6	2.0	5.2	-2.4	1.6	2.8	2.3
Netherlands	3.0	4.4	1.5	2.5	6.8	3.9	-	-	3.6	4.0	6.7	5.9	7.1	6.8	0.3	-
Norway	3.4	3.2	3.0	2.8	12.6	6.6	0.2	0.6	5.6	4.5	5.8	0.5	12.3	6.9	-1.8	-2.3
Portugal	3.0	3.6	2.5	2.8	11.3	7.8	0.2	-	5.2	4.5	8.4	10.5	10.4	10.0	-2.1	-1.2
Spain	3.1	3.5	1.4	1.3	5.1	8.8	-0.3	0.1	2.9	4.4	14.8	10.1	12.2	11.5	0.5	-0.7
Sweden	2.0	2.7	-2.1	2.0	-4.8	10.5	0.7	0.3	0.4	4.1	12.8	5.1	11.7	8.9	1.4	-0.9
Switzerland	1.7	1.8	-0.7	0.6	1.5	3.8	-	1.7	1.3	3.8	9.1	4.1	7.9	8.7	0.5	-1.7
Turkey	8.4	2.1	4.1	0.5	14.8	-2.0	-0.9	1.0	9.0	1.7	19.1	3.3	22.4	1.8	-1.9	0.3
North America	3.4	4.7	1.1	1.0	7.5	9.3	0.5	-0.1	4.3	4.8	12.4	2.1	13.8	10.3	-0.4	-1.2
Canada	4.1	2.7	-0.8	0.7	11.1	4.2	0.8	-0.4	5.2	2.2	8.0	8.1	13.3	6.4	-1.5	0.7
United States	3.4	4.8	1.3	1.1	7.1	9.7	0.5	-0.1	4.2	5.1	12.8	1.5	13.9	10.6	-0.4	-1.4
Total above	2.9	3.7	0.7	1.2	5.4	7.0	0.5	0.3	3.5	4.1	11.3	3.4	11.8	8.8	-0.1	-1.0
Japan	1.0	-1.1	1.5	0.6	-1.9	-9.0	-0.1	-0.2	0.1	-3.6	11.6	-2.3	0.5	-7.7	1.4	0.6
Total above, including Japan	2.6	2.9	0.8	1.1	4.3	4.5	0.4	0.2	2.9	2.9	11.3	2.5	10.0	6.2	0.1	-0.7
<i>Memorandum item:</i>																
European Union	2.0	2.7	0.1	1.3	2.8	5.0	0.5	0.6	2.3	3.5	9.9	5.0	9.1	7.6	0.4	-0.7
Euro area	1.7	2.7	0.2	1.3	2.0	4.2	0.5	0.7	2.0	3.4	10.2	5.5	9.0	7.6	0.5	-0.5

Source: OECD national accounts and national statistics.

Note: All aggregates exclude Israel.

^a Percentage point contribution to annual GDP growth.

expansion remained sluggish in Italy. In the United Kingdom, there was a marked slowdown in the rate of economic growth.

In France, the acceleration in economic growth to a rate of 3.1 per cent in 1998, markedly above the west European average, was mainly supported by domestic demand. Export growth weakened markedly reflecting, *inter alia*, a fall in shipments to Asia. In the presence of strong import demand, changes in real net exports subtracted significantly from overall economic growth. The most striking feature was the recovery in private consumption expenditures, which rose by nearly 3.5 per cent. Aggregate real incomes were boosted by gains in employment, falling inflation and reduced social security charges. Business fixed investment was stimulated by

high capacity utilization rates and lower costs of finance. The favourable outcome for the year as a whole, however, masks a deceleration in the pace of expansion in the second half of 1998, as the effects of the weakening of global growth forces began to increasingly affect activity in industry despite a partial offset by sustained growth in services. Despite the weakening of export growth and strong demand for imports, the merchandise trade surplus fell only slightly and the overall current account remained in comfortable surplus. Developments in 1999 will depend heavily on the impact of the deteriorating international economic environment on consumer and industrial confidence and investment behaviour. A major uncertainty is how the implementation of the 35-hour legal working week will affect industrial competitiveness.

TABLE 2.2.3

Total employment in the ECE market economies, 1995-1998
(Percentage change over previous year)

	1995	1996	1997	1998 ^a
Western Europe	1.0	0.8	0.2	1.2
4 major countries	0.3	0.2	0.1	0.6
France	1.0	0.2	0.2	1.4
Germany	-0.4	-1.3	-1.3	-
Italy ^b	-0.3	-	-0.2	0.2
United Kingdom ^c	1.1	2.4	1.9	0.9
17 smaller countries	2.0	1.6	0.3	2.1
Austria	0.2	-0.5	0.3	0.9
Belgium ^c	0.5	0.4	0.5	1.2
Cyprus	3.4	1.0	0.2	..
Denmark	1.1	0.8	2.0	1.9
Finland	1.7	1.0	2.0	2.7
Greece	0.9	1.2	-0.5	1.4
Iceland ^b	0.8	3.0	1.7	2.1
Ireland ^d	5.1	3.9	3.2	6.7
Israel	5.2	2.4	1.4	1.8
Luxembourg	2.5	2.8	3.2	4.5
Malta ^e	3.8	1.0	0.5	0.4
Netherlands ^b	1.4	2.0	2.6	2.7
Norway	2.1	2.5	2.9	2.3
Portugal	-0.7	0.7	1.9	2.8
Spain	2.7	2.9	3.0	3.1
Sweden	1.5	-0.5	-1.0	1.4
Switzerland	0.1	0.3	-0.3	1.2
Turkey	3.7	2.0	-2.5	1.5
North America	2.3	1.8	2.5	2.6
Canada	1.6	1.3	1.9	2.5
United States ^f	2.4	1.9	2.6	2.6
Total above	1.6	1.2	1.2	1.8
Japan	0.2	0.5	1.1	-0.6
Total above, including Japan	1.3	1.1	1.2	1.4
Memorandum items:				
European Union	0.6	0.6	0.5	1.1
Euro area	0.5	0.2	0.2	1.1

Source: National statistics; OECD, *National Accounts Detailed Tables*, Vol. II, 1998 and *OECD Economic Outlook*, No. 64, December 1998 (Paris); UN/ECE secretariat estimates.

Note: All aggregates exclude Israel. Unless otherwise indicated, data refer to the annual average number of persons employed, i.e. no adjustment is made for part-time workers. Comparisons with previous years are limited due to changes in methodology in Israel (1996).

^a Provisional.

^b Full-time equivalent data.

^c June.

^d Mid-April estimates.

^e End of year.

^f Full-time equivalent employees plus the number of self-employed workers (unpaid family workers are not included).

In *Germany*, real GDP rose by 2.8 per cent in 1998 compared with 2.2 per cent in 1997. This improved performance was solely due to the strengthening of domestic demand. Export growth weakened significantly and changes in real net exports subtracted slightly from overall economic growth in 1998 (table 2.2.2). None of the domestic demand components, however, developed any significant upward momentum during the course of

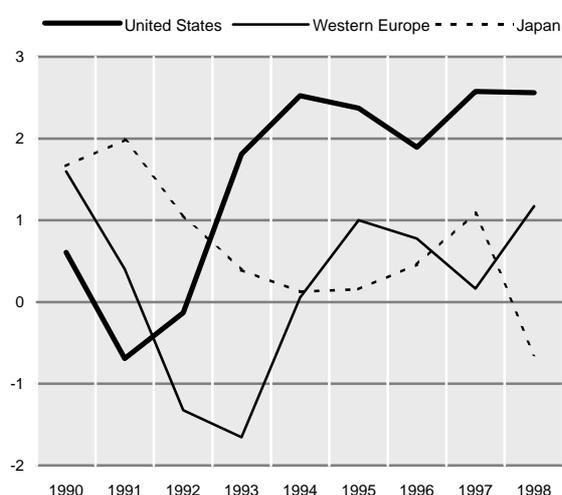
the year. Households' consumption expenditures were supported by larger gains in nominal wage rates which, combined with the fall in inflation and the stabilization of employment levels, led to higher growth in real disposable incomes. Disposable incomes were also supported by a lowering of the income tax burden, which was only partly offset by the rise in VAT at the beginning of April 1998, and by the fall in the savings ratio to historically low values. Business expenditures on machinery and equipment rose strongly, by some 8.5 per cent year-over-year, but this was mainly due to a strong recovery in the first quarter of 1998 which petered out into broad stagnation for the rest of the year. Construction investment fell sharply, by some 5 per cent. The contribution of changes in stockbuilding to overall growth in GDP was some 1¼ percentage points in the past two years, which is very high by international standards.⁷² In the labour market, the fall in employment in recent years finally bottomed out in 1998, but there was very little growth during the year. The number of unemployed, which was at a postwar high at the end of 1997, fell steadily in 1998, a reflection, as in France, of special labour market measures. Labour cost pressures were negligible and unit labour costs continued to fall. The merchandise trade surplus rose somewhat in 1998, in part a reflection of the fall in import prices, but this was more than offset by the deterioration in the invisibles balance; as a result, the current account deficit increased to some DM 15 billion in 1998 (or 0.4 per cent of GDP), about twice its level in 1997.

In *Italy*, overall economic activity remained very sluggish in 1998. Real GDP rose by only 1.4 per cent slightly less than in 1997. Fiscal policy was more neutral, following the sharp retrenchment in 1997, but monetary policy was relatively tight for most of the year. Private consumption remained subdued, reflecting little growth in real disposable incomes which was only partly offset by a fall in the household savings ratio. The weakness of private consumption was partly counterbalanced by a moderate strengthening of fixed investment. Government consumption expenditures rose in real terms, more than offsetting their decline in 1997 (table 2.2.2). Private sector domestic demand was restrained in the second half of 1998 by the ending of the special incentive scheme for the purchase of new cars introduced by the government in 1997. The ensuing fall in car sales was a factor behind the weakness of industrial activity in the second half of 1998. The overall deterioration in export performance in 1998 reflects also the adverse effects of the Asian crisis on the domestic textile and clothing sector, which still accounts for an important part of Italian industry. Changes in real net exports subtracted from overall economic growth in 1998. Employment rose only slightly and the high rate of

⁷² There is a presumption that these inventory changes are overstated as they are difficult to reconcile with advances in inventory management and general economic developments. Given that inventory changes for recent years are typically calculated as a residual, this would therefore point to biases in other national accounts aggregates. DIW, "Grundlinien der Wirtschaftsentwicklung 1999", *Wochenbericht 1/99* (Berlin), 7 January 1999, p. 18.

CHART 2.2.5

Changes in total employment in industrialized countries, 1990-1998
(Percentage change over previous year)



Source: National statistics; OECD, *National Accounts Detailed Tables*, Vol. II, 1998 and *OECD Economic Outlook*, No. 64, December 1998 (Paris); UN/ECE secretariat estimates.

unemployment remained unchanged. The merchandise trade surplus fell in 1998, but the current account remained in comfortable surplus corresponding to some 2.5 per cent of GDP.

In the *United Kingdom*, the pace of economic expansion slowed down from the high rates of 1997 to near stagnation in the final quarter of 1998. The lagged effects of tight economic policies were amplified by the dampening impact of the appreciation of the pound sterling and the effects of the Asian crisis on net exports. The growth of both private consumption and fixed investment has slowed down significantly; this has affected mainly manufacturing industry, which was on the edge of recession throughout the second half of 1998. But there are increasing signs that activity in the services sector has also started to slow down. In response to the weakening of GDP growth and a favourable inflation performance in line with the official target, the stance of monetary policy has been progressively relaxed since early October, although nominal and real interest rates are still significantly higher than in the euro area. Real GDP rose by 2¼ per cent in 1998 down from 3.5 per cent in 1997. Changes in the real foreign balance subtracted about 1.5 percentage points from overall economic growth. Overall employment growth slowed down significantly in 1998, although there were continuing gains in services. The unemployment rate fell to 6.3 per cent in 1998, the lowest in nearly 20 years. But the improvement in the labour market has petered out. Labour cost pressures are difficult to gauge since the suspension of the Average Earnings Index in November 1998, but there are some indications that they have been easing recently. The question is whether in the face of weakening external and domestic demand, a recession can be avoided in 1999.

TABLE 2.2.4

Standardized unemployment rates^a in the ECE market economies, 1995-1998
(Per cent of civilian labour force)

	1995	1996	1997	1998 ^b
Western Europe	10.1	10.1	9.9	9.2
4 major countries	9.8	10.1	10.2	9.7
France	11.7	12.4	12.4	11.9
Germany	8.2	8.9	9.9	9.4
Italy	11.9	12.0	12.1	12.2
United Kingdom	8.7	8.2	7.0	6.3
17 smaller countries	10.4	10.1	9.5	8.5
Austria	3.9	4.4	4.4	4.4
Belgium	9.9	9.7	9.2	8.8
Cyprus ^c	2.6	3.1	3.4	3.2
Denmark	7.3	6.8	5.6	5.1
Finland	15.3	14.6	12.7	11.4
Greece	9.2	9.6	9.6	9.3
Iceland	5.0	4.4	3.9	2.8
Ireland	12.3	11.6	9.9	7.8
Israel	6.9	6.7	7.7	8.6
Luxembourg	2.9	3.0	2.8	2.8
Malta ^c	3.8	4.4	5.0	4.9
Netherlands	6.9	6.3	5.2	4.0
Norway	5.0	4.9	4.1	3.4
Portugal	7.3	7.3	6.8	4.9
Spain	22.9	22.2	20.8	18.8
Sweden	8.8	9.6	9.9	8.2
Switzerland	4.2	4.7	5.2	3.8
Turkey	6.9	6.0	5.7	5.6
North America	6.0	5.8	5.4	4.9
Canada	9.5	9.7	9.2	8.3
United States	5.6	5.4	4.9	4.5
Total above	8.3	8.3	7.9	7.3
Japan	3.2	3.4	3.4	4.1
Total above, including Japan	7.5	7.5	7.2	6.8
<i>Memorandum items:</i>				
European Union	10.7	10.8	10.6	9.9
Euro area	11.4	11.6	11.6	10.9

Source: National statistics; OECD, *Quarterly Labour Force Statistics*, No. 4, 1998, *Main Economic Indicators*, various issues and *OECD Economic Outlook*, No. 64, December 1998 (Paris); UN/ECE secretariat estimates.

Note: All aggregates exclude Israel.

^a Adjusted to achieve comparability between countries, except for Cyprus, Iceland, Israel, Malta, Switzerland and Turkey.

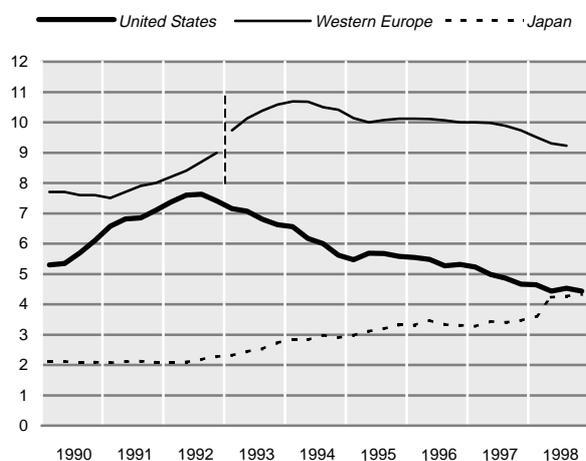
^b Provisional.

^c End of year.

Among the *smaller west European economies*, the pattern of performance was as diverse as among the four larger economies, but the general factors shaping outcomes were much the same. The dominating feature was for weakening export growth in the second half of 1998, accompanied by a slowdown in the growth of domestic demand. For the year as whole, real GDP rose by 3¼ per cent, down from nearly 4 per cent in 1997 (table 2.2.1). This outcome reflects to a large degree a pronounced weakening of economic growth in Denmark, Norway and Turkey. In contrast, the rate of economic expansion remained quite vigorous in most of the other countries, notably Finland, Ireland, Luxembourg, the Netherlands, Portugal and Spain.

CHART 2.2.6

Unemployment rates in industrialized countries, 1990-1998
(Per cent of civilian labour force, quarterly average, standardized rate)

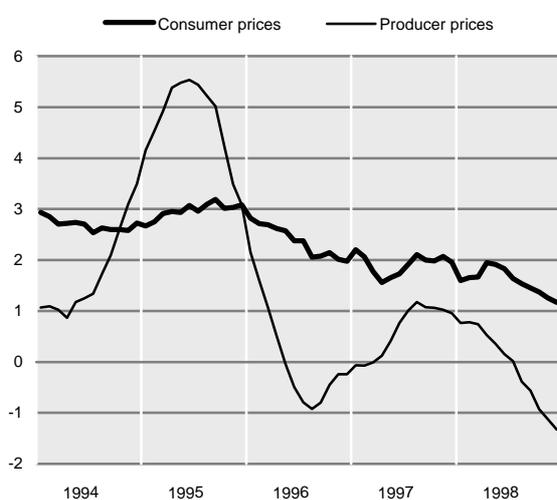


Source: National statistics; OECD, *Quarterly Labour Force Statistics*, No. 4, 1998, *Main Economic Indicators*, various issues and *OECD Economic Outlook*, No. 64, December 1998 (Paris); UN/ECE secretariat estimates.

Note: The average unemployment rate for western Europe does not include data for east Germany before 1993.

CHART 2.2.7

Inflation in four major European countries, 1994-1998
(Percentage change over same month of previous year)



Source: National statistics.

Note: Four major European countries: France, Germany, Italy and the United Kingdom.

In *Denmark*, in addition to the adverse changes in real net exports, the deceleration in economic growth also reflects the effects of restrictive fiscal measures introduced to prevent the overheating of domestic activity.

In *Norway*, a cyclical peak was passed in 1998 after a long and high rate of economic expansion which started in 1993. Monetary policy was significantly tightened

between March and August 1998 in response to considerable capital outflows which put downward pressure on the exchange rate. These capital outflows were associated with the sharp fall in oil prices and mounting wage cost pressures originating in the increasingly tight labour market. In late August, the central bank abandoned its attempt to maintain the exchange rate within the established target range against the ECU. The krone is currently still below the official target range but the stabilization of the exchange rate and the marked cyclical slowdown led to a lowering of official interest rates at the end of January 1999. The sharp fall in oil prices was the main factor behind the swing in the current account from surplus in 1997 to small deficit in 1998. As a reaction to falling prices, oil and gas production was cut in 1998. High interest rates were restraining both private household expenditures and business fixed investment in the final months of 1998.

In *Turkey*, the pace of economic expansion slowed down sharply in the second half of 1998. This was partly in response to the tightening of economic policies within the framework of the government's three-year stabilization programme which was launched in the first half of the year and which aims to curb very high inflation and reduce high fiscal deficits. The restraining effects of tighter macroeconomic policy, however, were significantly amplified by the adverse effects of the Asian and Russian crises. Exports were depressed by the fall in demand from Russia⁷³ and increasing competitive pressures from Asian producers in domestic and foreign markets. In addition, the Russian crisis triggered capital outflows which were mirrored in a significant rise in yields on short-term treasury bills and of overnight lending rates in the interbank market. High real domestic interest rates and a tightening of lending standards have restrained private sector borrowing, with concomitant negative effects on consumption and investment spending.

The steady economic recovery in Switzerland during 1997 increasingly lost momentum in 1998, reflecting mainly the effects of slowing export growth and the adjustment of business inventories, which offset the steady growth of consumption and fixed investment.

Among the remaining countries, annual rates of economic growth were rather favourable but, again, the annual average masks a more or less pronounced slowdown in domestic demand and exports during the course of the year. In Portugal and Spain, domestic demand was stimulated by falling interest rates in the course of 1998 but despite high levels of activity the deteriorating international environment appears to have alleviated fears of overheating.

In *Greece*, macroeconomic policies are focused on meeting the key Maastricht convergence criteria by mid-2000. Economic growth in 1998 was largely supported

⁷³ The sharp depreciation of the Russian rouble eroded the incentives for the so-called "suitcase trade" with Russia and other members of the CIS, which was estimated to exceed official exports by a large margin.

TABLE 2.2.5

Consumer price indices in ECE market economies, 1996-1998
(Percentage change over previous year)

	According to national definitions			HICP ^a
	1996	1997	1998	1998
Western Europe	2.3	1.9	1.6	..
4 major countries	2.4	1.9	1.6	1.1
France	2.0	1.2	0.7	0.7
Germany	1.5	1.8	0.9	0.6
Italy	3.9	1.7	1.8	2.0
United Kingdom	2.4	3.1	3.4	1.6
16 smaller countries^b	2.3	1.8	1.5	1.8
Austria	1.9	1.3	0.9	0.8
Belgium	2.0	1.6	1.0	0.9
Cyprus	2.9	3.6	2.2	..
Denmark	2.0	2.2	1.9	1.4
Finland	0.5	1.2	1.4	1.4
Greece	8.3	5.5	4.8	4.6
Iceland	2.3	1.8	1.7	1.4
Ireland	1.7	1.4	2.4	2.2
Israel	11.3	9.0	5.4	..
Luxembourg	1.3	1.4	1.0	1.0
Malta	2.5	3.2	2.2	..
Netherlands	2.0	2.2	2.0	1.8
Norway	1.3	2.6	2.3	1.9
Portugal	3.1	2.3	2.8	2.3
Spain	3.6	2.0	1.8	1.8
Sweden	0.5	0.5	-0.1	1.0
Switzerland	0.8	0.5	0.1	..
Turkey	79.8	84.8	86.2	..
North America	2.8	2.2	1.5	..
Canada	1.6	1.6	0.9	..
United States	3.0	2.3	1.6	..
Total above	2.6	2.1	1.5	..
Japan	0.1	1.8	0.6	..
Total above, including Japan	2.2	2.0	1.4	..
Memorandum items:				
European Union	2.4	1.9	1.6	1.3
Euro area	2.4	1.7	1.3	1.2

Source: National statistics and Eurostat.

Note: All aggregates exclude Israel.

^a Inflation according to the Harmonised Index of Consumer Prices (HICP).

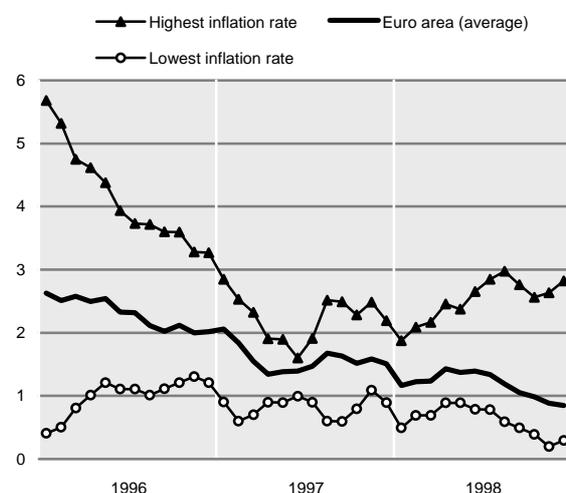
^b Thirteen smaller countries in the case of inflation according to the HICP.

by fixed investment in both the private and public sectors, with the latter partly financed by EU structural funds. Inflation was below 3.7 per cent in January 1999 down from 6.8 per cent in the same month of 1997. The general government budget deficit fell below 3 per cent in 1998, but government debt, which is more than 100 per cent of GDP, fell only slightly.

In *Ireland*, the economy has so far displayed a striking resilience to the repercussions of the Asian and Russian crises on the global economy. Continued buoyancy of exports and domestic demand led to an increase in real GDP of 8.5 per cent in 1998, down from 9.8 per cent in the previous year. Mounting inflationary pressures on labour costs and asset prices in some sectors of the domestic economy have failed so far to show up in

CHART 2.2.8

Inflation rate differentials in the euro area, 1996-1998
(Harmonized Index of Consumer Prices, percentage change over same month of previous year)



Source: Eurostat.

the average change of the consumer price index. Growth prospects for 1999 will be affected by the expected near stagnation of the United Kingdom economy, the major trading partner.

Outside Europe, economic growth in *Israel*⁷⁴ has been sluggish since the second half of 1996. Economic developments in 1998 were influenced by the cumulative effects of the Asian crisis which affected capital inflows and depressed export growth. Domestic demand remained weak against a background of tight economic policies and the petering out of the capital stock adjustment process that had been triggered by the earlier surge in immigration and which stimulated notably residential investment.

(b) North America

In the *United States*, the last recession ended in March 1991. This was followed by the longest period of peacetime expansion (96 months in April 1999) since the dating of business cycles began in 1854.⁷⁵

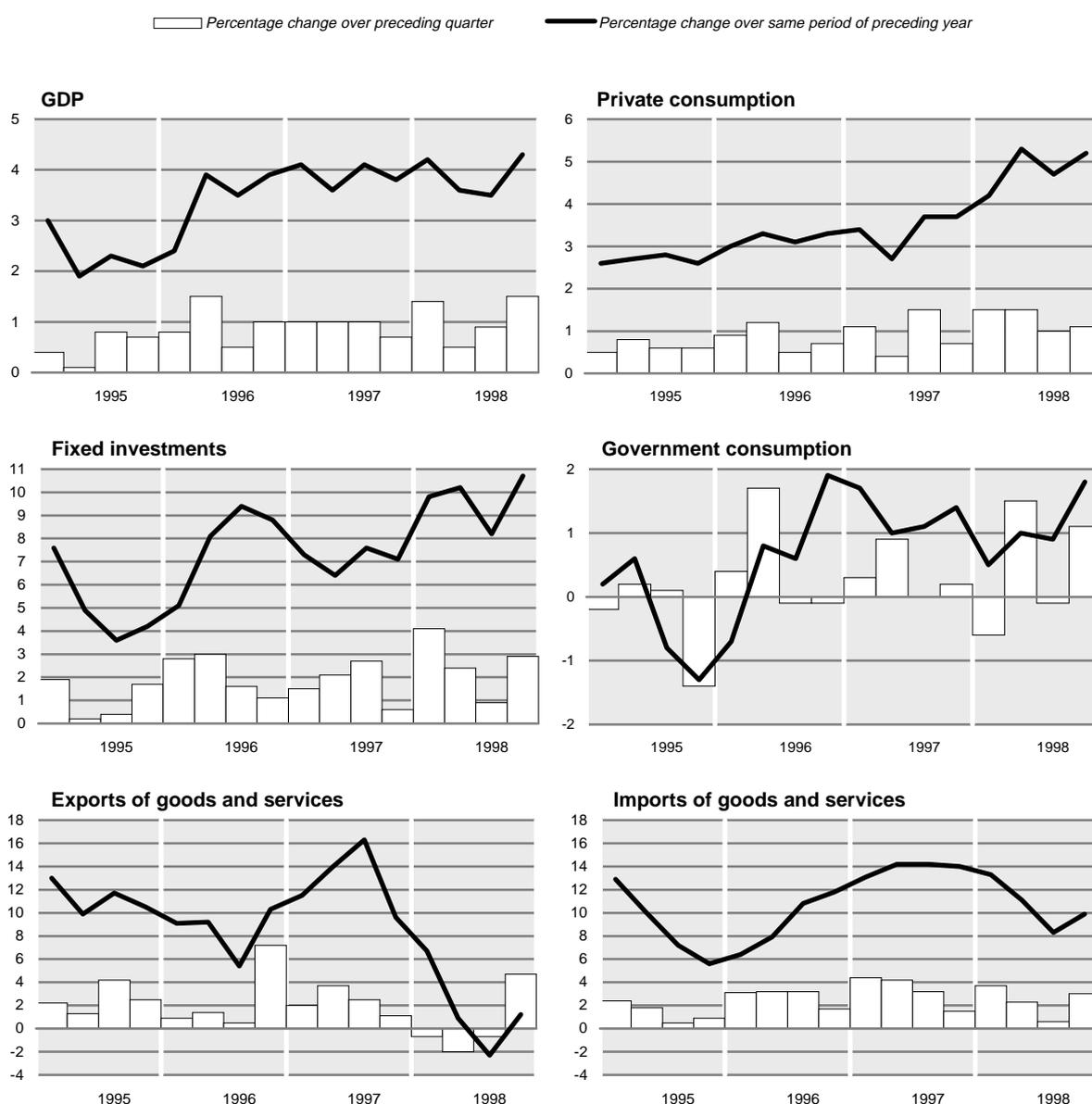
The marked acceleration in economic growth, by 1.5 per cent, between the third and final quarters of 1998 was not expected by economic forecasters (chart 2.2.9). The growth of personal consumption expenditures remained very high and business fixed investment accelerated sharply following moderate growth in the

⁷⁴ Israel has been a member of the UN/ECE since July 1991.

⁷⁵ National Bureau of Economic Research, *US Business Cycle Expansions and Contractions* (internet website). The longest expansion so far lasted 106 months starting from February 1961 (trough) until December 1969 (peak) – but this was influenced by the Viet Nam war.

CHART 2.2.9

Quarterly changes in real GDP and major demand components in the United States, 1995-1998



Source: National statistics.

Note: Data are seasonally adjusted.

third quarter. Residential investment maintained its high momentum. Real exports of goods and services also rose markedly following three consecutive quarters of decline. Import demand growth remained strong in the presence of buoyant domestic demand but, following seven consecutive quarters of negative contributions to quarterly GDP growth, real net exports even provided some slight support to domestic activity.

For the year as a whole, real GDP rose by 3.9 per cent in 1998, the same rate as in 1997. Total domestic demand rose by more than 5 per cent, but this was significantly offset by adverse changes in real net exports. Real exports rose only 1.5 per cent for the year as a

whole, restrained by the strong dollar (for most of the year) and weakening demand in foreign markets. Personal consumption expenditure rose at its strongest rate since 1985, and continued to be supported by the combined effect of continuing employment growth, increases in average nominal earnings, and falling inflation. Consumer confidence rose to very high levels, a tendency which was only temporarily interrupted by the financial market turbulence in late summer 1998 (chart 2.2.2). Household savings fell to only 0.1 per cent of disposable incomes in the fourth quarter, down from an already low 1.1 per cent in the first quarter. This willingness of households (in the aggregate) to spend all of their disposable income is associated with the

significant gains in financial wealth stemming from the rise in share prices. One result of the favourable gains in incomes and wealth and low mortgage interest rates, was a considerable demand for single-family housing, which contributed to a boom in the construction sector. The buoyancy of business fixed investment reflects to a large degree the continuing surge in expenditure on information processing equipment which, in real terms, was some 31 per cent higher in the fourth quarter of 1998 than a year earlier.⁷⁶ Manufacturing production was relatively sluggish in the course of 1998, a result of the Asian crisis and competitive pressures from the strong dollar. Production rose only slightly in the course of the year, and the relatively strong average annual growth rate of 4 per cent largely reflects a significant statistical carry-over effect from 1997.⁷⁷ As a result of the continuing strong growth in productive capacity, due to high levels of fixed investment, there was a significant fall in capacity utilization rates (chart 2.2.3). Capacity output in January 1999 is estimated to have been 5.5 per cent higher than in the same month of 1998. Capacity utilization rates fell by more than 3 percentage points over the same period and were some 6 percentage points below their previous peak in 1988-1989. Business confidence recovered slightly in the final quarter of 1998 after falling to a seven-year low in the third quarter, which was marked by turbulence in financial markets (chart 2.2.2).

The continuing economic expansion in the United States supported further large gains in employment and a fall in the unemployment rate to 4.3 per cent at the end of 1998. Increased demand for labour in services, financing, insurance and the construction sectors was partly offset by labour shedding in manufacturing industry during the year. Driven by strong output growth, there was a considerable rise in labour productivity (output per hour worked) in the non-farm business sector by some 2.5 per cent in 1998. This partly reflects the rise in capital intensity associated with the surge in fixed investment during the current expansion. Strong growth in productivity offset to a large degree the rise in labour costs, unit labour costs in the non-farm business sector rising by somewhat less than 2 per cent in 1998. Changes in the consumer price index have remained quite moderate: in addition to the favourable changes in productivity and unit labour costs, this also reflects falling prices of energy and imported finished goods, as well as the pass-through of lower commodity prices (chart 2.2.10). But core inflation (excluding food and energy prices) also did not rise significantly in 1998.

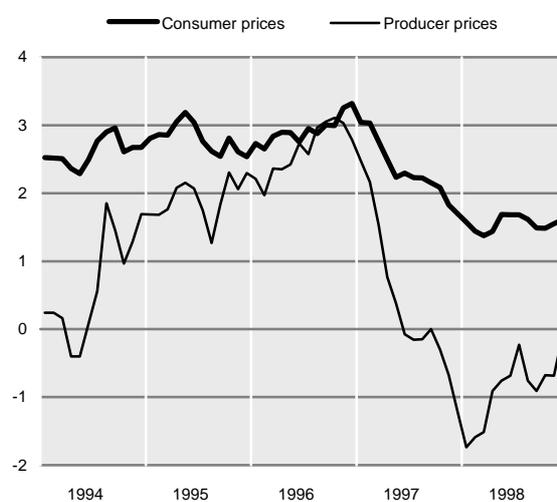
Given the differential strength of domestic and foreign demand, there was a large increase in the foreign trade deficit to \$169.1 billion in 1998. This was

⁷⁶ Spending on computers rose in real terms by 70 per cent over the same period. This contrasts with an increase by some 17 per cent in nominal terms, the implication being that prices fell by 31 per cent.

⁷⁷ The output level in December 1997 was 3 per cent above the annual average, which ensured *ceteris paribus* an annual growth rate of the same amount for 1998.

CHART 2.2.10

Inflation in the United States, 1994-1998
(Percentage change over same month of previous year)



Source: National statistics.

Note: Producer prices of finished goods.

amplified by the weakening of net investment income from abroad, leading to a current account deficit of \$233.4 billion or 2.7 per cent of GDP and a further rise in United States net foreign indebtedness. The mirror image to the current account deficit is an excess of domestic investment over national savings, which occurred despite the general government financial balance moving into surplus.

Economic growth also strengthened in *Canada* in the final quarter of 1998. This followed two quarters of only moderate expansion, which was partly due to labour strikes in various sectors of the economy. Apart from the return to normal production levels, the rebound in economic growth was also supported by the stronger demand for goods from the United States, Canada's major trading partner. Fixed investments also edged upward but personal consumption expenditure was rather sluggish, as gains in disposable incomes were used to rebuild savings, which had fallen significantly over the first three quarters.

For the year as a whole, real GDP rose by 3 per cent, down from 3.8 per cent in 1997. This slowdown was entirely due to the weaker growth of domestic demand, the increase in real net exports supporting overall economic growth in 1998 (table 2.2.2). Export growth remained quite robust because the negative effects from Japan and developing countries were offset by the strong import demand from the United States. Exports were also supported by strong gains in price competitiveness stemming from the significant depreciation of the Canadian dollar. Natural resource industries reacted to falling commodity prices and the associated decline in profits by cutting output and

investment expenditures. Despite the various disturbances, nearly half a million jobs were created in 1998, the largest gain since 1987. The unemployment rate fell in December 1998 to its lowest level since July 1990.

(ii) Monetary conditions and fiscal policy

In western Europe the framework for monetary policy has changed radically with the launching of the euro at the beginning of 1999.⁷⁸ In the second half of 1998, the orientation of monetary policy in the future member countries of EMU was increasingly determined by the objective of achieving convergence of official interest rates before the end of the year, an aim which entailed a progressive lowering of official interest rates in the so-called periphery countries. The final step to complete convergence was taken on 3 December 1998, when the central banks of the 11 member countries agreed on a coordinated cut of interest rates to 3 per cent. This decision also reflected concerns about the increasing evidence of a cyclical slowdown, notably in France and Germany, where the repo rate was reduced by 0.3 percentage points (or 30 base points). In other countries with interest rates significantly above those prevailing in France and Germany, the cuts were correspondingly larger.⁷⁹ The European Central Bank (ECB) decided to maintain the 3 per cent rate for its first major refinancing operation⁸⁰ which was conducted on 7 January 1999. This key official interest rate has since remained unchanged in spite of the continuing cyclical slowdown in the euro area. The three-month EURIBOR,⁸¹ has accordingly been rather stable at some 3.1 per cent in the first few months of 1999 with a slight tendency to move closer to 3 per cent in mid-March (chart 2.2.11).

The average real short-term interest rate in the euro area was 2.3 per cent in January 1999, down from 2.8 per cent⁸² in the same month of 1998, but still about 0.3 percentage points higher than in January 1997. Falling inflation has more than offset the significant decline in nominal rates by 1 percentage point between January 1997 and January 1999. In view of the deteriorating economic situation and the modest rate of inflation in the euro area it is generally expected that the ECB will reduce official interest rates in the near term. Overall

monetary conditions have already eased slightly as a result of the depreciation of the euro against the dollar (see below).

In the *United Kingdom*, the significant weakening of economic growth led to a progressive relaxation of monetary policy in the final quarter of 1998 and this has been continued in early 1999. The base lending rate was reduced by half a percentage point to 5.5 per cent in February, which is two percentage points below its recent peak in June 1998, when monetary policy was still being tightened.⁸³ Short-term interest rates in the United Kingdom have fallen significantly since the autumn but they were still some 2.5 percentage points higher than in the euro area in February (chart 2.2.11).

In the *United States*, monetary policy has been on hold after the target for the federal funds rate was cut in three steps from 5.25 per cent to 4.5 per cent between end-September and mid-November 1998. These moves helped to ease the severe tensions in the international financial markets in the wake of the Russian crisis, but they also provided a potentially significant monetary stimulus to the United States economy. The unexpected strengthening of economic growth in the final quarter of 1998 has made it more difficult for the Federal Reserve to find an appropriate balance between the timely countering of potential inflationary pressures and the avoidance of any further shocks to the still fragile stability of the financial markets. One source of concern could be the high rate of growth of money supply. Broad money (M3) in the final quarter of 1998 was 11 per cent higher than in the same period of 1997, far above the range of 2-6 per cent growth fixed by the FOMC⁸⁴ and the most rapid increase since 1981. But the Federal Reserve has argued that this strong growth of broad money reflects to a large degree the combined impact of temporary special factors which led to large fall in velocity with correspondingly few consequences for inflation.⁸⁵

⁷⁸ For a more detailed discussion see sect. 2.3 below.

⁷⁹ The largest cut, by some 0.7 percentage points, occurred in Ireland. In contrast, the repo rate in Finland had to be increased by 0.4 percentage points to achieve convergence at 3 per cent. But in Italy, for domestic policy reasons, the central bank lowered its key official interest rate to only 3.5 per cent on 3 December 1998; a further reduction to 3 per cent took place later in the month.

⁸⁰ This was a so-called fixed rate tender, which involves commercial banks submitting bids for funds at an interest rate fixed by the monetary authorities. The advantage of a fixed rate against a variable rate tender, where the interest rate on the latter adjusts to demand pressures, is that it sends a clear signal about the intentions of the monetary authorities.

⁸¹ Euro Interbank Offered Rate.

⁸² GDP-weighted average.

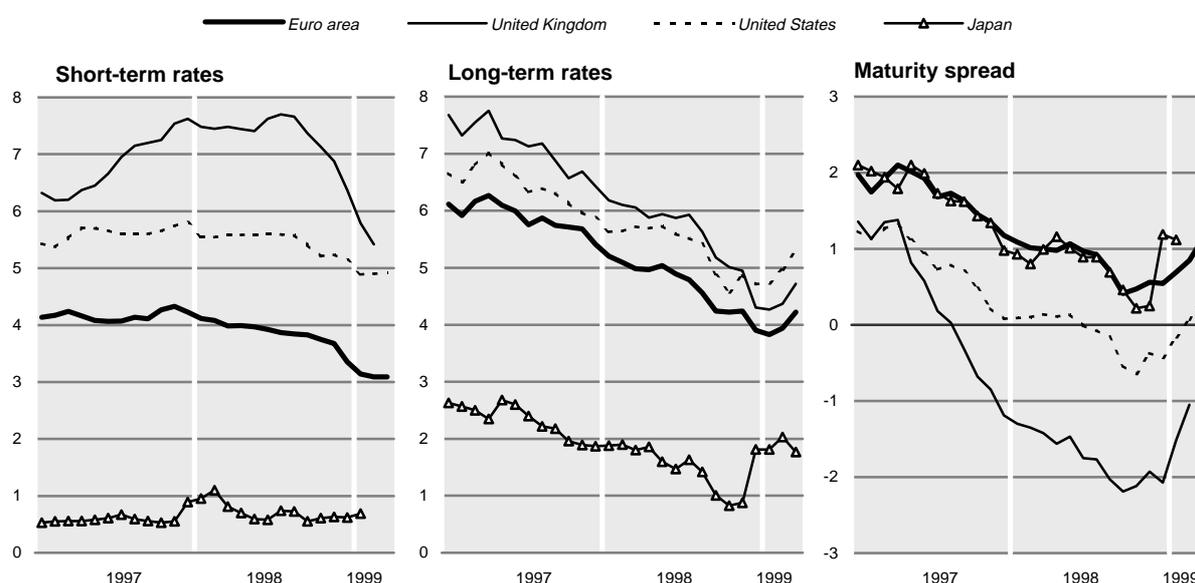
⁸³ This decision was influenced by the publication of statistics showing strong growth in average earnings, a development which raised fears of mounting inflationary pressures. But these figures were subsequently shown to be overstated; publication of the Average Earnings Index has been suspended and its calculation is currently under independent review. This has led to considerable uncertainties about the cost pressures arising from the labour market, especially after the recent introduction of a working time directive and a national minimum wage.

⁸⁴ M2 rose by 8.5 per cent over the same period, also significantly above its target range of 1-5 per cent. It should be noted that the Humphrey-Hawkins Act requires the Federal Reserve to announce a target range for money supply growth but these targets have been ignored in the conduct of monetary policy since about 1992 because of the weakening link between changes in money supply and economic activity.

⁸⁵ The fall in velocity is, *inter alia*, attributed to a shift of portfolios away from equities to monetary assets against the background of the increased volatility in the financial markets and to the increased sensitivity of the demand for monetary assets to changes in long-term interest rates and the slope of the yield curve, which was inverse in the second half of the year with long-term rates falling below short-term rates. Federal Reserve Board, *Humphrey-Hawkins Report*, 23 February 1999 (internet website).

CHART 2.2.11

Nominal interest rates, January 1997-March 1999
(Average monthly rate, per cent per annum)



Source: National statistics; OECD, *Main Economic Indicators* (Paris), various issues; European Central Bank; *Financial Times*, various issues.

Note: Short-term interest rates: three-month money market rates. Long-term interest rates: yields on 10-year government bonds. Maturity spread: long-term interest rates less short-term interest rates. The interest rates for the euro area prior to 1999 are GDP weighted averages of national rates. The figures for March are the average rates of the first half of the month.

Another difficult issue in the formulation of monetary policy in the near future is the current level of equity prices in the United States. These have recovered strongly after the financial market turbulence receded last autumn and have helped to sustain domestic demand, both directly through wealth effects and indirectly by easing the availability and terms of credit. How monetary policy should respond to asset prices, however, is difficult to determine.⁸⁶ It cannot be excluded, of course, that the current level of asset prices also reflects excessive money creation in the past, and that a tightening of monetary policy may provoke a major fall in equity prices, with considerable downside risks for the United States economy.

Long-term nominal interest rates are still very low, though they have tended to rise slightly in the United States in early 1999: yields on 10-year treasuries rose to some 5.3 per cent in early March. There has also been some upward pressure on interest rates at the shorter end of the maturity spectrum, but increases were larger at the longer end, with the result that the yield curve is no longer inverted as in the second half of 1998 (chart 2.2.11). This change in the slope of the yield curve also reflects changing expectations in the financial markets

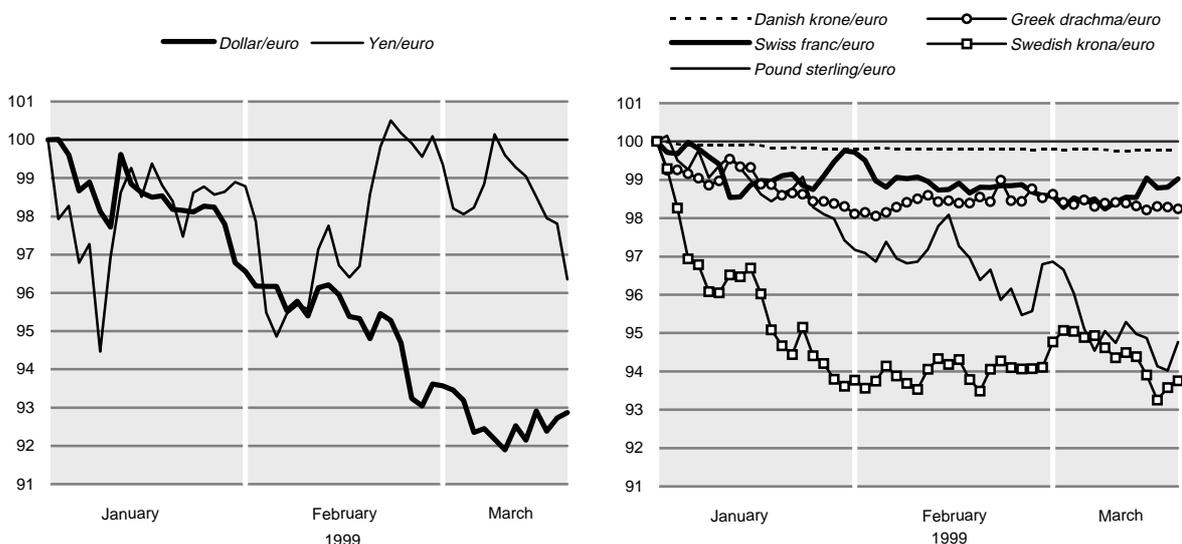
about future changes in official interest rates. Given the stronger than expected rate of economic growth, no further easing of monetary policy is expected in the near term.

Long-term interest rates also edged upward in the euro area in early 1999, partly reflecting the spillover effects from the United States bond market. As expected, there is no complete convergence of long-term interest rates among the various member countries of EMU. Yield spreads on national 10-year government bonds over German bonds were very small for France (about 0.05 percentage points) and the Netherlands (0.15 percentage points) in February. For the other countries they were within a range of 0.2 to 0.3 percentage points. Among the possible elements affecting these spreads are the risks of default and of exit from the EMU. The exchange rate or realignment risk, which was a major factor in the relatively high yield spreads in the former EMS, has been eliminated with the adoption of a single currency.

In the *foreign exchange markets* the depreciation of the dollar against the deutsche mark and other west European currencies in the wake of the Russian crisis was partly reversed in the last two months of 1998. This reflected changing assessments about the relative strength of economic growth and expectations of monetary easing, which did indeed occur in the form of the coordinated interest rate cut in early December 1998 (see above). Nevertheless, in December 1998 the deutsche mark had appreciated, on average, by 8.9 per cent against the dollar compared with January 1998.

⁸⁶ BIS, *67th Annual Report* (Basle), June 1997, pp. 74-75. For a study on the role of asset prices in obtaining inflation forecasts see F. Smets, "Financial asset prices and monetary policy: theory and evidence", Centre for Economic Policy Research, *Discussion Paper*, No. 1751 (London), November 1997.

CHART 2.2.12

Euro reference rates, January 1999-March 1999
(Indices, 4 January 1999=100)

Source: European Central Bank.

Note: Daily rates from 4 January to 15 March 1999.

The changeover to the euro at the beginning of 1999 meant the end of trading in the currencies of the 11 member states of EMU in the foreign exchange markets. The conversion rates of the national currencies implied an initial value of \$1.16675 per euro. On its first trading day on 4 January 1999 the euro rose to a reference value⁸⁷ of \$1.1789. But this “premium” disappeared in the following days when the euro started to depreciate against the dollar, a tendency which has since continued (chart 2.2.12). On 15 March 1999, the reference value had fallen to \$1.0949, equivalent to a depreciation of the euro by 7.1 per cent since 4 January 1999. The exchange rate of the euro against the yen has been rather volatile with no significant trend discernible so far. On 15 March, the euro had depreciated by some 3.5 per cent against the yen compared with the beginning of the year (chart 2.2.12). The euro has also weakened against the pound sterling and some other west European currencies, including those in the ERM2, i.e. the Danish krone and the Greek drachma (chart 2.2.12).⁸⁸

⁸⁷ The ECB has decided that there will be no euro area-wide official fixing procedure for the euro involving the ECB and the national central banks. Instead, daily reference values will be published. These are the mid-rate of exchange rates communicated by the national central banks in a daily concertation procedure. Note that this allows for the theoretical possibility that the reference value is not used in any actual transaction.

⁸⁸ The implication is that the dollar strengthened more against the euro than against the ERM2 currencies. Within the former ERM, when the dollar appreciated against the deutsche mark, it tended to appreciate more against the other currencies, i.e. the other currencies tended to weaken against the deutsche mark. The same empirical pattern was *mutatis mutandis* observed in the case of a weakening of the dollar against the deutsche mark.

On a trade-weighted basis against the currencies of major trading partners, the euro had fallen on average by some 3 per cent in February 1999 against its level in December 1998, both in nominal terms and when adjusted for changes in consumer prices.

The weakness of the euro in its early days has to some extent been a surprise, since most conjectures ahead of its introduction pointed toward a strong euro at the beginning of 1999. These were based on expectations of an initial strong rise in demand for euro denominated assets and the presumption that the ECB would keep interest rates high in order to establish an anti-inflation reputation.⁸⁹ But these scenarios did not take into account the evolution of the business cycle. In fact, to a large degree the recent changes in the exchange rate against the dollar can be attributed to differences in cyclical positions and in the stance of monetary policy of the United States and Europe. These differences are also reflected in the sizeable short-term interest rate differential in favour of dollar denominated assets, which was more than 1.5 percentage points in early March 1999, and in the above-mentioned expectations of further divergence in 1999.

The stance of *fiscal policy* was broadly neutral in western Europe in 1998 following the sharp fiscal retrenchment in the two preceding years. Structural budget deficits, on average, fell only slightly in the euro

⁸⁹ See, for example, D. Cohen, “How will the euro behave?” in P. Masson, T. Krueger and B. Turtelboom (eds.), *EMU and the International Monetary System* (IMF, Washington, D.C., 1997), p. 397.

area.⁹⁰ In France, where fiscal measures were introduced to support incomes and economic activity, there was in fact a small rise in the structural deficit. Outside the euro area, fiscal policies were relatively tight in Greece, Sweden and the United Kingdom. General government financial deficits fell slightly to a level corresponding to some 2¼ per cent of GDP in the euro area in 1998. Deficits in France, Germany and Italy are quite close to the 3 per cent threshold established for “normal economic conditions” in the Stability and Growth Pact. This leaves little room for manoeuvre in the event of a more protracted or deeper cyclical slowdown than is currently expected. In the United States, continued buoyant economic growth has stimulated growth of tax revenues which, combined with tight fiscal policy, has led to comfortable budget surplus corresponding to some 1.5 per cent of GDP in 1998.

(iii) The short-term economic outlook

Short-term economic prospects in the western market economies are surrounded by a wider than usual margin of uncertainty, reflecting the significant downside risks associated with the lingering instability in financial markets and the possibility of a further worsening in economic performance in other parts of the world economy. In addition there are a number of domestic imbalances, which may prove unsustainable in the event of a stronger than expected cyclical slowdown.

In *western Europe*, forecasts of economic growth have been reduced further since the final months of 1998. Real GDP is now expected to increase by slightly less than 2 per cent in 1999, down from 2.7 per cent in 1998 (table 2.2.1). This outcome reflects above all a weakening in the growth of all the major components of domestic demand. Business fixed investment will be affected by the deteriorating sales prospects both abroad and at home, as well as by the associated decline in capacity utilization rates and reduced profitability. A pronounced weakening of expenditures on machinery and equipment, however, is expected to be partly offset by a slight strengthening of construction investment. Inventory accumulation is expected to provide less support to economic activity than in 1998. Private consumption will remain the mainstay of economic growth, but in general its rate of expansion should be more moderate. This largely reflects the slowdown in employment growth and the associated smaller gains in aggregate incomes. In the real foreign balance, the deceleration in export growth in 1998 is expected to continue in 1999, but the net effect, however, will be somewhat offset by the weakening of the growth of imports, in turn, a reflection of the more moderate increase in domestic demand. Altogether, changes in real net exports are likely to subtract about 0.5 percentage points from overall economic growth, somewhat less than

in 1998. These forecasts are based on the assumption of a strengthening of economic activity in the second half of the year, which would pave the way for further gains in the cyclical upturn in 2000.

In the euro area, aggregate economic growth is forecast to be slightly above 2 per cent in 1999, down from 2.8 per cent in 1998. The basic factors behind this slowdown are those already described above. The somewhat weaker outcome for the larger west European aggregate mainly reflects the sharp cyclical downturn in Turkey and the United Kingdom. Inside the euro area, relatively strong cyclical divergences continue to prevail. Although on average there is a pervasive slowdown in economic growth, this masks a continuing robust expansion in Finland, Ireland, Portugal and Spain, with output growth significantly above average. In contrast, economic activity in Germany and Italy, which accounts for about half of GDP in the euro area, is expected to remain sluggish in 1999.

The aggregate slowdown in economic growth in the euro area below its long-term trend will lead to a widening output gap in 1999. It will also mean smaller gains in employment and little further progress, if any, in curbing high levels of unemployment. Inflation is currently not a problem, even if the deflationary effects of falling commodity prices will no longer be present. The scope for fiscal policy to support economic activity is narrowly circumscribed by the current levels of budget deficits and the rules of the Stability and Growth Pact. But there is certainly scope for a lowering of interest rates in the euro area. The design of economic policy in the euro area has imposed rather strict fiscal rules, with precise, but largely arbitrary, quantitative limits on budget deficits. Many governments are now striving to meet the established objective of broadly balanced budgets by the year 2002 in order to gain room for fiscal manoeuvre to counter a subsequent cyclical downturn.⁹¹ The current economic environment does not facilitate this task. Achieving the budget targets would also serve the ECB because it would effectively reduce the burden on monetary policy to stabilize economic activity. A further easing of monetary policy in the euro area would support economic growth and therefore create at the same time a more conducive environment for further progress in fiscal consolidation.

In the *United States*, the unexpected strengthening of economic activity since the autumn of 1998 has confounded the forecasters who, in general, were expecting a marked deceleration in economic growth (a “soft landing”) in 1999. This was also reflected in the forecasts prepared by the OECD⁹² and the IMF⁹³ in the late autumn and which pointed to a slowdown in the rate of economic expansion, compared with 1998, to some

⁹⁰ OECD *Economic Outlook*, No. 64 (Paris), December 1998, annex table 31.

⁹¹ On this see also sect. 2.3.

⁹² OECD *Economic Outlook*, No. 64 (Paris), December 1998.

⁹³ IMF, *World Economic Outlook* ..., op. cit.

1.5-1.8 per cent in 1999. This was not significantly different from private sector forecasts, the consensus of which in the autumn was for an increase in real GDP by 2 per cent.⁹⁴ These forecasts basically assumed that the sharp weakening in export demand, in combination with the strong dollar and rising labour costs, would squeeze corporate profits and lead to a sharp deceleration in the rate of expansion of business fixed investment. Private consumption was also seen to slow somewhat, but still to grow at a relatively robust rate, reflecting further large gains in real disposable incomes – in turn a reflection of further increases in employment and stronger earnings growth – which was only partly offset by a rise in the savings ratio.

This “baseline scenario” now appears to have been overtaken by the continuing buoyancy of domestic output and demand in late 1998 and which has persisted in the first two months of 1999.⁹⁵ The acceleration in GDP growth in the final quarter of 1998, moreover, has led to a considerable statistical carry-over effect which implies that even if total economic output stagnates for the entire year at the level attained in the final quarter of 1998 the average level of real GDP in 1999 would still be 1.7 per cent higher than in 1998. It is against this background that growth forecasts for the United States economy were increased significantly in early 1999. Forecasts of annual GDP growth now range from some 2.5-3.5 per cent. Most private sector forecasters see only a relatively mild deceleration in the growth rate, on average, to some 3¼ per cent in 1999.⁹⁶

The upshot is that the “virtuous circle” which has characterized the United States economy in recent years is now widely expected to persist in 1999: strong increases in fixed investment lead to gains in productivity, profits, real wages and asset prices, which in turn boost consumer demand and fixed investment and, hence, overall economic growth. Inflationary pressures continue to be held in check in spite of increasingly tight labour markets because intensive competitive pressures and business restructuring have led to changes in the wage-price process which restrain the scope for price increases with subsequent moderating effects on wage demands. But inflation has also been moderate because of the fall in commodity prices and because the strong dollar and the sharp rise in imports have limited domestic resource utilization. The consequence of this is the surge in the foreign trade deficit, which attained a record level in January 1999.

There are several factors, however, which will, nevertheless, work towards a slowdown in the rate of economic expansion in 1999. Business investment will

be dampened by the adverse effects on corporate profits associated with the squeeze on margins stemming from rising labour costs and falling capacity utilization rates in manufacturing industry. Real incomes of households will no longer benefit from falling oil prices, which have started to rise in early 1999. Also, more moderate gains in share prices will reduce the support from favourable wealth effects on spending. And weakening economic activity abroad at the same time as robust domestic demand will lead to further adverse changes in real net exports, which will pull down overall economic growth.

The progressive lowering of the target for the federal funds rate from 5.25 per cent to 4.5 per cent in the autumn of 1998 has not yet been officially reversed. But informally the Fed appears to have shifted to a more neutral stance in 1999 with possibly a slight bias towards tightening. This is mirrored in the rise of the federal funds rate above the official target to 5 per cent in mid-March 1999.

Altogether, real GDP in western Europe and North America is now forecast to increase by some 2.5 per cent in 1999, down from 3.3 per cent in 1998.

This benign scenario, however, is confronted by considerable downside risks, the effects of which could be amplified because they are partly interrelated.⁹⁷ A major cause of concern is whether the recession in Japan will bottom out or deepen in 1999. This will depend on sufficient progress being made in the restructuring of the banking sector which, if significant, could boost business and consumer confidence. A deepening recession in Japan would, via reduced domestic demand and a depreciation of the yen, have significant spillover effects on the other countries in the region and beyond.

The outlook for the emerging markets of Asia and Latin America will also depend on their ability to return to the capital markets at more favourable terms than have prevailed in the wake of the Russian crisis. Any renewed capital outflows and a concomitant rise in the costs of external and domestic financing would deepen their recession.

Another important downside risk is the high level of equity or share prices in many industrialized countries. This is especially the case in the United States, where the Dow Jones index broke through 10,000 for the first time in mid-March 1999. It was already being repeatedly stated last year that the level of share prices appeared to be increasingly difficult to reconcile with the expected growth in corporate profits in 1998. This appears to be even more so in 1999. A major sustained downward correction of share prices in the United States would have potentially large negative effects on both consumer spending and business investment, with significant financial spillover effects on western Europe.

⁹⁴ Consensus Economics Inc., *Consensus Forecasts* (London), November 1998.

⁹⁵ Federal Reserve Board, *The Beige Book*, 17 March 1999 (internet website).

⁹⁶ Consensus Economics Inc., op. cit., March 1999.

⁹⁷ See also *OECD Economic Outlook*, op. cit., pp. 13-19 and *IMF, World Economic Outlook* ..., op. cit., pp. 110-112.

The projected rise in the United States current account deficit to very high levels (and the concomitant rise in net foreign indebtedness) could eventually arouse concerns of international investors about its sustainability and trigger a large-scale withdrawal from dollar denominated assets. The associated depreciation of the dollar would then affect activity levels in western Europe and other regions of the world economy.

The international environment facing the western market economies has continued to deteriorate since the final months of 1998. This reflects in the main the deepening recession in Japan and the deteriorating economic situation in Latin America triggered by the crisis in Brazil. Current forecasts point to a further fall in real GDP in Japan by some 0.5 per cent or slightly more in 1999. It is now also unlikely that a recession in Latin America can be avoided in 1999. Little growth is forecast for the transition economies in aggregate and a continued deterioration in the external environment could push many of them into recession.⁹⁸ In the Asian emerging markets directly affected by the crisis of 1997, the steep fall in output appears to have bottomed out, but no significant upturn is expected in 1999. Also, the continuing depression in commodity prices will dampen activity levels and import demand in most of the commodity exporting countries. All these factors will feed through to the western economies via foreign trade and restrain their domestic output growth.

How far these risks materialize will depend to a large extent on the policy responses to the weakening forces for economic growth.

2.3 The start of EMU

(i) Introduction

On 1 January 1999, 11 member states⁹⁹ of the European Union adopted a common currency, the euro. The conversion rates between the euro and national currencies were fixed on 31 December 1998.¹⁰⁰ The

⁹⁸ See chap. 3.1.

⁹⁹ Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

¹⁰⁰ Two constraints had to be observed: first, the conversion rates between national currencies and the euro had to be based on the bilateral central rates prevailing in the ERM and, second, the conversion from the ECU to the euro had to be made at parity. The first condition was agreed upon in May 1998 and was designed to prevent speculative tensions in the ERM in the run up to EMU. Tensions failed indeed to occur, a reflection of the credibility of the exchange rate commitment. But the strong dollar was also helpful given that in the past dollar weakness was often associated with an asymmetric appreciation of the deutsche mark, with concomitant tensions in the ERM. The second condition was stipulated in the Maastricht Treaty (Article 109(4)). It was this condition which allowed the euro conversion rates to be fixed only on the eve of monetary union, because the ECU is a currency basket which includes currencies of countries (Danish krone, the Greek drachma and the pound sterling) not participating in EMU. For a detailed account of the technical steps involved see European Union, *Joint Communiqué on the Determination of the Irrevocable Conversion Rates for the Euro*, 2 May 1998 (internet website).

national currencies have become *uno actu* (non-decimal) subunits of the euro until they will be withdrawn in the course of the first half of 2002 and replaced by euro notes and coins. Private households, companies and public administrations can already use the euro in the form of “write money” (e.g. cheques, bank transfers, credit cards). More importantly, however, all transactions in the money, capital and foreign exchange markets, which were formerly made in the national currencies of the members of the euro area, are now done on the basis of the new currency.

EMU will have a major impact on international financial markets and foreign exchange markets. Indeed, the introduction of the euro is certainly the most important change in the international monetary system since the collapse of the Bretton Woods system of fixed exchange rates in 1972.

Aggregate GDP of the 11 member states (measured at purchasing power parities) corresponds to some 75 per cent of the GDP of the United States and is nearly twice as high as Japan’s. The size of the population is somewhat larger in the euro area than in the United States and more than twice as high as in Japan (table 2.3.1). The share of the euro area and the United States in world merchandise trade are broadly the same, but exceeding the share of Japan by a very large margin.

From a monetary perspective, the trade of goods and services among countries in the euro area is no longer considered foreign trade: what were previously external exchanges have now become domestic transactions. Given that intra-area trade constitutes on average some 50 per cent of total trade, the effect is that the degree of openness of the euro area¹⁰¹ will be significantly reduced (by about half). The relative exposure to foreign trade is therefore only slightly higher than that of the United States but significantly more than for Japan (table 2.3.1). EMU also means that the balance of payments problem is eliminated for the individual member countries.

The international role which the euro will play in the longer run as an international investment currency, as a component of official reserves, in international trade invoicing and in foreign exchange transactions is necessarily subject to a large degree of uncertainty. But from its inception, the euro has been the second most important currency in all these functions, albeit occupying a considerably smaller role than the dollar. Given its economic base, the role of the euro area in international trade and the fact that introduction of the euro should lead to a closer integration of national financial markets (an increase in breadth, depth and liquidity), however, “the potential for the euro as an international money comes into view”.¹⁰²

¹⁰¹ It should be noted that statistics about the extra-area trade in goods and services of the euro area are relatively uncertain. The estimate of the degree of openness in table 2.3.1 should therefore be regarded with some caution.

¹⁰² R. McCauley, “The euro and the dollar”, *BIS Working Papers*, No. 50 (Basle), November 1997, p. 44. A key factor will be the role that the

TABLE 2.3.1

Comparison of economic indicators for the euro area, Japan and the United States

	Period	Euro area	United States	Japan
GDP ^a (billion dollars)	1997	6 016.9	7 824.0	3 100.4
Population (millions)	1997	290.4	271.8	126.0
GDP per capita ^a (thousand dollars)	1997	20.7	28.8	24.6
Degree of openness ^b (per cent of GDP)	1996	14.2	12.3	9.7
Balance on current account (per cent of GDP)	1998	1.9	-2.7	3.2
General government financial balance (per cent of GDP)	1998	-2.3	1.6	-6.1
Inflation ^c (per cent)	1998	1.3	1.6	0.6
Unemployment ^d (per cent)	1998	11.0	4.5	4.1

Source: National statistics; OECD, *National Accounts, Main Aggregates 1960-1997*, Vol. 1, 1999 and *OECD Economic Outlook*, No. 64, December 1998 (Paris); United Nations Comtrade Database.

^a At current prices and purchasing power parities.

^b Arithmetic average of imports and exports of goods and services as a per cent of GDP. Intra-euro area trade is excluded. It was assumed that the share of intra-euro area trade in services is the same as the share of intra-euro area trade in goods.

^c Consumer price index; percentage change over previous year.

^d Standardized unemployment rate. Per cent of civil labour force.

To what extent the euro will become a serious competitor with the dollar is, however, more difficult to gauge. This will depend largely on the speed and extent of integration of financial markets in the euro area and the role which the euro will play in foreign trade invoicing in other regions of the world economy, notably Asia, where the dollar is well established. Also relative long-run dynamics will play a role, as these affect the importance of the euro area in the world economy. The existing economies of scale will tend to preserve the competitiveness of the dollar for quite some time and they may also affect the different functions of money differentially. This points to a more gradual extension of the international role of the euro, which could well remain much more limited than the role of the dollar even in the long run.¹⁰³

euro can occupy in foreign exchange transactions which, by a significant margin, dominate the transactions in security markets and international merchandise trade. The dominant role of the dollar in forex transactions reflects its role as "vehicle currency", i.e. it is used as the medium of exchange between third currencies. The reason for this is reduced exchange related transaction costs, reflecting network externalities (economies of scale) from its wide use. This (virtuous) circularity implies a tendency for a single currency to dominate in forex transactions. Any change in this pattern is likely to occur only gradually over time. See, for example, P. Hartmann, *Currency Competition and Foreign Exchange Markets. The Dollar, the Yen and the Euro* (Cambridge, Cambridge University Press, 1998).

¹⁰³ For an optimistic scenario in which the international role of the euro and the dollar as means of payment and stores of value will be broadly similar, see R. Portes and H. Rey, "The emergence of the euro as an international currency", *Economic Policy*, 26 April 1998, pp. 307-343.

On the macroeconomic plane, the transfer of monetary policy authority from sovereign national states to the independent (supranational) European Central Bank and the establishment of rules governing fiscal policy will radically alter the framework for the conduct of economic policy in the euro area. National monetary policy is no longer available to respond via changes in interest or exchange rates to adverse economic shocks. A single monetary policy implies a single short-term interest rate, which will be set with a focus on the *average* economic conditions in the euro area.¹⁰⁴ Nevertheless, in view of the marked differences in the economic size of the countries in the euro area, this "average" will be dominated by France, Germany and Italy, which together account for some 75 per cent of GDP in the euro area (table 2.3.2). A general concern with regard to monetary policy is whether "one size will fit all". As this is unlikely to always be the case, EMU will put an increased adjustment burden on fiscal policy and on the goods and factor markets, notably the labour markets.

A centralized monetary policy in the presence of decentralized fiscal policies across 11 countries will make the ECB the "single most important policy-making body in the new Europe".¹⁰⁵ There are many challenges facing this new institution which has not only to build its reputation, but also to operate, at least in the initial years, in uncharted territory. The regime shift to a new currency and a single monetary policy will not only trigger structural changes in financial markets but will also influence the expectations and behaviour of economic agents. This, in turn, will affect the stability of relationships between economic variables observed in the past, rendering it more difficult to predict the effects of changes in monetary policy.¹⁰⁶ Different cyclical positions of member states and different degrees of aversion to inflation, and, more generally, different rates of trade-off between policy objectives, moreover, may be potential sources of tension in the formulation of monetary policy within the ECB on the one hand and between the central bank and governments on the other hand. This in turn raises the issue of the proper policy mix, notably between monetary and fiscal policy.

¹⁰⁴ An often made comparison is with the tightening of monetary policy by the Bundesbank in the wake of German unification which was designed to curb inflationary pressures. In the context of the ERM this forced other countries to raise their interest rates as well, although this was not necessarily appropriate for their cyclical positions. If German unification had occurred when EMU was in place then the ECB would have raised interest rates by less than the Bundesbank, because it would have responded to the *average* inflationary pressures in EMU rather than to *above average* rate of price increases in Germany.

¹⁰⁵ C. Allsopp and D. Vines, "The assessment: macroeconomic policy after EMU", *Oxford Review of Economic Policy*, Vol. 14, No. 3, Autumn 1998, p. 3.

¹⁰⁶ This is the so-called *Lucas critique* of the use of standard economic models to predict effects of economic policy in the presence of major regime changes. R. Lucas, Jr., "Econometric policy evaluation: a critique", *Studies in Business Cycle Theory* (Cambridge, MA), 1981, pp. 104-130.

In fact, EMU has started against the background of weakening growth in western Europe, which is part and parcel of a significant slowdown in the world economy.¹⁰⁷ This is not a situation that will induce governments to provide a generous grace period to the ECB. High unemployment is the major economic and political problem in the euro area and governments have declared its reduction as their main priority. Faced with the rigid rules of the game established in the Stability and Growth Pact for the conduct of fiscal policy, pressures have mounted on the ECB to further lower interest rates, which were reduced by a coordinated action of the national central banks of the euro area to 3 per cent in early December 1998.

At the same time there have been suggestions for exchange rate management to limit movements in the bilateral exchange rates of the dollar, the euro and the yen.¹⁰⁸ Economic developments in each of the three major economic powers in the global economy will have a bearing on the economic performance of the remaining two. This raises the important issue as to what extent EMU increases the need for and the possibility of global macroeconomic policy coordination, notably in the area of exchange rates.¹⁰⁹

(ii) The new institutional framework for monetary policy

The European System of Central Banks (ESCB) was created on 1 June 1998, but it assumed its full functions only as from the beginning of 1999. The ESCB is composed of the ECB and the national central banks of EU member states.¹¹⁰

The ESCB has four main tasks, namely:

- To define and implement monetary policy for the euro zone with the primary objective of maintaining price stability;
- To conduct foreign exchange operations;
- To hold and manage the official reserves of the countries in the euro area;
- To promote the smooth operation of payment systems.

All decisions in matters of monetary policy are taken by the Governing Council, which is composed of

the 11 national central bank governors of the countries which have adopted the euro and the six members of the Executive Board of the ECB.¹¹¹ Decisions in the Governing Council are, as a rule, taken by simple majority, with each member having one vote.¹¹² The President of the ECB has the casting vote in case of a tie. The fact that the national central bank governors have a clear majority in the voting on monetary policy points to the problem that their voting behaviour may be excessively influenced by the specific economic conditions prevailing in their own countries. This could contribute to some inertia, always inherent in group decision-making, in changing the course of monetary policy.¹¹³ The Executive Board of the ECB has to implement the decisions taken by the Governing Council. The actual implementation of monetary and foreign exchange rate operations, however, is delegated to the national central banks, based on corresponding instructions received from the ECB. The President of the Ecofin Council can participate at the meetings of the Governing Council. Although this government representative does not have the right to vote (Article 109b of the Maastricht Treaty), she/he can participate in the debate on the orientation of monetary policy, present the assessment of the Council, and thus possibly influence decision-making.

The existing national competencies relating to the prudential supervision of credit institutions and the stability of the financial system have been maintained. The ECB is to “contribute to the smooth conduct of policies pursued by the competent authorities.” (Article 105(5) of the Treaty). It is in line with these arrangements that there are no explicit provisions for the ECB to assume the role of lender of last resort in the event of financial crisis. This could be problematic because it may affect the ability to arrange for an effective monetary policy response to a liquidity crisis in the financial sector of one country which threatens to spread rapidly across the euro area. In the absence of close central control and authority by the ECB, the responses of a national central bank to a banking crisis may prove to be inadequate since the transboundary

¹⁰⁷ This is discussed in more detail in sects. 2.1 and 2.2 above.

¹⁰⁸ See also sect. 2.3(iv) and box 2.3.1 below.

¹⁰⁹ This is in contrast to the classical gold standard, which included all the most advanced economies at that time. The consequence was that the economic performance and policies of countries outside the gold standard area did not have a significant impact on policies inside the area. M. Panic, *European Monetary Union. Lessons from the Gold Standard* (New York, St. Martin's Press, 1992), p. 130.

¹¹⁰ The basic rules governing monetary policy in the euro area are enshrined in the Treaty on European Union (Articles 105-109) and the Protocol on the Statute of the European System of Central Banks and of the European Central Bank, which is annexed to the Treaty.

¹¹¹ There is also a General Council, with all 15 central bank governors as members together with the President and Vice-President of the ECB. But this body has no decision-making authority in matters of monetary policy.

¹¹² This was a major concession of the larger countries (notably Germany) to the group of smaller countries. The strong independence of the ECB and the emphasis on price stability as the single major goal may be regarded as the counterpart to this. In certain matters votes will be weighted according to central banks' shares in the subscribed capital of the ECB. This is the case if decisions have to be taken concerning the capital of the ECB, the transfer of foreign assets from central banks to the ECB, the allocation of monetary income of central banks and of profits and losses of the ECB (see Article 10 of the Protocol annexed to the Treaty).

¹¹³ This need not necessarily be negative because it can also create an internal system of checks and balances. A. Blinder, *Central Banking in Theory and Practice* (Cambridge, MA/London, The MIT Press, 1998), pp. 20-22.

spillover effects may not be given the appropriate weighting.¹¹⁴ In the absence of a centralized and regulatory supervisory authority, this points to the need for very close coordination of the various national authorities in the area of bank regulation and supervision.

The ECSB is a supranational institution, which is independent of national governments and the general political process.¹¹⁵ Article 107 of the Treaty stipulates that “neither the ECB nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions, from a government of a Member State or from any other body”. Given that central bank independence does not have a tradition in many of the countries which have adopted the euro, their national legislation had therefore to be adapted as part of the required convergence process towards EMU.

In the economic literature, central bank independence is generally seen to shield monetary policy from the so-called time inconsistency problem of government behaviour. The presumption is that governments tend to conduct monetary policies only with a short-term view, which is revealed in a temptation to exploit any short-run tradeoff between inflation and output growth, which would lead to an inflationary bias of monetary policy.¹¹⁶ Thus, the delegation of monetary authority to an independent central bank is tantamount to governments deliberately tying their hands with regard to monetary policy. Although a negative correlation has been shown to exist between an index of central bank independence in industrialized countries and their corresponding rate of inflation, the association is not very robust and does not necessarily reflect a causal relationship. Rather, central bank independence may be simply the institutional complement to the preference which a society already attaches to low inflation. There is evidence that central bank independence per se does not ensure a more favourable “sacrifice ratio”, i.e. the output costs associated with disinflationary policies are not necessarily lower.¹¹⁷ This trade-off depends also on the credibility (reputation) of the central bank, which will influence expectations and actions of economic agents.

There has been much speculation as to what extent the ECB will inherit some of the credibility of the Bundesbank. This will be difficult to establish. In general, a reputation can only be built over a fairly long time, allowing observers to see whether, in fact, central bankers are “matching deeds to words”.¹¹⁸ But the ECB is a new institution with no track record and it will therefore have to build up a constituency which supports its goals and policy actions. A key factor for this is effective accountability and communication with the broader public.

Accountability is the natural counterpart to central bank independence in a democratic society.¹¹⁹ In fact, the ECB cannot operate outside the political context; “it must be able to justify its policies to the general public and to political leaders”.¹²⁰ As a supranational institution, the ECB is not accountable to national governments or national parliaments. But to sustain its legitimacy, the ECB will have to provide the public with a coherent account of its assessment of the general economic conditions and an explanation of policy measures taken to meet the established goals. An important channel for this are regular reports and hearings. Apart from a monthly bulletin, which will be addressed to the public at large, annual reports will be presented by the President of the ECB to the European Parliament, the Ecofin Council, the Commission and the European Council. The European Parliament can invite the ECB to hearings by the competent committees of the Parliament, and ECB itself may also take the initiative for such events to take place.

(iii) Monetary policy goals and strategy

The ECB has a single primary objective, namely to maintain price stability. Although the central bank is called upon to support the general economic policies in the euro area, this will only be done if it does not conflict with the primary objective (Article 105(1) of the Treaty). Apart from this general mandate, it is up to the ECB to define what price stability shall mean in practice, and in addition, it is free to choose the policy instruments and strategy to pursue this goal. In other words, it is independent both in setting the target and in deciding how to reach it.¹²¹

¹¹⁴ B. Eichengreen, “Designing a central bank for Europe: a cautionary tale from the early years of the Federal Reserve system”, in M. Canzoneri, V. Grilli and P. Masson (eds.), *Establishing a Central Bank: Issues in Europe and Lessons from the US* (Cambridge, Cambridge University Press, 1992), pp. 13-40.

¹¹⁵ R. Smits, “The European central bank has been devised as the epitome of an independent central bank”, *The European Central Bank* (The Hague/London/Boston, Kluwer Law International, 1997), p. 151.

¹¹⁶ C. Bean, “The new UK monetary arrangements: a view from the literature”, *The Economic Journal*, Vol. 108, November 1998, pp. 1795-1809. Alternatively, the emphasis has been put on the time profile of disinflationary policies, with costs up front and benefits emerging only gradually over time, which may not be convenient for policy makers. A. Blinder, op. cit., pp. 55-57.

¹¹⁷ A. Blinder, op. cit., pp. 62-63.

¹¹⁸ Ibid, p. 64.

¹¹⁹ This is an area which is not well defined. The United States Federal Reserve is “generally, but not precisely accountable to the Congress” and the Bundesbank is “accountable to the public”. S. Fischer, “Central bank independence revisited”, *The American Economic Review, Papers and Proceedings*, Vol. 85, No. 2, May 1995, p. 205.

¹²⁰ These are the words of P. Volcker, a former chairman of the United States Federal Reserve. P. Volcker, “An American perspective on EMU”, in P. Masson et al., op. cit., p. 256.

¹²¹ An alternative arrangement would be for the government to set an inflation target and then give the central bank the necessary power to achieve this goal. Examples of this are Canada, New Zealand, Sweden and the United Kingdom. Central banks can also have multiple goals. In the United States, the Federal Reserve Act stipulates that the Federal Open Market Committee has “to promote effectively the goals of maximum employment, stable prices and moderate long-term interest

The most important policy instrument for steering short-term interest rates and refinancing conditions of financial institutions will be open market operations.¹²² The main refinancing operations are so-called “reversed transactions”, i.e. the buying or selling of domestic currency assets, which will be reversed at an agreed later date. Purchasing of assets (“repos”) is equivalent to injecting liquidity, while sales do the opposite. The difference between the buying and selling price corresponds to the (very short-term) interest rate, which is typically known as the “repo-rate”.

Only monetary targeting and inflation targeting were seriously considered as potential candidates for the monetary policy strategy.¹²³ Monetary targeting involves the use of a more or less broad monetary aggregate as an intermediate target, which is linked via the monetary transmission mechanism to the ultimate goal of price stability. Inflation targeting involves the definition of an explicit preferred rate (or range) of inflation, which the central bank aims to attain via changes in interest rates or other policy instruments.¹²⁴ Hence, the ultimate goal is common to both approaches and in practice elements of both strategies are often combined. Thus, the Bundesbank conducted its monetary policy within the framework of a monetary target, but this involved the definition of an implicit inflation target. The Bundesbank also displayed significant flexibility when it came to meeting the monetary target, provided that the inflation rate was regarded as satisfactory.¹²⁵

The link between money supply and inflation, however, requires a stable demand for money function (i.e. the relationship between money demand, real incomes and interest rates) for policy to be effective. The demand for money function, however, has become quite unstable (or less stable) in many countries, a phenomenon which is partly attributed to significant financial sector innovations, and this has forced many central banks to move away from monetary targeting. Although a stable aggregate demand for money function was found to exist in the individual member states of the euro area, and for

selected groups of EU countries,¹²⁶ there are strong doubts as to whether this stability will persist, at least initially, in EMU. The shift to a single currency is a major structural break (a “regime change”) which will affect behavioural relationships, the structure of financial markets and, therefore, the monetary transmission mechanism. Similarly, direct inflation targeting has to rely on stable and predictable effects of changes in monetary policy on inflation. Given the long and variable time lags with which the effects of monetary policy appear, such forecasts are surrounded in general by large margins of error, which are likely to be amplified by the uncertainty surrounding the monetary transmission mechanism in EMU.

Against this background, the ECB has opted for a more discretionary strategy, which combines elements of both monetary and inflation targeting, but leaves open their relative importance in the overall conduct of monetary policy.¹²⁷ These elements are:

- The quantitative definition of a preferred inflation rate;
- A reference value for the growth of a broad monetary aggregate (M3);
- A continuous assessment of overall economic developments in the euro area with emphasis on the inflation outlook.

The measurement of price stability is based on the HICP and the target is to keep the average year-on-year inflation rate for the euro area below 2 per cent. This asymmetry, i.e. the absence of a definite floor, will leave markets guessing as to which inflation rate is low enough for the ECB and this will therefore affect the transparency of monetary policy. Also, it is possibly an excessively ambitious target, notably in view of the well-known upward biases of inflation measures, which over time will also affect the new HICP.¹²⁸ At very low levels of inflation these could risk imparting a deflationary bias to monetary policy and raises the wider issue of the costs of targeting such low rates of inflation.¹²⁹

One factor which will affect the average inflation performance in the euro area is the significant variation in real incomes across the member countries of the EMU.

rates”. Goals which are not precisely defined leave the central bank with room for interpretation, which is tantamount to a de facto enhancement of power. A. Blinder, op. cit., pp. 54-55.

¹²² For a detailed overview of the various instruments see European Central Bank, *The Single Monetary Policy in Stage Three* (Frankfurt am Main), September 1998.

¹²³ The other main alternative would have been exchange rate targeting, which would have been unusual for such a large economic area and would have risked coming into conflict with the main goal of price stability.

¹²⁴ It has been argued that in the case of an inflation target, the central bank’s inflation forecast becomes the intermediate target of monetary policy.

¹²⁵ What speaks, in principle, in favour of a monetary target is that the money supply is more closely under the direct control of the central bank and is a variable which can be directly observed by the public, which enhances the transparency of monetary policy. In contrast, inflation cannot be directly controlled and inflation forecasts are inherently less transparent. C. Bean, “Monetary policy under EMU”, *Oxford Review of Economic Policy*, Vol. 14, No. 3, Autumn 1998, p. 43.

¹²⁶ European Central Bank, *Monthly Bulletin*, February 1999, p. 36; K. McMorrow, “Is there a stable money demand equation at the Community level?”, European Commission, *Economic Papers*, No. 131, November 1998; V. Clausen, “Money demand and monetary policy in Europe”, *Weltwirtschaftliches Archiv*, Vol. 134, No. 4 (Kiel), 1998, pp. 712-740.

¹²⁷ European Central Bank, “A stability-oriented monetary policy strategy for the ESCB”, *Press Release*, 13 October 1998 (internet website).

¹²⁸ UN/ECE, *Economic Survey of Europe, 1998 No. 1*, pp.39-40.

¹²⁹ In the case of downward rigid nominal wages, very low inflation would be more or less equivalent to real wage rigidity which, in case of adverse output shocks, would drive up unemployment. G. Akerlof, W. Dickens and G. Perry, “The macroeconomics of low inflation”, *Brookings Papers on Economic Activity*, 1 (Washington, D.C.), 1996, pp. 1-76.

TABLE 2.3.2

Selected economic indicators for the euro area

	GDP ^a (percentage share in total) 1997	GDP per capita ^a (average euro area=100) 1997	Degree of openness ^b (per cent of GDP) 1996	Unemployment rate ^c (per cent of civil labour force) 1998	General government financial balance ^d (per cent of GDP) 1998	Inflation rate ^e (annual percentage change) 1998	Memo. item: Conversion rates (national currency units per euro)
France	22.3	111	11.0	11.9	-2.9	0.7	6.55957
Germany	33.3	118	13.3	9.7	-2.4	0.7	1.95583
Italy	18.1	92	12.5	12.2	-2.6	2.0	1936.27
Austria	3.3	118	15.8	4.4	-2.2	0.8	13.7603
Belgium	3.9	111	25.8	8.8	-1.5	0.9	40.3399
Finland	1.9	106	23.5	11.8	0.8	1.4	5.94573
Ireland	1.2	92	46.8	7.8	2.5	2.2	0.787564
Luxembourg	0.3	175	25.8	2.2	2.2	1.0	40.3399
Netherlands	5.8	108	23.8	4.1	-1.2	1.8	2.20371
Portugal	1.6	47	11.9	4.9	-2.3	2.3	200.482
Spain	8.4	62	10.5	18.9	-1.9	1.8	166.386
Euro area	100.0	100	14.2	11.0	-2.3	1.3	..

Source: National statistics; OECD, *National Accounts, Main Aggregates 1960-1997*, Vol. 1, 1999 and *OECD Economic Outlook*, No. 64, December 1998 (Paris); United Nations Comtrade Database.

^a GDP at current prices and current dollar exchange rates.

^b Arithmetic average of imports and exports of goods and services as a per cent of GDP. Intra-euro area trade is excluded. It was assumed that the share of intra-euro area trade in services is the same as the share of intra-euro area trade in goods.

^c Standardized unemployment rate.

^d OECD estimates.

^e Harmonized Index of Consumer Prices (HICP).

In the catching up process, the relative prices of non-tradeables in countries with below average real incomes will tend to rise faster than in the other countries. This reflects the tendency of wages in this sector to outpace productivity growth.¹³⁰ The direct consequence is an appreciation of the implicit real exchange rate of the “periphery” within the monetary union. Although currently the inflation differentials among the various countries in the euro area are relatively small (table 2.3.2), this need not remain so. Evidently, any significant inflation differentials across countries would make the task of monetary policy more difficult.¹³¹

The reference value for the growth of money supply (M3) has been set at a year-on-year increase of 4.5 per cent in 1999.¹³² This figure was derived on the basis of the standard money equation¹³³ using estimates for the

trend growth rate of GDP (2-2.5 per cent), a trend decline in velocity between 0.5 and 1 per cent, and the inflation target (less than 2 per cent). The ECB has opted for a single reference value rather than a reference range to avoid any connotation with monetary targeting, which has traditionally involved defining upper and lower bounds for the growth of money supply. Along these lines, the ECB has emphasized that the public should not expect that any deviation of money supply growth from the reference value will automatically trigger a change in official interest rates.¹³⁴

Despite all the uncertainty surrounding the growth of potential output and money velocity, this nevertheless appears to be quite a cautious estimate of the adequate growth of money supply in view of the existing large margins of spare capacity in the euro area. Taking the values at the upper range of the corresponding variables would have led to a money supply growth of nearly 6 per cent. The lower range values (assuming an acceptable inflation rate of 1.5 per cent) imply a growth rate of money supply of 4 per cent. This illustrates the cautiousness of the ECB in setting the reference value. An additional indication of this is that the growth rate of M3 was only slightly above 4.5 per cent in the final quarter of 1998 against the background of very low

¹³⁰ This is the implication of the Harrod-Balassa-Samuelson theorem, which states that countries with higher productivity levels in tradeables have higher price levels than other countries.

¹³¹ In case of large relative price changes this could even go so far that the average inflation rate targeted by the ECB could well have “no meaning for consumers in any particular country”. C. Bean, “Monetary policy ...” op. cit., p. 44.

¹³² European Central Bank, “The quantitative reference value for monetary growth”, *Press Release*, 1 December 1998 (internet website).

¹³³ This equation states that the product of money supply and velocity is equal to the product of real output and the price level. Accordingly, estimates of the rate of the change of the latter three variables allow money supply growth to be calculated.

¹³⁴ To prevent irregular fluctuations from distorting the underlying trend, monthly money supply figures will be smoothed, using three-month moving averages. European Central Bank, “A stability-oriented monetary policy strategy”, *Press Release*, 13 October 1998 (internet website).

inflation and increasing evidence of a cyclical slowdown in the euro area. This could point to a procyclical bias of the current stance of monetary policy (if the reference value were strictly adhered to) with detrimental repercussions for economic growth.

An important source of uncertainty surrounding the effects of monetary policy is the existing variation in the financial structures of the countries in the euro area. This concerns, for example, the importance of short-term relative to long-term interest rates in private sector borrowing or the share of short-term government bonds in private households' financial assets. These differences could lead, via the various channels of monetary transmission, to monetary policy having asymmetric effects across countries. In fact, recent research points to notable differences in the degree to which output in various EU countries is affected by a change in interest rates. This holds, however, only for the medium-term, i.e. over a period of some two years.¹³⁵ Similarly, effect of changes in the euro exchange rate on output might also differ across countries. Fluctuations of the euro-dollar exchange rate are estimated to have a potentially much larger effect on output in the euro area than in the United States.¹³⁶ But these results will have to stand up to the Lucas critique, i.e. it is not clear to what extent these effects will materialize under the new monetary regime. It can be expected that over time there will be a closer integration of financial markets in the euro area, with the consequence that these asymmetric effects in the transmission mechanism will be largely eliminated. In the intermediate period, however, the uneven effects of monetary policy could be a source of tension not only within the Governing Council of the ESCB but also in the Ecofin Council.

Another conflictual consequence of the change in policy regime may be that trade unions in the individual countries perceive the existence of a more favourable inflation-unemployment trade off. The reason for this is that the impact of a given wage increase in a country will have less of an impact on the aggregate inflation rate in the euro area compared with the national inflation rate. As the ECB will focus on the average inflation rate in the euro area, the restrictive monetary policy response will be smaller than under the pre-EMU regime. This might arise notably in Germany where the trade unions, traditionally, have anticipated the Bundesbank's reaction to high wage claims, behaviour which has probably contributed to the wage restraint observed in the past. The large wage claims of the metal workers in the current wage round illustrate this potential problem. However, a fallacy of composition could arise if unions in several countries pursued a wage bargaining strategy on this assumption, because the resulting euro area-wide inflationary shock would trigger a tightening of monetary policy. The upshot would be that, at least temporarily, the ECB might be confronted with an

inflation output trade-off that could be worse than that previously faced by the Bundesbank.¹³⁷

(iv) Exchange rate policy

Given that the euro is fluctuating against other currencies,¹³⁸ notably the dollar and the yen, the ECB is also in a position to influence, via changes in interest rates and foreign exchange operations, the exchange rate of the euro. EMU member governments, however, have retained influence on exchange rate policy. The Ecofin Council can decide, although only unanimously, to conclude formal exchange rate arrangements for the euro (Article 109(1) of the Treaty). The term "formal" points to fixed exchange rate systems such as Bretton Woods or a mechanism like the ERM with countries outside the EU. The second lever which governments have is the right to provide "general orientations for exchange rate policy" (Article 109(2)) in the context of floating exchange rates. Informal exchange rate target zones (without any obligatory intervention mechanism) would probably fall into this category. These orientations, however, are subsidiary to the goal of price stability, a provision which provides the ECB with considerable scope for blocking the implementation of such recommendations. Evidently, any attempt to formulate an explicit exchange rate policy could create tensions between the ECB and governments because it would effectively limit the room for manoeuvre of the Governing Council in matters of monetary policy. In December 1997, the Ecofin indicated that it will issue such orientations only in exceptional circumstances, for example, in the case of a clear exchange rate misalignment. But even then a conflict between the ECB and governments cannot be excluded.¹³⁹

The adoption of a single currency has eliminated exchange rate instability within the euro area, which in the aggregate is much less open than its individual member countries. But should the euro exchange rate therefore be treated with "benign neglect"? In fact, although the euro area resembles more a large, relatively closed economy in which domestic prices are less influenced by fluctuations in the euro exchange rate (for a given level of foreign prices) this is not per se a sufficient reason for being indifferent to exchange rate movements, especially if these are very large. A potential source of conflict among countries is that their vulnerability to adverse exchange rate movements will vary because of their different degrees of exposure to trade with the rest of the world (table 2.3.1).

¹³⁵ R. Dornbusch, C. Favero and F. Giavazzi, "Immediate challenges to the European Central Bank", *Economic Policy*, No. 26, April 1998, pp. 15-64.

¹³⁶ *Ibid.*, p. 48.

¹³⁷ *Ibid.*, p. 51; D. Soskice and T. Iversen, "Multiple wage-bargaining systems in the single European currency area", *Oxford Review of Economic Policy*, Vol. 14, Autumn 1998, pp. 110-124.

¹³⁸ The ERM2 limits, in principle, exchange rate fluctuations between the euro and currencies of EU member states which did not adopt the single currency at the beginning of 1999. But of these four countries, only Denmark and Greece have entered this mechanism.

¹³⁹ It is significant that the ECB has pointed out that the announcement made by the Ecofin Council is not legally binding. European Central Bank, *Monthly Bulletin*, January 1999, p. 41.

An argument against “benign neglect” – at least in the initial years – is that “not only financial market participants but also domestic wage and price setters would look to the ECB’s reaction for evidence bearing on its credibility”¹⁴⁰ if the euro were to weaken significantly against the dollar. It can also be argued that the considerable uncertainties surrounding both monetary and inflation targeting in the early years of the euro should induce the ECB to give greater weight to the exchange rate when setting monetary policy. “In these circumstances, coordination with the United States and Japan to limit exchange rate fluctuations may naturally emerge.”¹⁴¹

In fact, trans-Atlantic exchange rates and capital flows have received considerable attention since the start of EMU. Some governments, although by no means all, have expressed their preference for a more or less large measure of exchange rate stability between the three major currencies of the world economy. Suggestions have ranged from explicit exchange rate target zones to a more informal monitoring of exchange rates with the possibility of coordinated intervention in the case of emerging misalignments. Box 2.3.1 provides a brief overview of some of the salient issues involved.

The potential, in the longer run, for greater exchange rate volatility of the euro-dollar exchange rate (compared with the deutsche mark-dollar exchange rate in the past) should certainly not be underestimated, especially if both the United States and the euro area were to adopt an attitude of “benign neglect”.¹⁴² This could result in prolonged misalignments between the major three currencies with the associated risk of trade protectionism and competitive depreciations.¹⁴³

(v) Domestic economic policy coordination

The abandonment of national monetary policies should, in principle, argue in favour of increased flexibility of fiscal policy to cope with adverse shocks. But there may be a need to avoid possible negative externalities if diverging fiscal policies were to lead to excessive deficits and debts in individual countries. This points to the need for rules and the desirability of a mechanism for fiscal policy coordination.¹⁴⁴ It is also

important to ensure a sound policy mix between fiscal and monetary policy. More generally, coordination will also be required to prevent “free rider problems” and the emergence of “prisoner’s dilemma” situations.¹⁴⁵

The institutional foundations for economic policy coordination and multilateral surveillance in the euro area are embodied in the Maastricht Treaty.¹⁴⁶ The Ecofin Council is the sole decision-making body in all matters of economic policy coordination. As not all EU member states have adopted the single currency, a euro-11 group was set up to provide a platform for informal discussion of policy issues related to EMU. Put simply, the role of the euro-11 group is to reach agreement on all those issues (e.g. exchange rate management) that are not the responsibility of the ECB, to ensure that despite the decentralization of fiscal policy there is effective coordination when needed and a single voice in the discussions of macroeconomic policy with the ECB and in other international policy fora such as the Group of Seven. Although the euro-11 group cannot take any legally binding decisions it can be expected to become de facto a strong political counterweight to the ECB.

The Stability and Growth Pact, which was adopted in June 1997, is intended to ensure that national budgetary policies do not conflict with the objectives of the single monetary policy. The Pact restricts the room for manoeuvre of fiscal policy by putting a ceiling on government budget deficits (3 per cent of GDP) and debt (60 per cent of GDP). The deficit can exceed the 3 per cent threshold only in the case of severe recession. The latter is defined as an annual decline in real GDP by at least 2 per cent, but under certain conditions an “excessive deficit” may also be permitted if the fall in real GDP lies within a range of 0.75 to 2 per cent. The target is to achieve broadly balanced budgets in the medium term (i.e. over the business cycle).¹⁴⁷ Countries have pledged to achieve this by the year 2002. This is to provide sufficient scope for the working of automatic stabilizers in the case of a subsequent cyclical downturn. There will be surveillance of how countries intend to observe these targets on the basis of annual stability programmes to be elaborated by the individual governments. Significant deviations from targets can lead to recommendations of corrective policy measures.

¹⁴⁰ R. McCauley, *op. cit.*, p. 18.

¹⁴¹ P. Masson and B. Turtelboom, “Characteristics of the euro, the demand for reserves and policy coordination”, in P. Masson et al., *op. cit.*, pp. 216-217.

¹⁴² P. Volcker fears that, “If markets sensed that governments and central banks were neglectful, benignly or otherwise, of the desirability of exchange rate stability, huge amounts of capital could be easily mobilized to ride a trend”, P. Volcker, *op. cit.*, p. 258.

¹⁴³ C. Bergsten, “The impact of the euro on exchange rates and international policy cooperation”, in P. Masson et al., *op. cit.*, pp. 42-43. Bergsten argues in favour of a target zone system between the euro, the dollar and the yen, but only in the medium term, i.e. after it has been possible to calculate the fundamental equilibrium exchange rate of the euro.

¹⁴⁴ It should be noted that fiscal policy, including the potential need for fiscal federalism, is “an aspect of monetary union on which consensus

remains most elusive”. B. Eichengreen, “European monetary union: a tour d’horizon”, *Oxford Review of Economic Policy*, Vol. 14, No. 3, Autumn 1998, pp. 27-29.

¹⁴⁵ A prisoner’s dilemma arises (in game theory) if the combined outcome of policies, which are rational from the point of view of each player (here, governments and the central bank) are socially undesirable.

¹⁴⁶ Article 103(1) stipulates that “Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council”. The Ecofin Council will also formulate “broad guidelines of the economic policies of the Member States” (Article 103(2)) and “monitor economic developments in each of the Member States” (Article 103(3)). Article 104c arranges for the surveillance of the government financial positions (budget deficits and stock of debt).

¹⁴⁷ The implication is that there will be little scope for borrowing for the sole purpose of financing investment (the so-called “golden rule”).

BOX 2.3.1

Exchange rate target zones for major currencies

An explicit target zone consists of pre-announced limits on the deviations of the exchange rate from a central parity, which are enforced through foreign exchange intervention. As such, it is an example of an exchange rate arrangement with limited flexibility: the exchange rate is fixed at the limits, but fluctuates freely within them.

Its behaviour, however, is different from that of a flexible rate. This is due to the effect of the target zone on exchange rate expectations in financial markets. In the case of an explicit target zone, these derive not only from economic fundamentals, such as the money supply or short-term interest rates, but also from expected central bank interventions, the more so the closer the exchange rate is to its floor or ceiling. As a result, in a target zone the exchange rate displays less sensitivity to fundamentals than a flexible rate, a feature sometimes dubbed the “honeymoon effect”.

Given these properties, exchange rate target zones have been proposed as a means of combining both the scope for policies oriented towards domestic objectives that exists under flexible rates and the exchange rate stability usually associated with fixed rates. Like fixed exchange rate arrangements, they can also be viewed as a defence against exchange rate overshooting that could be triggered by capital flows of a purely speculative nature. Moreover, they prevent the deliberate use of the exchange rate as a strategic variable to achieve a temporary competitive advantage.

The properties of target zone exchange rates, however, hinge crucially on the credibility of the zone, i.e. whether financial markets believe in the commitment, or the willingness, of the authorities involved to defend it. If credibility is lacking, a target zone may actually be destabilizing and the exchange rate may be more sensitive to fundamentals than a flexible rate (the “divorce effect”).

One factor that determines credibility is the level of reserves available for the defence of the zone, another characteristic that target zones share with fixed exchange rate systems. If the level of reserves is low, it is likely that the zone will be attacked and abandoned. In addition, there is the possibility that speculative attacks may be self-fulfilling, in the sense that although the exchange rate is consistent with economic policies the zone will be abandoned once an attack occurs, as the domestic policy costs of defending it become too high.

Another factor that affects the credibility of a target zone is the extent to which the central parity or fluctuation margins are adjustable.¹ The possibility of frequent and large adjustments tends to lower credibility, as it implies less of a constraint on the participating currencies.

An alternative to explicit rule-based target zones is an informal monitoring of exchange rates with intervention in support of undisclosed target values (parity or margins) decided on an ad hoc basis. An arrangement of this kind has more flexibility than an explicit target zone, but does not ensure as much stability, because it does not lead to strong expectations of intervention.

In the past, there was such monitoring of exchange rates for the major currencies (at that time, the dollar, the yen and the deutsche mark) during the second half of the 1980s, in the context of the Plaza Agreement and Louvre Accord of September 1985 and February 1987, respectively.² These agreements did not contain any reference values, but they did reveal the general concern at exchange rate movements that did not reflect economic conditions.

The Plaza Agreement followed a substantial appreciation in the dollar, which arose from a mix of tight monetary and lax fiscal policies and a concomitant rise in United States interest rates, but nevertheless went beyond what was considered to be consistent with economic fundamentals. Its objective was to foster an orderly depreciation of the dollar, which had turned around earlier in the year, as a means of correcting the considerable current account imbalances in Japan, the United States and, to a lesser extent, Germany. When the fall in the dollar was considered to be sufficient the Louvre accord then sought to stabilize exchange rates at around the prevailing levels.

This period was marked by concerted interventions, which seem to have influenced the external value of the United States dollar, especially at its peak in February 1985 and trough in April 1987.³ There were other factors, which may have contributed as well, for instance an increased awareness in the financial markets of the major currencies’ misalignments. This period has also shown the difficulties inherent in exchange rate management.

One difficulty is focusing monetary policies on the exchange rate objective. Following the Plaza Agreement, for example, further coordination on interest rates was resisted in May 1986 by Germany and Japan because they feared excessive money growth and asset inflation, respectively. As a result, the United States acted unilaterally to cut rates and manage the dollar exchange rate. Similarly in late 1987, interest rates in the United States were kept low to limit the fallout from the October stock market crash, despite the fact that the dollar had resumed the downward trend that was supposed to be avoided under the Louvre Accord.

Since the Plaza-Louvre period, coordinated attempts to manage exchange rates have receded. To some extent this can be attributed to the absence of any pronounced trends in the major exchange rates. But it may also reflect relatively greater attention to domestic policy issues, as Germany experienced the economic impact of unification, Japan the consequences of asset price deflation, and the United States the 1990-1991 recession and credit crunch. In fact, the only recent episode of concerted intervention was in June 1998, when the Federal Reserve and the Bank of Japan intervened jointly in reaction to a large rise in the dollar against the yen.

BOX 2.3.1 (concluded)

Preoccupation with domestic concerns could also be an impediment to an exchange rate arrangement for the dollar, the yen and the euro, which replaced the deutsche mark and 10 other European currencies on 1 January 1999. The orientation of monetary policies over the last few years suggests that it is unlikely that either Japan or the United States are going to place much emphasis on the external value of their currencies in the near future. Such an emphasis also looks improbable for the newly established European Central Bank, which has been assigned the sole objective of price level stability by virtue of Article 105 of the Maastricht Treaty.

On the other hand, it is possible to imagine scenarios under which managed exchange rates would again become attractive. This could be the case, for instance, if the weakening of the euro were to proceed so far as to pose a serious threat to the goal of price stability in the euro area or disturb relative prices across the economies of the euro area. The current proponents of managed exchange rates in France, Germany and Japan emphasize the need to contain volatility and huge swings in exchange rates, which are seen as harmful to domestic output growth and employment.

In more general terms, an exchange rate arrangement would also be subject to the so-called n-1 problem. As one exchange rate links two currencies, n-1 exchange rates automatically determine the n-th rate. This implies that all n exchange rates are determined if n-1 economies target their exchange rate to the currency of the n-th economy. This leaves a degree of freedom for the n-th economy, which can set policies regardless of their impact on its currency. The key question is who is going to have this degree of freedom or who will have to subject monetary policy to targeting the exchange rate.⁴

Finally, there is the issue as to what should be the central values around which exchange rates are allowed to fluctuate. In principle, it is possible to estimate these values on the basis of purchasing power parities or one of the concepts for calculating equilibrium exchange rates. Unfortunately, these approaches do not always yield the same results,⁵ and the calculation of equilibrium exchange rates for the euro is further complicated by the fact that its introduction constitutes a shift in regime.

¹ Examples of both types of adjustment can be found in the history of the European Exchange Rate Mechanism, which linked currencies through a grid of bilateral parities, a second generation of which is now in place for the Danish krone and the Greek drachma against the euro.

² For an assessment of the attempt to maintain exchange rate stability at the time of the 1987 stock market crash see UN/ECE, *Economic Survey of Europe in 1987-1988*, pp. 11-13.

³ These interventions are documented by P. Catte, G. Galli and S. Rebecchini, "Concerted interventions and the dollar: an analysis of daily data", in P. Kenen, F. Papadia and F. Saccomanni (eds.), *The International Monetary System* (Cambridge, Cambridge University Press, 1994), pp. 201-239.

⁴ The experience during the European Monetary System has shown that this problem may arise even if the exchange rate arrangement is symmetrical in design.

⁵ For an evaluation of the G-3 economies, see P. Clark and R. MacDonald, *Exchange Rates and Economic Fundamentals: A Methodological Comparison of BEERs and FEERs*, IMF Working Paper WP/98/67 (Washington, D.C.), May 1998.

To what extent the automatic stabilizers can be allowed to operate, however, depends on the actual budgetary position of governments at the time economic conditions are starting to deteriorate.¹⁴⁸ If the financial positions were such as to require a need for restraining the working of automatic stabilizers, this could lead, if repeated, to significant and cumulative losses in output and employment. Once the "steady state" balanced budget has been attained, however, the rules of the Stability and Growth Pact should, in principle, provide the necessary fiscal latitude for offsetting a cyclical slowdown. The problem is to get to such a favourable financial position in the first place. The most favourable environment for reaching this goal would evidently be a sustained economic upswing. In contrast, any unexpected cyclical setback in the early stages of an

upswing, would confront governments with the dilemma of abstaining from policies to correct the setback or even contemplating corrective measures to keep their stability programmes on course while worsening the setback. In fact, such a dilemma is currently facing the three larger economies in the euro area.¹⁴⁹

Evidently, in sticking to the rules of the Stability Growth Pact there is a risk that policy could be procyclical, with concomitant negative spillover effects on other economies inside and outside the euro area. The consequence of such a policy constellation is to increase the stabilization burden on monetary policy, a development which is reflected in the pressures on the ECB to lower interest rates in order to offset the restrictions on fiscal policy.¹⁵⁰

¹⁴⁸ A dilemma is that the severity of an economic downturn is difficult to gauge *ex ante*. Thus, by restraining the working of automatic stabilizers, governments could actually make the downturn more severe than otherwise.

¹⁴⁹ This was the thrust of the recent evaluations by the European Commission of the stability programmes of France, Germany and Italy.

¹⁵⁰ "European economic policy rift intensifies", *Financial Times*, 19 February 1999.

Another problem which may arise – mainly in the case of asynchronous cyclical developments – is that any fiscal impulse in EMU is bound to have more or less large leakage effects (via import demand for goods from the rest of the EU), a factor which could restrain the willingness of governments, especially of the smaller economies, to use fiscal policy for stimulating domestic demand. Alternatively, in the case of a synchronous cyclical downturn, there may be a “free rider problem”, i.e. a tendency for countries to benefit from the fiscal expansion originating in another country, with a concomitantly smaller fiscal stimulus of its own. From the point of the “free rider” this would also reduce the need for fiscal restraint later on if it were required to move back to a balanced budget position. This points to the potential benefits of fiscal coordination because the aggregate fiscal multiplier will be more than the sum of the national multipliers. But this will also depend on how fiscal policy affects the exchange rate.

The basic aim of any form of coordination of fiscal and monetary policy is to avoid a poor policy mix, which is currently understood to mean an expansionary fiscal policy which would clash with the concern of the ECB about price stability and therefore lead to an offsetting monetary tightening. The result would be a combination of larger budget deficits and an overvalued real exchange rate.¹⁵¹ But coordination may also be required to provide a favourable environment for fiscal consolidation. The alternative could be a “prisoner’s dilemma”, where the incentives of a single country in the euro area to pursue a restrictive fiscal policy is reduced by the prospect of little or no change in monetary policy. Such a prospect would raise *ceteris paribus* the costs of fiscal consolidation in terms of output and employment losses and lead to inadequate fiscal restraint in the aggregate.¹⁵² Alternatively, coordinated fiscal restraint which is not “accommodated” by an easing of monetary policy would also risk inordinately high costs in terms of lost output.

All this illustrates the potential benefits from a full exchange of information and of open discussions of the course of economic policy between governments in the euro area and the ECB. A further area where coordination is desirable is structural policies, notably labour market reforms and measures to increase occupational mobility and intraregional migration since the adjustment burden on the labour markets will be accentuated by the limited scope for countercyclical policies implied by the rules of the Stability Pact. The adjustment costs associated with labour market reforms can probably be best “absorbed” in the context of a sustained cyclical upswing. Also attempts by individual countries to implement such policies alone may be

costly, especially in a low growth environment and in view of the fact that national monetary policy will not accommodate these reform efforts. This also points to the benefits of a euro area-wide approach to labour market reform and other structural policies.¹⁵³ A more difficult question is to what extent monetary policy should be used to support these policies. The ECB has taken a defensive position on this, arguing that the high level of unemployment in the euro area is largely structural and that “attempting to reduce unemployment by implementing an inflationary monetary policy would ultimately be self-defeating since such a policy would only undermine price stability ...”.¹⁵⁴

Evidently, various forms of labour market rigidities exist and the need for labour market reforms is generally acknowledged. There is, on the other hand, considerable variation in unemployment across the member countries of the euro area (table 2.3.2). But there is no clear relationship between various measures of labour market rigidity and differences in national unemployment rates in western Europe to support the argument that unemployment is mainly structural.¹⁵⁵ What proportion of total unemployment is, indeed, “structural” is controversial. Estimates of structural unemployment are surrounded with more or less large margins of uncertainty, as illustrated by the successive significant downward revisions of the perceived structural rate of unemployment (NAIRU) in the United States in the current cyclical upswing. This suggests that the ECB should adopt a more flexible approach to macroeconomic policy and that once serious labour market reforms are underway, the scope for an *accommodative* policy deserves to be carefully examined.

¹⁵¹ B. Eichengreen, “European monetary ...”, op. cit., p. 27.

¹⁵² See C. Allsopp and D. Vines, op. cit., pp. 8-13, for alternative constellations of policy mixes which resemble a prisoner’s dilemmas.

¹⁵³ I. Visco, “Should economic policies be coordinated for EMU?”, *OECD Observer*, No. 215 (Paris), January 1999, pp. 3-5.

¹⁵⁴ *Ibid.*, p. 42.

¹⁵⁵ S. Nickell, “Unemployment and labour market rigidities: Europe versus North America”, *Journal of Economic Perspectives*, Vol. 11, No. 3, Summer 1997, pp. 55-74.