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The European Economy in 1999 and 2000

Report prepared by the following research institutes:

CPB Netherlands Bureau for Economic Policy Analysis, *The Hague*

Institut für Weltwirtschaft an der Universität Kiel, *Kiel*

National Institute for Economic and Social Research, *London*

Observatoire Français des Conjonctures Economiques, *Paris*

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I. World Economic Developments

World economic growth this year is likely to remain as weak as in 1998, despite a gradual acceleration in the course of the year. The volume of world trade is estimated to have fallen significantly in the latter half of last year, and to date there are few signs of a rapid recovery. However, there are indications of improved investor sentiment in a number of emerging market economies, and the monetary authorities in many industrial economies have lowered short-term interest rates significantly since last autumn. In the absence of further financial market turmoil, a modest global recovery is expected to develop this year, led by improved prospects for the Asian economies. World GDP is expected to rise by 3 per cent in 2000, after growth of 2¼ per cent this year (Table 1).

The industrial economies as a group are not expected to contribute significantly to the overall rebound. The economy of the United States has remained much stronger than expected, but could experience a soft landing next year, particularly if the Federal Reserve decides to tighten monetary policy. Activity in Japan may at best stabilise next year after two years of declining GDP, with many firms continuing to have excess capacity, and domestic demand expected to remain weak. The continuing weakness of Japan will help to keep the upturn in the emerging markets within bounds. Growth should pick up in Western Europe over the next eighteen months, helped by the present relaxed monetary conditions. However, a recovery this year remains far from assured, with activity likely to be particularly weak in Germany and Italy.

The present, historically low, rate of inflation in the industrial world may rise slightly, partly as a result of some recovery in world prices for primary commodities, recently in particular for oil. In the euro area, import prices will also rise as a result of the recent depreciation of the euro against the dollar. The continued strength of the dollar can be partly attributed to the very strong performance of the American economy compared with the European economy, and to the rising interest rate differentials with Europe. We expect that developments in the opposite direction will weaken the dollar again. Section VI of this report illustrates a scenario with a more substantial weakening in the aftermath of a collapse in equity prices.

The Western European economy has been strongly affected by the adverse developments in the crisis regions. This has depressed industrial production significantly over the past year. The prospects for Europe are heavily dependent on the timing and extent to which these effects fade away. The American economy has been a strong engine for world economic growth up to now, but there are several imbalances that may lead to a slowdown over the next eighteen months. This could have a substantial impact on the European economy.

Table 1: GDP Volume Growth by Regions, 1997–2000

	Share in world GDP[a]	1997	1998	1999	2000
World	100	4.3	2.3	2.3	2.9
Industrial countries	52	3	2.4	2	1.7
United States	20.2	3.9	3.9	3.8	2.3
Japan	8	1.4	–2.8	–1.3	0
European Union	19.3	2.7	2.8	1.9	2.6
Non-industrial countries	48	5.6	2.3	2.3	4
Transition countries	4.8	1.9	–0.8	–1.1	1.6
Asia	26.5	6.9	2.5	4.4	5.2
Latin America	8.8	5.2	2.5	–2.6	3
Africa/Middle East	7.9	3.9	2.9	0.8	2.4

[a]The GDP shares are based on the purchasing-power-parity (PPP) valuation of country GDPs.

1. Moderate Recovery in Non-industrial Countries

The current pattern of economic growth in the non-industrial world is mixed. Since the latter half of last year, conditions have worsened in many emerging market economies. Output has declined in Latin America, and growth in the transition countries has slowed in the aftermath of the Russian crisis and the cyclical downturn in Western Europe. However, a number of Asian economies now show signs of recovery. Overall, we expect output in the non-industrial world to grow by 2¼ per cent this year, for the second year in succession. Growth is projected to accelerate to around 4 per cent next year.

Activity in South East Asia is expected to pick up this year and next, but by less than might be expected, because demand in the Japanese economy is expected to weaken once more as the current public investment expansion comes to an end. Even so, growth for Asia excluding Japan may reach 4½ per cent this year and rise to over 5 per cent in 2000. Signs of an improved outlook are particularly apparent in Korea where GDP has begun to rise. Growth in China appears to have remained robust, helped by further significant fiscal stimulus.

Activity in the transition countries is projected to decline this year by 1 per cent as in 1998. For next year, little improvement is expected for this area as a whole, particularly if the war in Kosovo continues to disrupt trade in the Balkan region. However, some countries such as Poland and the Czech Republic may show a stronger rebound, helped by stronger export markets in Western Europe. Conditions in Russia do not favour a revival, although the fall in production seems to have bottomed out.

Latin America, including Mexico, will remain in the doldrums this year, with only little growth in the region as a whole. But 2000 may bring a gradual recovery helped by monetary relaxation and improvements in the terms of trade if nominal exchange rates rebound and commodity prices strengthen.

2. World Trade

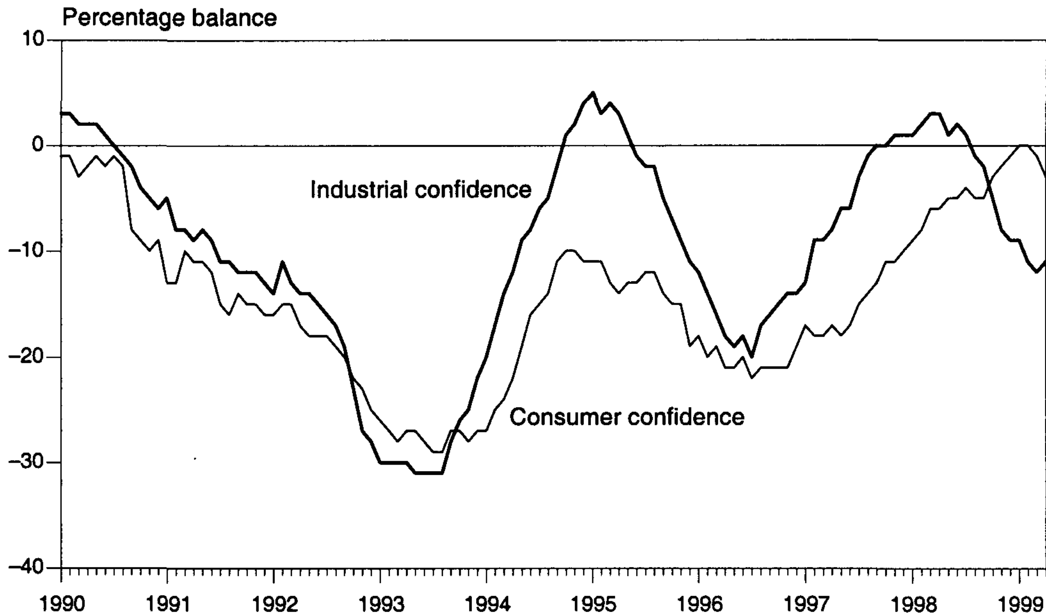
World trade growth came to halt at the beginning of last year. Trade volumes declined in the final quarter of 1998, with no noticeable improvement in the first quarter of this year. Although world import demand is expected to pick up from the second quarter at an annualised rate of 6 per cent, calendar year growth in 1999 is likely to be just 3 per cent, reflecting the very low level of trade at the start of the year. Trade volumes are projected to rise by around 6 per cent in 2000 (Table 2).

The sharp deceleration in world trade growth was initially due to the fall in demand in South East Asia, including Japan. In the course of 1998, the slowdown spread to the Middle East, Russia and Latin America. Figure 1 shows that, in the years prior to the outbreak of the financial crisis, imports of non-industrial countries rose at an average rate of about 11 per cent. The annual growth rate peaked at more than 15 per cent in the autumn of 1997. However, by the fourth quarter of 1998, import volumes were 10 per cent lower than a year earlier. This had a tremendous effect on the total volume of world trade, as imports of the non-industrial

Table 2: Volume of Merchandise Trade, 1997–2000 (annual percentage changes)

	Exports				Imports			
	1997	1998	1999	2000	1997	1998	1999	2000
Industrial countries	10.7	3.6	2.3	5.2	9.7	7.8	4.7	5.8
Non-industrial countries	10.5	5	4.5	8	12.3	–2.5	–0.5	6.5
World	10.6	4.1	3	6	10.6	4.1	3	6

Figure 1: Confidence Indicators for the Euro Area



countries account for more than one-third of total world demand. Exports from the industrial world as a whole actually fell in the last quarter of 1998. By that time, import growth in the industrial countries had also come to a standstill. European trade was particularly hard hit. However, trade continued to grow in North America, reflecting the strong growth in domestic demand.

The year-on-year change in imports into non-industrial countries has begun to recover since November last year. This is due entirely to a revival of demand in South East Asia. Elsewhere the fall in imports has continued or just begun to bottom out. Imports in the industrial world did not change much in the first months of this year, with a further increase in the United States imports counterbalanced by a further decline in Western Europe.

We expect a broadening and strengthening of import demand in the non-industrial countries from now on, but, given the low level at the start of the year, average import growth will still be slightly negative this year. Next year, imports in the non-industrial countries could increase by 6.5 per cent. Imports in the industrial countries are forecast to rise by 4.5 to 5 per cent this year, with a modest acceleration of growth next year. European imports are expected to pick up from the second quarter of this year, but the growth of imports into the United States is likely to decelerate, and demand is expected to remain weak in Japan.

World trade prices fell sharply last year due to weak global demand. The prices of many industrial products and non-oil commodities fell further in the early part of this year. However, oil prices have shot up by some 50 per cent following an agreement between major oil producing countries to limit production. On average, we assume that oil prices remain at their current levels of $15–$16 per barrel during the forecasting period. Raw material prices are expected to pick up in the course of this year in reaction to stronger demand, stock reductions and supply restrictions. Prices of internationally traded manufactures may remain broadly unchanged in national currency terms over the projection period. This implies a small increase in dollar terms, given the expected depreciation of the dollar.

II. Soft Landing United States Economy

Economic growth has remained unexpectedly robust in the United States. Output rose by 1.1 per cent in the first quarter of this year to a level 4 per cent higher than a year earlier. The last three years have all seen output growth of 3½ to 4 per cent, with high resource utilisation and a rising rate of growth of total factor productivity, but low, and declining, price inflation. Private sector demand rose by 5 per cent in 1998, supported by the wealth effects generated by the sustained appreciation in equity prices, and the unemployment rate fell to its lowest level since 1970. However, inflation, as measured by the private consumption deflator, fell further to less than 1 per cent, the lowest rate since 1955.

We expect to see further growth in GDP volume of around 3¾ per cent on average this year, with strong domestic demand. The pace of the expansion is expected to moderate over the course of the next year, slowing to around 2¼ per cent in 2000, reflecting tighter monetary conditions, the impact of the recent declines in corporate profitability and the gradual dissipation of the wealth effects from the past growth in equity markets.

The prompt monetary policy response of the Federal Reserve following the onset of the financial market crisis last autumn has helped assuage feared financial market contagion, and thus helped to maintain the momentum of the present cyclical expansion. The federal funds rate was reduced by 75 basis points to 4¾ %, and until recently, the financial markets continued to expect a modest further easing during the course of this year. This now appears unlikely. Domestic demand continues to be much stronger than had been widely expected, suggesting that the labour market will continue to tighten. The growth of real wages has accelerated over the past 18 months as unemployment has fallen to below 4½ per cent, although this has not been reflected in nominal wages because consumer price inflation has been so low. The potential for some pick-up in inflation has been reinforced by the recent strength of oil prices, which may raise consumer price inflation a little. Monetary growth also remains strong, with broad money (M3) rising by 10½ per cent over the year to the first quarter of 1999, well above the monitoring range of 2 to 6 per cent specified by the Federal Reserve.

The forecast is based on the assumption that short-term interest rates rise by 50 basis points by the end of this year, as presently expected by the financial markets. This will help to maintain short-term real interest rates at their current levels at a time when inflation is expected to have begun to rise. Long-term interest rates are projected to stabilise at around 5½ %. Consumer confidence has rebounded significantly since last autumn, reflecting the recovery in the stock market since that time, along with the continued buoyancy of the domestic economy. This has been reflected in the recent continued vigour of consumption, which rose by 1.6 per cent in the first quarter to a level 5½ per cent higher than a year earlier. Housing investment has also expanded rapidly. The savings ratio is now negative and forecast to average minus 0.5 per cent this year, with the volume of consumers' expenditure rising by 5 per cent.

The counterpart to the persistent decline in the savings ratio has been the climb in the wealth-income ratio, largely as a result of the sustained growth in equity prices. If at some future point the growth rate of asset prices begins to moderate, or even turns negative, then a gradual recovery in the savings ratio might be expected. A turnaround of this sort lies behind the forecast projections. One key assumption concerns the future behaviour of equity prices. The projections assume that they remain flat throughout the remainder of this year, before rising in line with the growth of nominal GDP. This acts to slow the growth of net wealth relative to incomes, and moderates expenditure accordingly. The growth rate of consumers' expenditure is expected to slow to 2½ per cent next year. If a more significant drop in equity prices were to actually occur, then a more marked slowdown in expenditure over the next two years could be expected. The consequences

of a collapse in equity prices are explored in Chapter VI of this report.

Business investment remains robust, rising by 1.8 per cent in the first quarter of 1999 after growth of 11¾ per cent last year. The presently high spare capacity in the industrial sector and weak corporate profits are likely to reduce the growth of investment next year. The economy continues to enjoy the beneficial supply-side effects from the rapid expansion in fixed investment over the past five years, with the net stock of fixed capital having risen by nearly 13 per cent in real terms since the end of 1993. This has raised the capital-labour ratio and expanded the production possibility frontier of the economy. The Federal Reserve has acted to accommodate this development by holding interest rates lower than they otherwise might have been at a time of rising resource utilisation.

Labour productivity rose by 2¼ per cent last year, the fastest growth since the pro-cyclical pick-up in 1992 when the economy was emerging from recession. Over the past three years, labour productivity growth has averaged 2 per cent per annum, well above the trend of 1 to 1¼ per cent observed over the previous two decades. This is consistent with the view that the recent strength of fixed investment and the consequent rise in the capital-labour ratio has helped to raise potential output per worker. To the extent that this investment has also embodied new technologies it may also have affected the potential rate of technical progress. If the steady state rate of technical progress has risen, then it should be possible to sustain higher utilisation rates than in the past without adding significantly to inflationary pressures. There is too little evidence, however, to evaluate this hypothesis with any degree of confidence at present.

The recent strength of labour productivity is certainly unusual at a time when many workers with relatively low levels of productivity are being brought into employment. We expect labour productivity to rise by around 1¾ per cent this year, and by an average 1¼ per cent over the next five years, implying gradual convergence of production on a higher level of potential output rather than a permanently higher trend rate of growth that would allow the present rate of labour utilisation to be sustained.

There are some signs of a modest upturn in inflationary pressures in recent months, although to date this primarily reflects movements in energy prices and special factors. The private consumption deflator rose by just 0.25 per cent in the first quarter, after growth of 0.8 per cent in 1998. Energy prices rose by more than 20 per cent in March, whilst aggregate import prices have begun to stabilise after falling by more than 6 per cent last year. Some increase in import prices is to be expected over the next year if the dollar begins to weaken. On balance, some pick-up in price inflation is expected this year and next, with inflation moving back into line with the growth of domestic costs. Unit labour costs are projected to rise by 2½ per cent this year, broadly in line with their growth in 1997 and 1998. In conjunction with higher import prices, this may raise consumer price inflation to around 2½ per cent in 2000.

The current account moved further into deficit last year, rising to 2.7 per cent of GDP from 1.9 per cent of GDP in 1997. The volume of exported goods and services rose by just 1½ per cent last year. Trading conditions remained subdued in the first quarter of 1999, with the volume of merchandise exports declining by 3 per cent. In contrast, strong domestic demand acted to raise import volumes by a further 3 per cent. Net exports are projected to reduce GDP by 1.2 percentage points this year, as in 1998, with the current account deficit widening to average 3½ per cent of GDP over the next two years. The increase in the current account deficit reflects the trends in the financial deficit of the private sector, which is now higher than at any time in the last 35 years. This is unlikely to be sustained indefinitely, as it would imply a continuing build-up of net foreign liabilities by United States residents and an ever higher burden of debt interest payments overseas. Net overseas liabilities are expected to rise to around 25 per cent of GDP by the end of 2000 from 9¼ per cent of GDP in 1995. It is quite possible that there will be a relatively smooth adjustment of the present imbalances, with growth easing to just below trend levels for a

short time. However, there is a growing risk that the adjustment could be more severe, with a rapid correction of the dollar exchange rate, and increasing political pressures for the implementation of barriers to trade.

III. No Recovery yet for Japan

The economic situation in Japan remains depressed, with nominal GDP continuing to fall. In real terms, output declined by nearly 3 per cent last year, the largest annual drop in the post-war period. There are signs that recent fiscal initiatives have begun to stabilise the economy this year. However, with external and private sector demand expected to remain weak, output is forecast to fall further this year by 1 to 1½ per cent. Firms have finally begun to tackle excess capacity and excess labour. Ultimately, this should help to create the conditions for a more firmly based recovery, but in the short term, it can only add to the downward pressures on activity. We do not presently expect to see any significant growth in the Japanese economy next year.

Activity is currently supported by the impact of the fiscal policy measures introduced last year, although these have been partially crowded out by higher long-term interest rates. The "emergency economic measures" announced last November were worth 4¾ per cent of GDP if implemented in full. These came on top of the initiatives worth around 3¼ per cent of GDP announced last April. Together, these packages have expanded public investment significantly and will eventually lower direct taxes. We expect a significant rise of 12½ per cent (equivalent to 1.1 per cent of GDP) in the volume of public investment this year. The general government budget deficit is projected to rise from an estimated 6 per cent of GDP in 1998 to 8½ per cent this year and 10 per cent of GDP in 2000. A supplementary budget may be necessary this autumn in order to prevent any decline in the volume of public expenditure next year.

Significant public financial support of up to 60 trillion yen (12 per cent of GDP) has also been made available to help support the financial system. The schemes should help to gradually restore public confidence and ease the present credit contraction taking place, although it is likely to take some time before the bad debt problem is over and private sector confidence is restored.

The Bank of Japan reduced the overnight call rate to 0.15 % in February. Although there is little sign yet that the bank is about to embark on a programme of sustained monetary expansion, a number of measures has been adopted to boost market liquidity and ease the financial constraints faced by many companies. Monetary growth is already robust given the present contraction in the level of nominal activity in the economy, with broad money rising by 3½ per cent over the year to January. Capital markets have stabilised since the turn of the year, and equity prices have begun to recover. However, monetisation cannot be excluded as it remains one of the few possible policy options if the economy fails to recover. The appreciation of the yen since last summer has helped to tighten overall monetary conditions, with the real effective exchange rate presently some 10 per cent higher than a year ago.

There is now widespread price deflation in Japan. Wholesale and consumer prices both fell in the first quarter of 1999. The appreciation of the yen has been reflected in import prices, which were some 12¾ per cent lower in the first quarter of this year than a year earlier. Although higher energy costs should push up input costs this year, this will not suffice to raise the price of finished goods and services in the absence of any significant strengthening in demand. Consumer prices are projected to fall by 0.3 per cent this year and 0.2 per cent in 2000.

The March Tankan survey reported a modest upturn in business sentiment in both the manufacturing and non-manufacturing sectors, reflecting the impact of the injection of public funds into the banking sector and the expansion in public investment. The recent rebound in equity prices may help to ease financial pressures on the corporate sector, with profits esti-

mated to have fallen by around 25 per cent last year. However, there seems little prospect of any imminent pick-up in expenditure. Many businesses have begun to restructure their operations, with inevitable short-term implications for domestic activity. Business sector fixed investment declined by 11¼ per cent last year. Leading indicators suggest that private sector investment will remain weak throughout the coming months. In the six months to February, new orders for machinery were 16½ per cent lower than a year earlier. Investment intentions remain weak, and the number of firms reporting excess capacity continued to rise in the March Tankan survey. We expect to see a further significant decline in the volume of business investment this year, with, at best, a stabilisation in 2000.

Labour market conditions have continued to deteriorate in recent months, with the unemployment rate rising to a new post-war peak. In the three months to February, total employment was 1 per cent lower than a year earlier. This small decline disguises the steps firms have taken to reduce costs, with hours worked and wages having been reduced, and many jobs being made part-time. Total nominal labour compensation per employee is projected to decline by 1¼ per cent in 1999 and a further ¾ per cent next year. Total employment is projected to decline by 1¼ per cent this year and next, with the unemployment rate averaging more than 5 per cent in 2000. The fall in employment is likely to have a significant impact on income growth and expected job security in the coming months, and hence on private sector expenditure. Real disposable incomes are expected to fall by up to 1 per cent this year, following an estimated decline of ½ per cent last year. Consumer confidence remains subdued, and monthly household surveys provide little indication of any pick-up in expenditure so far this year. Housing starts have also declined further. Consumers' expenditure is forecast to fall by ½ per cent this year, with housing investment declining by 6½ per cent.

External demand was also weak last year, although despite the downturn in many of Japan's major export markets in Asia, net exports still raised GDP by 0.7 percentage points last year. Weak domestic demand led to a large drop in import volumes, more than offsetting the decline in export volumes. Although export market growth is expected to pick up a little this year, the rise in the real exchange rate since the middle of last year is likely to constrain export growth. The current account surplus is expected to remain around 3 to 3¼ per cent of GDP this year and next.

IV. European Economic Policies

1. Fiscal Policy

The fears about the sustainability of the fiscal adjustments that some countries made to meet the requirements for joining the European Monetary Union have begun to disappear. In 1998, all EMU member states succeeded in keeping the budget deficit within the 3 per cent limit, consolidating the 1997 results with a more or less neutral fiscal stance. However, over the last year the situation has changed. Economic growth has been affected to a surprising extent by the turmoil in emerging markets. Political priorities have also changed, with the biggest European countries all now having centre-left governments. It is not yet clear which policies these governments will choose to undertake in the present circumstances, although we do not expect that they will question the principles of the Stability and Growth Pact. Fiscal measures will be used to stimulate recovery and employment, but without expanding structural deficits. For the countries with a high debt-to-GDP ratio, like Italy and Belgium, there is little room for manoeuvre, due to the need to ensure further reductions in the debt burden as soon as possible.

At the beginning of this year, all EMU countries presented stability programmes in which the ratio of the general government net borrowing to GDP was planned to be reduced over the next two years. These plans will be jeopardised by the lower-than-expected economic growth in

Europe. We expect that governments will let automatic stabilisers work and accept that the budget deficits for 1999 will be higher than announced in order to avoid prolonging the downturn through an unnecessarily restrictive fiscal stance. We expect the deficit-to-GDP ratio to be around 2 per cent for the euro area as a whole this year. It has to be noted, however, that in some countries, like France and Italy, the deficit probably will remain at or above 2.5 per cent. In other countries, like Austria and Germany, the deficit will still be close to 2 per cent. In 2000, the reduction of the deficit should gain momentum if the expected economic upswing occurs. If it does not, then these countries could find themselves in danger of breaching the requirements of the Stability and Growth Pact.

Outside the euro area, the fiscal policy stance differs across countries. While in the United Kingdom, policy is supporting demand this year and next (even if the net tax burden has been increased), it is quite restrictive in Denmark and, to a lesser extent, in Sweden.

One important challenge facing the euro area is the high level of unemployment in most member countries. Numerous studies show that a reduction in unemployment needs several factors. Faster economic growth can help bring unemployment back towards its structural level, but it is not enough if the structural level itself has to be reduced. For this, active consideration needs to be given to labour and capital market reforms, a reduction in labour taxes and longer-term measures such as investment in human capital, education and R&D.

In the short term, employment growth is likely to weaken, and many governments have little scope to support private demand or increase public investment in infrastructure due to budget constraints. If unemployment is not to rise once more, national governments need to implement structural labour market reforms as soon as possible. Measures should also be taken to reform the tax system. Structural reforms take time to be realised and time to produce effects on the economy. Without them, employment growth is likely to prove disappointing if a cyclical upswing begins to take place.

2. On the Stability and Growth Programmes

In the summer of 1997, the Stability and Growth Pact was ratified in an attempt to prevent member states from pursuing unsustainable fiscal policies after the start of the third stage of EMU. It was feared that without such a constraint on national fiscal policies, there could eventually be pressures on the European Central Bank to reduce the real value of an ever-expanding stock of euro-denominated public debt through inflation, despite the existence of a "no-bailout clause" in the Maastricht Treaty. The commitment to the Stability Pact might also help to reduce political pressures for individual governments to pursue expansionary policies that would eventually lead to insolvency. The Stability and Growth Pact calls on governments to aim for balanced budgets or even a surplus over the longer term. To enforce sustainable fiscal policies, a mechanism was introduced which threatens the imposition of financial penalties if the budget deficit exceeds 3 per cent of GDP, unless there are exceptional circumstances such as a severe recession. It was also agreed that governments submit Stability and Growth Programmes with medium-term projections of fiscal developments to the European Commission and the Council of Finance Ministers. This allows the Commission to assess whether fiscal policies comply with the Maastricht Treaty.

All countries[1] have now submitted their first reports with projections up until 2002. These reports are supposed to be updated annually. The table presents key figures from the current programmes. Finland, Ireland, Denmark, Sweden and the United Kingdom already had a budget surplus last year. All plan to have a surplus in 2002 as well. Spain is the only country that plans to move from a budget deficit to a surplus over this period. In most other countries, the budget deficit is projected to decline to around 1 per cent of GDP, although the

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1 The Stability and Growth Programmes of Italy and Ireland and the convergence programme of Sweden only cover the period until 2001.

Table 3: Key Figures of the Stability and Growth Programmes

	General government budget balance[a]		Gross public debt[a]		Real GDP growth[b]		General government structural budget balance[a,c]	
	1998	2002	1998	2002	1994–1998	1998–2002	1998	2002
				Stability programmes				
Austria	−2.2	−1.4	64.5	60	2.3	2.4	−2.3	−1.9
Belgium	−1.6	−0.3	117.5	106.8	2.2	2.3	−1.6	−0.5
Finland	1.1	2.3	51.9	43.2	4.9	3	0.5	2.7
France	−2.9	−1.2	58.2	57.6	2.3	2.5	−2.8	−1.4
Germany	−2.1	−1.0	61.1	59.5	1.7	2.4	−1.9	−1.0
Ireland[d]	1.7	1.6	59	43	9.4	5.6	0.5	0.8
Italy[d]	−2.6	−1.4	118.2	107	1.6	2.8	−2.1	−2.8
The Netherlands[e]	−1.3	−1.0	68.6	64.5	3.2	2.25	−1.6	0.1
Portugal	−2.2	−0.8	58	53.2	3.4	3.3	−2.3	−1.5
Spain	−1.9	0.1	67.4	59.3	3.1	3.5	−1.5	−0.1
Euro area	*−2.3*	*−0.9*	*73.5*	*67.7*	*2.2*	*2.6*	*−2.3*	*−1.2*
				Convergence programmes				
Denmark	1	2.4	56	42	3.2	2	0.5	2.3
Sweden[d]	1.5	2.5	74.2	580	2.5	2.4	2.1	3.1
United Kingdom	0.8	0.2	47.9	42	2.8	2.3	0.6	0.2

[a]In per cent of GDP. — [b]Average annual growth rate. — [c]Taken from the Stability and Growth Programmes or the respective commission assessments where available; otherwise own estimates based on potential output estimated with Hodrick-Prescott filter. — [d]Projection until 2001 only. — [e]Cautious scenario. The Stability and Growth Programme of the Netherlands' government includes three different scenarios based on average annual GDP growth of 2.25, 2.75 and 3.25 per cent, respectively.

Source: OECD; European Commission; Stability and Growth Programmes; own calculations and estimates.

Austrian government views a deficit of 1.5 per cent of GDP as sufficient to satisfy the requirements of the Stability and Growth Pact. The resulting deficit for the euro area as a whole would be about 0.9 per cent of GDP in 2002, compared to 2.3 per cent last year (Table 3).

It is important to focus on the structural, cyclically adjusted budget balance, since fiscal consolidation is defined as a reduction of the structural deficit. Several governments assume a rate of GDP growth above that achieved in the recent past and above what is generally considered to be the long-term potential rate of growth. This is quite possible, particularly in economies with a negative output gap at present, but in these countries, structural deficits will decline by less than the headline deficits. Furthermore, the European Commission has noted that some of these projections seem to be optimistic in light of the recent downward revisions to GDP growth this year. Consequently, there appears to be a reasonable chance at present that some of the official targets in the programmes will be missed if further fiscal measures are not introduced.

It also matters whether fiscal consolidation is achieved by restraining expenditures or by raising taxes. The latter may lower medium-term growth if higher taxes and social contributions have detrimental effects on capital accumulation and work effort. Experience shows that a consolidation that relies on expenditure reduction is more likely to be successful.[2]

In all countries for which relevant information has been made available, public expenditures are projected to rise more slowly than GDP, albeit only slightly in some cases. In a number of countries, this follows a significant reduction in the ratio of expenditure to GDP between 1994 and 1998. Revenues have risen relative to GDP in many countries in recent years to help bring budget deficits down below 3 per cent of GDP. In the period until 2002, the revenue-to-GDP ratio is generally projected

2 However, it may matter which kind of expenditures are cut. Lower public consumption is likely to bring greater benefits than lower public investment. In Europe, between 1990 and 1997, most countries have cut public investment considerably while other expenditures (public consumption, subsidies and transfers) have often continued to rise in relation to GDP.

to decline gradually. Thus, the balance of the medium-term consolidation programmes appears appropriate. However, the actual policies pursued so far raise concerns that the medium-term objectives may not be met. For example, we do not expect to see a significant reduction in the ratio of public expenditure to GDP in France or Germany this year.

The Maastricht Treaty requires fiscal policies to be sustainable. Sustainability is indicated by a primary budget surplus of sufficient size to stabilise or lower the debt-to-GDP ratio. The stability programmes show the debt ratio declining in all countries between 1998 and 2001/02. However, there are some important differences between countries. In some, notably Ireland, Finland, Spain, Denmark and Sweden, the debt ratio is declining rapidly; in others, such as Germany and France, comparatively little progress is projected. Consequently, the fiscal policies in the Stability and Growth Programmes are not likely to bring a marked reduction in the debt-to-GDP ratio for the overall euro area, with gross public debt projected to remain well above 60 per cent of GDP in 2002. Italy and Belgium will still have debt stocks larger than their annual GDP. The Netherlands may also have a debt stock in excess of 60 per cent of GDP, at least under their cautious growth scenario.

Thus, the current stance of fiscal policy in the euro area does not appear to comply fully with the principles of the Maastricht Treaty and the Stability and Growth Pact, mainly due to limited consolidation efforts in the major member states. Even slow progress is contingent on a rather benign macroeconomic environment. In contrast, in some of the smaller countries, consolidation has progressed much further and appears much more soundly based.

3. Monetary Policy in the Euro Area

At the start of the European Monetary Union on January 1, 1999, monetary conditions were quite favourable in the euro area. Long-term interest rates had come down to about 4 % with practically no differences between the individual countries. On average, this implied an expected real rate of approximately 2½ %, assuming that the European Central Bank (ECB) was expected to hold inflation at 1½ per cent. For several countries this was even a historical low, as many had experienced long periods with considerable risk premia due to inflationary risks and uncertainties about possible currency devaluation. But even for those economies where such premia had not existed, such as Germany and the Netherlands, the real rate was below the historical average. Similarly, short-term money market rates had converged to a level slightly above 3 %, following the coordinated cut of key interest rates by the European central banks in December 1998; they were thus about one percentage point lower than a year before. Short-term real interest rates in the euro area were thus about 2 %, nearly three-quarters of a percentage point lower than a year earlier. Again this was unusually low for most countries. Monetary and credit aggregates expanded quite rapidly. Monetary conditions were eased further during the first quarter of this year with the euro depreciating significantly against currencies of major non-EMU countries.

Yet on April 8, 1999, the Governing Council of the ECB decided to reduce the interest rate on its main refinancing operations by half a percentage point to 2½ %. This first and strong action of the ECB was rather surprising and hard to interpret given the previous statements of the ECB and the improvement in monetary conditions that had already occurred. The difficulty facing the ECB is to explain its monetary policy on the basis of a rather uncertain set of indicators and in a transitory context of possible instability of money demand in the euro area. These circumstances were generally expected to induce rather cautious behaviour by the central bank. This suggests that additional changes in the operating procedures of the ECB are required in order to improve the transparency of monetary policy decisions.

On October 13, 1998, the Governing Council of the ECB announced the main elements of the stability-oriented monetary policy of the euro system. It announced a reference value for the

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growth rate of the broad monetary aggregate M3 of 4½ per cent per annum. It was the only quantitative indicator explicitly stated. During the first months of 1999, the 12-month growth rate of the broad money aggregate was around 5 per cent. At the same time, the total amount of credit increased at an annual rate of more than 7 per cent. The ECB indicated that it feels entitled to take into account special circumstances which may temporarily push monetary growth away from the reference level, as other monetary authorities have chosen to do in the past. For example, part of the growth in M3 appeared to be related to the considerable rise in land and housing prices in a few euro area countries. Another possible factor mentioned in the April Bulletin of the ECB is the demand for credit by non-financial corporations in order to finance inventories, which, according to business survey data, have increased to above-normal levels. So the formulation of the appropriate monetary policy stance is conducted using discretionary interpretations.

One possible model of the link between short-term interest rates and macroeconomic variables is provided by the Taylor Rule. A number of studies have shown that such a rule can approximate the behaviour of the German Bundesbank since the late 1970s. However, such a rule does not appear to fit with the present policy stance of the ECB. If we consider the ECB behaviour according to this rule, with an output gap for the euro area of around 1 per cent (as is estimated by the OECD, for example), 2 to 2½ per cent real GDP medium-term growth (which the euro system considers a consensual estimate of the potential output growth), an implicit inflation target of 1½ per cent and an equilibrium real rate of 3 per cent, then, with inflation at 1 per cent, the appropriate short-term interest rate might be 3 % or even higher. Here, we assume that the respective weights for the deviations of inflation and output from their respective targets are the same. The present level of short-term interest rates might suggest that either the ECB estimates the output gap to be at least 2 per cent, or that it expects that the equilibrium real interest rate reverts toward levels last seen in the 1960s.

However, the ECB reports are not very conclusive on either point. In its first Annual Report published in March 1999, the ECB indicated that the euro area unemployment was largely of a structural nature, caused by factors "of an institutional and regulatory character". This suggests that the present output gap is thought to be small. In its April Bulletin the central bank indicated that the output gap "cannot be used as a summary measure for guiding monetary policy decisions" because its size cannot be determined with the necessary level of precision, and estimates differ quite significantly across institutions. Although the ECB notes that "since the beginning of the 1990s the euro area economy has been growing somewhat below, rather than above, trend", it admits that this situation of excess productive capacity has been declining over the past two years. All in all, it appears unlikely that the ECB thinks that the output gap is large.

It is also difficult to interpret the ECB's policy because of a lack of clear information about their assessment of future inflationary pressures. The ECB does not follow a strategy of inflation targeting in a strict sense like the Bank of England or the Swedish Riksbank. Nevertheless, its strategy has similar principles, and the assessment of inflation perspectives must be communicated with the public if policy decisions are to be understood. After all, the expectations of economic agents had to be stabilised, and it would be helpful if they had the same information as the ECB and knew the underlying model that is being used.

The first problem of communication has been the precise value of the target for inflation. This has been quite obscure for a while because at first, there was only an upper limit ("below 2 per cent") for the increase of the harmonised index of consumer prices (HICP); then, there appeared to be a target range between 0 and 2 per cent, and then an indication that the floor was above zero because of measurement biases in the price index. Being at either the top or the bottom of the band is likely to be regarded as less desirable than being toward the middle, but the value which would imply a symmetric reaction of the ECB has not

been stated. The second problem is due to the fact that the ECB — unlike other central banks that have an explicit inflation target — does not publish its inflation forecast. For example, the recent cut in the key interest rate could have been justified by an explicit statement that the inflation forecast was revised downwards, with an associated reduction in the probability that it would exceed 2 per cent in the next two years. All in all, the policy is therefore less transparent than it could be, making it unnecessarily difficult for the ECB to establish its credibility.

The ECB will have to follow closely the development of the business cycle and the prospects for inflation in the euro area. There are signs that there has been a turnaround in business sentiment and that activity in the euro area may gain momentum. Also, the inflation rate has probably passed its trough unless further unexpected deflationary shocks occur. However, the acceleration so far is mainly due to a rise in volatile prices — in particular oil prices — and not due to an increase of the core rate which is more relevant for inflation performance and thus, presumably, for the policy decisions of the ECB. In the course of this year and also in 2000, the inflation rate is likely to pick up somewhat as the cyclical upturn strengthens; we expect core inflation to rise slightly to around 1½ per cent, with the aggregate HICP for the euro area rising by 1.4 per cent next year. If this occurs, the ECB will have to act and raise interest rates in time to be credible in its anti-inflationary stance. We expect to see short-term interest rates rise by about half a percentage point, reversing the cut made this April. Such a move would not be unduly restrictive because real interest rates would remain more or less the same. For the euro area, a short-term interest rate of 3 to 3½ % must still be viewed as accommodative, given a longer-term inflation target of 1½ per cent as implied, for example, in the reference path for money growth. Long-term interest rates in the euro area are expected to rise from 4 to 4¼ % at present to 4½ % next year. The exchange rate of the euro should strengthen against the dollar, helped by the expected cyclical development in the euro area relative to that in the United States.

V. Temporary Slowdown in Europe

Real GDP in the euro area rose by 2.7 per cent (ESA 95 data) last year. Growth was a little weaker in Western Europe as a whole than in the euro area, with a slowdown in the United Kingdom and Norway and a subdued recovery in Switzerland offsetting further strong growth in Greece and Sweden. Domestic demand in the euro area was particularly strong, helped by the easing of monetary policy, wealth effects from rising equity and house prices and an appreciation in the terms of trade. In contrast, the volume of net exports declined for the first time since 1991 due to weak demand outside the industrial countries and the appreciation of many European currencies against the dollar. Labour market conditions improved, with employment rising by 1.3 per cent and the standardised unemployment rate declining by 0.6 percentage points. Nevertheless, inflation slowed, largely due to the fall in global commodity prices. Harmonised consumer prices rose by 1.1 per cent last year, after rising by 1.6 per cent in 1997. Excluding the most volatile components, food and energy, core inflation averaged 1½ per cent and slowed towards the end of the year.

The reduction in unemployment and the cessation of fiscal tightening helped sustain consumer confidence and private consumption expenditure. In turn, stable inflation, the recovery in consumers' expenditure and the low cost of capital supported corporate investment for much of last year. However, growth slowed significantly in the fourth quarter of 1998. Export volumes and government expenditure both declined. This will also constrain calendar year growth in 1999.

The impact of the financial crisis in the developing countries has varied across the European economies. Italy and Germany have been particularly affected. In other countries, notably

Spain and the United Kingdom, strong domestic demand pushed up imports significantly. A decline in net exports reduced growth by more than 1 percentage point last year in Italy, Spain and the United Kingdom. A number of smaller economies, notably Portugal, Denmark and to a lesser extent Belgium, also experienced a large decline in net exports.

There continues to be a marked divergence between industrial and consumer confidence. Industrial confidence has declined since the middle of 1998, largely due to a fall in new orders, especially from foreign markets. Industrial production fell sharply at the end of last year, but has now begun to stabilise. We expect that this downturn will act to slow corporate investment this year. In contrast, consumer confidence continued to improve in the latter half of 1998 and the beginning of this year. Higher employment, low inflation and the good performance of the stock market have helped to improve current and expected future incomes. However, the most recent monthly figures for April show consumer confidence moderating a little. Industrial confidence stabilised, possibly reflecting somewhat brighter prospects for exports.

We expect euro area GDP to rise by around 2 per cent this year, driven by continued growth of 2½–3 per cent in France and Spain (Table 4). Growth in Italy and Germany is expected to be much weaker, with GDP rising by under 1½ per cent. The long lasting effects of the severe fiscal restrictions needed to join EMU can partly account for the present poor performance of the Italian economy. Whilst interest rates have fallen significantly, this has a limited impact on the household sector because of the corresponding decline in investment income. The relative weakness of the German economy is mainly due to the poor performance of exports. Uncertainty about future government policies may also have added to the cautious behaviour of investors.

Table 4: Real Gross Domestic Product and Consumer Prices (percentage change over previous year)

	Share in EU GDP[a]	GDP			HICP		
		1998	1999	2000	1998	1999	2000
Germany	23	2.3	1.2	2.3	7.0	5.0	1.3
France	18	3.2	2.6	3.2	7.0	8.0	1.2
Italy	17	1.3	1.2	2.3	2.0	1.5	1.3
Spain	8	3.8	3.0	3.5	1.8	1.8	1.9
Netherlands	4	3.8	2.3	2.1	1.8	1.0	8
Belgium	3	3.0	2.0	2.5	9.0	1.0	1.4
Austria	2	3.3	2.1	2.5	8.0	8.0	1.3
Finland	1	4.7	3.3	3.4	1.4	9.0	1.8
Portugal	2	3.9	3.0	3.5	2.3	2.2	2.3
Ireland	1	10.4	7.0	6.0	2.2	2.2	2.2
Luxembourg	0	5.7	3.3	3.8	1.0	1.0	1.5
Euro area	*79*	*2.7*	*2.0*	*2.7*	*1.2*	*1.1*	*1.4*
United Kingdom	15	2.3	1.2	2.4	1.6	1.7	2.6
Sweden	2	2.9	2.2	2.4	1.0	5.0	1.7
Denmark	2	2.9	1.7	2.1	1.4	8.0	1.2
Greece	2	3.5	3.0	2.5	4.6	3.4	3.3
EU countries	*100*	*2.7*	*1.9*	*2.6*	*1.3*	*1.2*	*1.6*
Memorandum:							
United States		3.9	3.8	2.3	1.6	2.0	2.5
Japan		–2.8	–1.3	0	6.0	–0.3	–0.2

[a]The GDP shares are based on the purchasing-power-parity (PPP) valuation of European country GDPs.

External demand remained weak in the first part of this year, but is expected to strengthen in the latter half of the year. The recent improvement in monetary conditions, both from the reductions in interest rates over the past year and the recent depreciation of the euro, should also begin to support demand. This is already visible in the equity markets. In many countries these have more than recouped their losses from last autumn. The accommodative monetary stance and the low cost of capital is already helping to boost the construction sector significantly. An expected recovery in final demand, along with the possibility of future rises in commodity prices, may also help to support inventory levels. Private consumption should also be supported by growth in real disposable incomes. Many governments are expected to postpone further fiscal tightening, at least until growth picks up and real wages are expected to increase. Employment growth is, however, expected to be modest, in spite of the Employment Action Plans now introduced in many countries, with the euro area unemployment rate expected to decline only modestly in the near future.

One uncertainty in our projections lies in the future course of stockbuilding. This contributed about 0.7 percentage points to GDP growth in the euro area last year, according to Eurostat data. At face value this is consistent with some observed weakness in final demand in some countries, particularly in the manufacturing sector, leading to an unintended build-up of stock levels. This, in turn, would normally lead to a period of destocking with a depressing effect on production. However, we do not expect this to occur. In many countries the data for inventories include any statistical discrepancies in the national accounts. These discrepancies appear to account for most of the recorded build-up of stocks last year, especially in countries such as Germany and Austria.

In the first three months of this year, inflation in the euro area was approximately 1 per cent, as measured by the HICP. Core inflation may have slowed further since the end of last year. The recent rise of oil prices and the depreciation of the euro will, however, generate a slight increase in consumer prices. Inflation is expected to average around 1 per cent this year, and 1.4 per cent in 2000.

Of the European countries outside EMU, the United Kingdom appears increasingly unlikely to experience any significant further downturn; in the first quarter of 1999, GDP remained at the level of the preceding quarter. Business and consumer confidence have begun to pick up, helped by the significant easing of 2¼ percentage points in the short-term interest rates since the autumn of last year. Growth is expected to recover slightly and to return to trend in the year 2000. Some risks of renewed inflationary pressure are present, especially if the British pound depreciates significantly against the euro. The government appears well on course to meet its fiscal objectives of avoiding a deficit on the current balance and keeping its net indebtedness below 40 per cent of GDP.

GDP growth slowed in Sweden at the end of last year due to weak exports, as in most European countries. However, past declines in the Swedish real effective exchange rate helped to offset the downturn in external demand to some extent. GDP growth is expected to be approximately 2¼ per cent this year, led by private consumption. Inflation is very low, with harmonised consumer prices rising by 0.5 per cent in the year to March, and the overall consumer price index is expected to remain within the central bank target band (2 per cent with a fluctuation band of +/– 1 per cent). Last year's large budget surplus of over 2 per cent of GDP is not expected to be repeated this year because further postponements of expenditure seem unlikely. Nevertheless, the surplus is likely to remain above 1 per cent of GDP.

Growth is expected to slow significantly in Denmark this year to a little over 1½ per cent. New fiscal measures are expected to slow the growth of private consumption, and exports have been significantly affected by the downturn in external demand and domestic labour disruptions. Confidence also fell sharply when interest rates were raised last autumn as the currency came under pressure in the foreign exchange markets. However, rates have subsequently been reduced significantly, and this

Box: Will European Inflation Exceed 2 Per Cent Next Year?

In forming judgements about the appropriate monetary stance for the euro area, the ECB needs also to form a judgement about the probability that euro area inflation might exceed its target band. One method of assessing the uncertainty around the central inflation forecast is to look at the errors made in past forecasts of European-wide inflation. At present, this can be done only for forecasts of inflation for the European Union rather than the euro area. For instance, the standard deviation of the errors made by the OECD in their spring forecasts of the year-ahead growth in the EU private consumption deflator for 1991–1998 is 0.52 percentage points. We look at this short sample as it covers a period of low inflation in all the major European economies, even though they could all have different monetary policies. Assuming that the distributions of past errors are normal, a rule of thumb is that a 70 per cent confidence interval can be obtained by adding a range of one standard error around the central forecast.

Our central forecast for the rate of harmonised consumer price inflation in the euro area next year is 1.4 per cent. By looking up in standard statistical tables the probability that a standard normal variant is greater than (2 – 1.4)/0.52, we find just a 10 per cent chance that inflation will exceed the top of the ECB's range for price stability. There is a negligible chance at present of inflation being negative, given recent forecasting errors. As being right at the top of the range is likely to be regarded undesirable by the ECB, it is also of interest to ask what the chances are of exceeding a rate such as 1¾ per cent. We would put this at close to 20 per cent at present.

should help to prevent a sharper slowdown. Unemployment has fallen significantly in recent years, but much of this appears to be attributable to structural reforms, and we do not expect inflation to rise above 1¼ per cent in the near future.

Growth remains much stronger in Greece. GDP rose by 3½ per cent last year, and we expect a further rise of at least 3 per cent this year. Demand has been led by strong investment, supported by structural funds from the European Commission. This has more than offset the short-term demand effects from fiscal consolidation. However, the war in Kosovo is likely to have an effect on Greece, disrupting supply routes and reducing earnings from tourism. This may reduce growth by up to half a percentage point next year.

VI. What Happens if Equity Markets Collapse?

An important risk surrounding our short-term forecasts lies in the behaviour of equity prices. Equity markets are stronger in almost all industrialised economies than they were at the beginning of the year, and significantly stronger than they were two years ago, except in Japan. Prices have risen by over 50 per cent in the United States, the United Kingdom, France and Germany since that time. Prices in Italy and Spain have doubled, partly reflecting sharper declines in long-term interest rates. The wealth effects arising from this real appreciation in equity prices are continuing to help support private sector demand.

Movements in equity markets depend by identity on changes in expected earnings and changes in the valuation placed on those earnings. The valuation depends on changes in the risk-free rate (the long-term government bond yield) and the equity risk premium. It is difficult to account for the renewed vigour of United States stock markets since the start of this year. By early May, prices had risen by about 20 per cent, in spite of a rise of nearly 1 percentage point in long-term bond yields. As there seems to be little grounds for assuming a faster rate of growth in nominal earnings than previously expected, unless more investors have come to believe that there has been a technological revolution that has permanently raised the growth rate, there would appear to have been a further decline in the risk premium. However, the IMF noted last year that implied risk premiums were already low by long-term standards. This raises the possibility that there might be a sudden correction in equity markets, either because earnings turn out to be weaker than expected and the present bubble bursts, or because the monetary authorities are forced to raise interest rates significantly as inflationary pressures emerge.

Any substantive correction in prices would be likely to have a marked adverse effect on the short-term economic outlook, given the extent to which consumers' expenditure and, potentially, corporate investment are presently driven by the gains arising from rising stock market valuations. We examine the short-term global economic implications of two separate scenarios. In the first one, US equity prices are reduced by 20 per cent in the first period of the simulation, but then allowed to subsequently adjust endogenously to reflect the induced policy response of the monetary authorities. This means that prices remain below their base levels for some years, but ultimately adjust back towards their baseline trajectory. In the second scenario, we explore the consequences of a simultaneous 20 per cent drop in global equity markets. The responses to such a shock may in part be model-dependent, reflecting differences in the monetary and fiscal policies which particular models assume in response to such a shock. We thus report responses using two different models, the National Institute Global Econometric Model (NiGEM) and the MIMOSA model maintained by OFCE. One important difference in the two models is that NiGEM is a quarterly model whereas MIMOSA is an annual one. Hence, the full shock persists for one year in the latter, but is partially offset by looser monetary policy in the former within the course of the first year.

The NiGEM model, in which agents are presumed to be forward-looking, assumes that both the Federal Reserve and the ECB set monetary policy to target some combination of nominal GDP (or equivalently the money stock) and consumer price inflation. Short-term interest rates adjust in relation to the difference between targets and actual outcomes. Hence, any shock that is expected to slow down activity should have its effects partly offset by the automatic shock absorbers in the financial system. This particular monetary rule is consistent with the mixed framework that is presently being used by the ECB. Nominal targeting combined with inflation targeting provides a framework for conducting monetary policy in which decisions are guided by the deviation of inflation from some target level as well as the deviation of a nominal magnitude from its baseline trajectory. The inclusion of the inflation component in the rule raises the sensitivity of interest rates in NiGEM in response to deflationary shocks. In contrast, the MIMOSA model does not embody forward-looking behaviour, so that agents adjust more slowly and changes in demand take longer to emerge in inflation. The monetary policy rule also differs from that used in the NiGEM analysis, with the authorities assumed to base their judgements on a Taylor Rule. These two separate econometric models thus encompass a wide range of possible models, and can provide some indication of the likely

Table 5: The Impact of a 20 Per Cent Fall in US Equity Prices — Difference from Baseline

	Region	NiGEM Model		MIMOSA Model	
		Year 1	Year 2	Year 1	Year 2
GDP (percentage points)	US	–0.9	–0.7	–0.7	–1.1
	EU	–0.4	–0.4	–0.4	–0.7
	Japan	–0.5	–0.5	—	—
Consumer price inflation (percentage points)	US	–0.5	–1.5	0.0	–0.2
	EU	–0.2	–0.2	–0.1	–0.1
	Japan	–0.1	–0.1	—	—
Short-term interest rates (percentage points)	US	–1	–1.8	–0.7	–1.2
	Euro area	–0.2	–0.4	–0.2	–0.3
	Japan	–0.2	–0.2	—	—
Dollar exchange rate (per cent)[a]	Euro area	–3	–1.9	–1.7	–2.1
	Japan	–3	–1.8	—	—
World trade volume (per cent)		–1.6	–1.4	—	—

[a]A negative sign indicates an appreciation.

Table 6: The Impact of a 20 Per Cent Fall in Global Equity Prices — Difference from Baseline

	Region	NiGEM Model		MIMOSA Model[a]	
		Year 1	Year 2	Year 1	Year 2
GDP (percentage points)	US	–0.9	–0.7	–0.8	–1.1
	EU	–0.4	–0.7	–0.4	–0.7
	Japan	–0.6	–0.9	—	—
Consumer price inflation (percentage points)	US	–0.5	–1.6	0.0	–0.3
	EU	–0.2	–0.3	0.0	–0.2
	Japan	–0.1	–0.2	—	—
Short-term interest rates (percentage points)	US	–1.1	–2.0	–0.7	–1.2
	Euro Area	–0.3	–0.7	–0.3	–0.5
	Japan	–0.2	–0.3	—	—
Dollar exchange rate (per cent)[b]	Euro Area	–2.2	–1.2	–1.0	–1.4
	Japan	–3.0	–1.8	—	—
World trade volume (per cent)		–1.7	–1.9	—	—

[a]Equity prices in the United States and the European Union. — [b]A negative sign indicates an appreciation.

sensitivity of any conclusions about the short-run impact of an equity price collapse.

Any given decline in equity prices will have more effect on private sector net financial wealth in the United States than elsewhere, in part because of the greater importance of equities in American private sector portfolios. In countries such as Germany, more wealth is held in bonds (directly or indirectly), and hence a fall in equity prices which generates a short-term monetary response and an associated fall in long-term rates has its effects partially offset by the rise in bond prices. This offset is larger, the more bonds are held as a proportion of the portfolio.

The responses to a collapse in US equity prices alone are summarised in Table 5. Both models give similar first year effects, with GDP of the United States declining by close to 1 per cent. The euro area and Japan cannot remain immune from developments elsewhere in the world economy. The fall in American equity prices reduces growth in Europe and Japan by 0.4–0.5 percentage points in the first year. This reflects lower external demand, with the volume of world trade declining by over 1½ per cent, as well as the appreciation of the euro and the yen against the dollar. This occurs because of a prompt monetary response in the United States, with short-term interest rates being reduced by around 1 percentage point. If the Federal Reserve did not act in this manner, then it is likely that there would be a larger downturn than shown here. The models differ in their estimate of the subsequent persistence of the shock on output, reflecting differences in the speed at which deflationary effects emerge on prices, as well as in the size of the adjustment in short-term interest rates.

The responses to a global equity price shock are summarised in Table 6. They are similar to those found from a price drop in the United States alone, although as might be expected they are larger and persist for longer. The direct, additional short-term effects on output in Europe and Japan are limited, reflecting the smaller direct effects from equity prices on final demand in these economies. Interest rates in the euro area are projected to fall by 30 basis points in the first year and over 50 basis points in the second year. The Japanese authorities would be likely to face an additional policy dilemma, as short-term interest rates are already assumed to be close to zero on the base, and hence, there is limited scope to reduce them further. This is likely to prolong the deflationary effects of such a shock in Japan.

In summary, there are grounds for suggesting that equity prices may currently be overvalued in a number of economies. A substantive correction would imply a negative effect on output, particularly in the United States, but also in other economies. This would have a considerable impact on the European economies, raising the possibility that the projected upturn may be postponed, or at least weaker than forecast.

VII. Country Reports

1. Germany

The switch to the new European system of national accounts (ESA95) has led to a major revision in German GDP figures. Although the level of GDP has been increased as a result of these changes, growth in recent years has been revised downwards significantly. However, despite a reduction in the 1998 growth rate to only 2.3 per cent, as compared to 2.8 per cent on the old statistical basis, the quarterly profile of developments through the year remained basically intact. The main change has occurred with respect to stockbuilding which had been implausibly high according to the old statistics and has been revised downwards substantially. After the revision of the statistical base, the underlying momentum of growth in the German economy appears to be weaker than before; however, the assessment of the cyclical situation and prospects has not changed significantly.

Economic activity in Germany started to slow in the summer of 1998 as the effects of the crises in the emerging markets worked their way through the world economy. This weakness has extended into the first half of 1999. Real GDP is estimated to have risen only slightly in the first quarter of this year, after falling by 0.6 per cent in the last quarter of 1998. The cyclical slowdown was triggered by dwindling exports and has resulted in a marked deterioration of corporate sentiment. Uncertainty and growing scepticism about the plans of the new government have also contributed to a cautious attitude of investors. In contrast, private consumption has continued to grow briskly, helped by increasing real disposable incomes and exceptionally low consumer price inflation. The improvement in the labour market has come to a standstill. Employment growth stalled during the winter, and rising short time work and an increase in inflows into unemployment indicate that the labour market has started to deteriorate. However, the overall unemployment rate has continued to decline, if only very slightly, mainly reflecting a reduction in labour supply.

In the economy as a whole, wages have risen by over 3 per cent in the wage round this year, following moderate wage settlements of around 1½ per cent in the preceding years. Given that price inflation is expected to remain low, real wages are likely to grow more quickly than productivity. This makes labour shedding even more probable than it already is as a result of the current slowdown in activity. We expect employment to fall during this year, but pick up slightly next year as production recovers and wage settlements moderate.

Leading indicators suggest that the German economy will gain momentum with demand, supported by low interest rates and an improvement in the external environment. The expansion will be driven by a recovery of exports and continued growth of around 2 per cent in private consumption, helped by rising disposable income. According to a provisional assessment in corporating the new statistical base, real GDP is expected to rise by about 1.2 per cent and 2.3 per cent in 1999 and 2000 respectively. The unemployment rate will continue to decrease gradually to under 11 per cent this year and below 10½ per cent next year. The decline of unemployment is larger than the expected increase of employment due to an unusually large projected drop in the supply of labour, amounting to some 500,000 people over the years 1999 and 2000. Consumer price inflation will remain moderate, but pick up from the low point seen in the first quarter of this year, reflecting rising import prices and increasing unit labour costs. Next year, the annual inflation rate will rise to 1.5 per cent.

Fiscal policies in 1999 and 2000 will, if anything, be slightly expansionary, mainly as a result of an easing of the expenditure restraint, particularly in the social insurance schemes. This year, a number of tax changes largely cancel out in terms of their effect on general government revenue. Energy taxes have been increased, but the rate of contribution to the public pension system has been reduced in the first step of the so-called "ecological tax reform". Fiscal policy measures for the coming

year are still under debate. There is an obligation to increase family allowances substantially due to a decision from the Federal Constitutional Court, but the precise way to achieve this and the effective tax relief resulting from it are not yet clear. The new minister of finance has made public commitments to proceed with the consolidation of government finances, which makes it likely that a small solution will be sought in order to minimise the effect on the public finances. It is likely that only minor changes will occur in the much debated reform of corporate taxation, consisting of a substantial cut in tax rates combined with a broadening of the tax base. A significant tax reform is expected to become effective only from 2001, but even this will be on a rather small scale given the apparent inability of the government to mobilise resources by reducing expenditure, particularly on subsidies. On balance, fiscal policy is expected to strengthen demand slightly in the coming year, but significant reforms to improve incentives in order to increase the underlying trend rate of growth are not expected.

2. France

In 1998, French GDP increased by 3.2 per cent, around half a percentage point above that for the euro area as a whole under the new ESA95 accounts. This gap, already perceptible during last year, has recently widened. Domestic demand, excluding inventories, has remained robust, and France has suffered less than Germany and Italy from the Asian and Russian crises. Even so, manufacturing output fell by over 1 per cent in the final months of last year. But recent surveys have pointed to a stabilisation of output which will help to support GDP in the first half of this year. The downturn in manufacturing has hardly affected the rest of the economy, apart from gross trade related to intermediate goods. Activity in the construction industry has remained strong, and retail sales volumes have continued to increase steadily. Service sector growth has slowed but activity has continued to rise.

Employment has risen by over 350,000 during last year, helping to boost household confidence to record levels. However, a small drop in hiring intentions has recently reduced optimism about unemployment prospects. Indeed, market activities are expected to add only 210,000 jobs in 1999, after 290,000 in 1998. However, an additional 60,000 jobs are expected to stem from the 35 hours scheme and other non-market job creation schemes. We expect to see around 320,000 new jobs created this year and in the year 2000. Unemployment is expected to decline from 11½ per cent to 10 per cent next year.

The reduction in the weekly working time is expected to cause the growth of nominal hourly wages to accelerate from 2 per cent to nearly 3 per cent this year and 4 per cent during 2000. However, the growth of real labour compensation will be restrained by fewer working hours and somewhat higher price inflation. Consumer prices are expected to increase by 1¼ per cent in 1999 and 2000, 1 percentage point more than in 1998. The growth of real disposable incomes will moderate to around 2½ per cent from a peak of almost 5 per cent in the middle of 1998. The growth of private consumption is expected to slow from 4½ per cent to around 3 per cent. Car sales have already recovered from their previous slump, while demand for other durables is still boosted by low interest rates and a booming real estate sector. With investment demand expected to remain strong, the slowdown of output growth in 1999 and 2000 will be limited. Growth is expected to dip to around 2½ per cent this year, before picking up to over 3 per cent next year.

The present strength of the French economy in the current global environment can be attributed partly to a catching-up process after many years of high real interest rates. Housing investment has only recently begun to recover from the 1990 crisis, as households and realtors have reduced their debt levels. The same applies to the manufacturing sector, where balance sheets have greatly improved, and capacity utilisation remains above normal levels in spite of weak demand. The recent fall of the euro may also help to raise the growth of in-

vestment. Stable unit costs and improved cash flows have helped many firms to cope with greater competitive pressures.

Strong consumption is likely to raise the growth of tax revenues. The public finances are not expected to be significantly affected by the slowdown in activity. However, general government expenditure will probably be greater than planned, due to higher health expenditure. The public deficit on the Maastricht definition is likely to be around 2.4 per cent of GDP in 1999 and 2 per cent in 2000. After the recent cut in nominal interest rates by the ECB, monetary policy can be considered as broadly neutral for France, having previously been somewhat restrictive.

3. Italy

According to new data on the ESA95 basis, GDP increased by 1.3 per cent in 1998, less than half the growth rate for the overall euro area. This was mainly due to weak export demand as a result of the Asian crisis. The extent of the difficulties faced by the Italian external sector last year came as a surprise and caused growth rate forecasts to be revised downward several times. There is a lively debate on the causes of the problems faced by the export sector and doubts about the competitiveness of the economy.

The decline in the quarterly growth of output through last year, with GDP decreasing by 0.3 per cent in the fourth quarter, will act to subdue calendar year growth in 1999. Growth is likely to be further affected by the unfavourable international economic environment in the early part of this year and by the effect of the Kosovo crisis on the confidence of households and businesses. Industrial production declined by 1½ per cent in the first three months of the year, and the available cyclical indicators remain weak. There is some sign of recovery in the April data on production expectations of companies, but household confidence continues to decline.

Economic activity is expected to pick up in the second half of the year, supported by some specific factors. The economy should begin to benefit from the significant reduction in interest rates over the past year, new fiscal incentives for housing investment and from a more favourable tax treatment of reinvested profits, helping to stimulate business investment. Nevertheless, a risk remains that the Kosovo crisis could have a significant impact on the economy, both by hitting the important tourist industry, and by adversely affecting expectations. Taking the very poor performance in the first part of the year into account, it is unlikely that GDP growth will be higher than 1¼ per cent. Even though the contribution of net exports to GDP growth is almost neutral after reducing growth by 1.1 percentage points last year, the rate of growth of internal demand is expected to slow to 1.4 per cent from 2.3 per cent in 1998.

Inflation is low; in the first quarter, production prices declined by 1.7 per cent year over year, with the prices of intermediate goods dropping by 3.7 per cent. Consumer price inflation averaged just 1.4 per cent in the period from January to April. In the next few months, inflation is likely to remain almost flat, despite the expected increase in oil and raw material prices as well as the appreciation of the dollar. Wages are growing at around 3 per cent and unit labour costs by 1.4 per cent. In spite of the weak growth of GDP, employment has been rising since last year. In 1998, the number of employees increased by between 0.5 per cent and 0.7 per cent (depending on the source of the data), and this development continued in January, with employment 1 per cent higher than a year earlier. Because most of the new jobs are part-time or with a predetermined time horizon, the recent measures introduced in order to make the Italian labour market more flexible seem to be successful. Nevertheless, the unemployment rate is still rising (from 12.3 per cent on average last year to 12.4 per cent in January) because of increased labour supply.

Next year, the growth differential between Italy and the euro area is predicted to decline. In 2000, Italian GDP growth is expected to be 2.3 per cent, mainly due to the recovery in domestic demand. Once the more favourable tax treatment of reinvested profits comes into

force, investment in machinery and equipment will be the most dynamic component of domestic demand rising by around 6½ per cent. The growth of household consumption will also gather momentum to around 2.6 per cent. At the same time, the contribution to the growth of GDP from net exports is expected to become less negative than in the recent past, even though the increase in aggregate demand will expand imports. Inflation is expected to remain low next year by historical standards, at 1.3 per cent using the HICP, and more in line with the rates forecast for the other euro area countries.

In spite of the fact that the public accounts so far this year are better than a year ago, the general government deficit in 1999 will be higher than the government had expected one year ago, due to the moderate pace of economic growth and the effects of the Kosovo crisis. In fact, we expect that the Italian government will let automatic stabilisers work and use a further reduction in interest payments to finance the increasing expenditures for the Kosovo crisis and humanitarian aid. Under these circumstances, the deficit for this year will be 2.7 per cent of GDP, as in 1998. In 2000, the general government deficit will decline towards a level of 2.2 percent, but it is unlikely to reach the target of 1.5 per cent announced by the government last year. It should be noted that new targets will be announced in June. An upward revision is probable, due to weaker economic growth. However, it is likely that the plans will show a further structural reduction of the deficit as the recovery expected from the year 2000 onward gets underway.

4. United Kingdom

Growth has slowed sharply in the United Kingdom over the past eighteen months. Preliminary estimates suggest that GDP was flat in the first quarter of 1999, after rising by 0.1 per cent in the last quarter of 1998, and was just 0.6 per cent higher than a year earlier. However, it appears increasingly unlikely that the United Kingdom will experience any significant further downturn. The latest monthly GDP estimates from the NIESR project growth of 0.2 per cent in the three months to April. Business and consumer confidence have begun to pick up, helped by the significant easing of 2¼ percentage points in short-term interest rates since the autumn of last year. Government expenditure is also set to rise in the current fiscal year at the fastest rate since 1991. Output at market prices is expected to be almost 2 per cent higher by the end of the year than it was at the end of 1998, consistent with a calendar year growth rate of about 1¼ per cent.

In 2000, growth is expected to return to trend, with GDP rising by 2.3 per cent through the course of the year. Indeed, there are some risks of renewed inflationary pressure. Household consumption is forecast to grow by over 2½ per cent, supported by further strong income growth and a good background of low nominal interest rates, increasing wealth and receding worries about the possibility of a significant upturn in unemployment. Share prices have reached record highs in the early part of this year. While there are strong grounds for believing them to be overvalued, the forecast makes the assumption that they continue to rise at the same rate as nominal income. Fixed investment is also likely to benefit from a low cost of capital and improving confidence as final demand strengthens. Unless the exchange rate rises further, the outlook for the traded goods sector should also improve next year.

The visible trade deficit has risen sharply over the past year, partly as a result of the uncompetitive level of the British pound. The deficit is expected to rise to £27½ billion this year, from £20½ billion in 1998, and rise further to £31½ billion next year. This has been partly offset by strong growth in net investment income and receipts from services. We expect the current account to remain in balance in 1999, but to show a deficit of £10 billion in 2000.

There continues to be a marked divergence between the industrial and service sectors at the present time, with industrial production declining by 0.9 per cent in the first quarter of 1999, whilst output of the service industries rose by 0.4 per cent. Service sector activity

continues to be supported by domestic demand. This is expected to rise by between 2–2¼ per cent this year.

The manufacturing sector has been hit by the downturn in external demand and the continued significant overvaluation of the real effective exchange rate. At present levels, the real exchange rate, measured on the basis of unit labour costs in the United Kingdom relative to the euro area, is some 20 per cent higher than the average level over the past 25 years. The decline in net exports of goods and services reduced GDP growth by 1.4 percentage points last year, with a further drop of 1 percentage point expected this year. Manufacturing output and investment both fell sharply in the latter half of last year. We expect manufacturing output to fall by 1¾ per cent this year and rise by just 0.5 per cent through the course of next year.

There is little sign in the United Kingdom of a pick-up in productivity similar to that seen in the United States and Australia. During the past four years, employment growth has been strong, but total labour productivity has risen by only 0.8 per cent per annum on average. Productivity growth is likely to slow to around 0.4 per cent this year, with firms retaining workers in the expectation that the downturn in demand will be temporary. The claimant unemployment rate is expected to remain at around 4½ per cent, in part because positive schemes have been implemented that would be reducing sustainable unemployment if the economy were growing at trend. The 'New Deal' activates the long-term unemployed and youths, and provides them with training, a subsidised job or public sector work.

Labour market developments over the next year are likely to reflect the recent introduction of the National Minimum Wage. This has been set at a level which directly affects the pay of around 1.9 million employees (7 per cent of total employment). This is likely to add around 1 per cent to the level of wages, and will ultimately have a modest negative impact on employment. Overall, average earnings are expected to rise by 4¼ to 4½ per cent this year and a little over 5 per cent in 2000. With productivity growth remaining weak, unit labour costs are forecast to rise by over 4 per cent this year, after growth of 4¾ per cent in 1998.

Domestic cost pressures have yet to show up in inflation, largely due to the strength of the pound. Import prices fell by over 6 per cent in both 1997 and 1998. With the pound not expected to appreciate further over the coming year, domestic price inflation is projected to gradually move back in line with domestic costs. The annual rate of increase in the official target measure of the Bank of England, the retail price index excluding mortgage interest payments, is expected to decline from 2.4 per cent this April to 1.8 per cent in the fourth quarter of this year, before rising to 2.7 per cent over the course of next year.

It is thus now possible that further interest rate reductions would endanger the inflation target, particularly, if the pound begins to depreciate rapidly over the course of next year, or if there are signs of a sustained pick-up in the growth rate of wages. The forecast in this report thus assumes that short-term interest rates remain at 5¼ % until the end of next year, with the pound depreciating against the euro by 4 per cent. However, if the pound were to remain at its present level, inflationary pressures would be weaker, and there would be scope for further reductions. Similar judgements are apparent in recent statements from officials at the Bank of England.

The outlook for the public finances has been transformed in recent years, with significant fiscal consolidation. The public sector net cash requirement declined from £31 billion in 1995/6 to £1.1 billion in 1997/8, with an estimated surplus of £7.4 million being achieved in 1998/9. The improvement was achieved by continued firm expenditure control and some increase in the tax share. There may be a small deficit this year, but this largely reflects changes in the timing of tax payments. The March Budget did little to change the thrust of fiscal policy in the short to medium term. Overall, the many measures in the Budget implied a small fiscal relaxation of up to £3½ billion in 2001/2 compared to previous plans, and so the rise in the net tax burden this

year and next will be smaller than previously expected. In cyclically adjusted terms, public sector net borrowing remains set to be approximately zero over the next five fiscal years. The government appears well on course to meet its own fiscal objectives of avoiding a deficit on the current balance and keeping its net indebtedness below 40 per cent of GDP.

5. Spain

The Spanish economy expanded at 3.8 per cent in the course of 1998, sustained by domestic demand (4.9 per cent). Easy monetary policy conditions and strong job creation supported consumers and industry confidence. Low inflation and strong equity and asset price growth have led to significant increases in real financial wealth, and this helped raise consumption. Strong demand and low cost of capital determined the strong growth of investments. On the other hand, net exports negatively contributed to GDP growth by 1.1 per cent. This reflected the effects of the slowdown in the rest of the euro area in the second part of 1998 as well as the greater exposure of the Spanish economy to the effects of slower activity in Latin America. Growth in merchandise exports slowed from 15.8 per cent in 1997 to 6.6 per cent in 1998, reflecting both a slowdown in market growth and a loss of competitiveness. Despite moderate wage settlements, inflation remained above the euro area average, with inflationary pressures in services being particularly stubborn.

Employment rose by 3.8 per cent in the fourth quarter of 1998, continuing several years of labour-intensive growth. This led to a marked fall in unemployment. The unemployment rate declined to 18.8 per cent on average in 1998 (20.8 per cent in 1997). These changes in employment and unemployment in 1998 confirmed the success of reforms over the last few years, aiming at suppressing the rigidities of the Spanish labour market. The reforms have been a major factor increasing employment, and they have also helped reduce real wage growth for all members of the workforce by reducing the bargaining power of permanent employees vis-à-vis employers and the unemployed. They allowed the very significant pool of unemployed workers to put downward pressure on real wages, and hence increased the effective supply of labour.

The government deficit fell to 1.8 per cent of GDP in 1998, outperforming the initial target, thanks to stronger than expected revenues. This mainly reflected robust economic activity and was helped by the cumulating effects of low interest rates on the stock of debt. Fiscal policy for 1999 and 2000 includes a significant personal income tax reform which, among other things, lowers marginal rates. In addition, the lowering of employers' social security contributions for targeted groups of employees will be extended for two more years. This will contribute to reduce receipts, but because of expected buoyant domestic demand, revenue growth should remain strong. The tax reform will boost disposable income, the total effect on demand remaining neutral, as the fiscal stimulus due to the tax reform will be offset by planned slow growth in primary spending.

According to the results of the collective bargaining process, wages will rise by 2.3 per cent on average in 1999, decelerating from the previous year (2.6 per cent). This will contribute to constrain the underlying inflation.

Confidence indicators show some worsening in the expectation of both consumers and industry. However, domestic demand is expected to remain strong. Household consumption will take advantage of the changes in the tax system and the favourable conditions on the labour market. Overall, investment growth may slow down only slightly with respect to 1998. Activity is still very strong, the rate of capacity utilisation is close to an historical peak, and profits are solid. The low cost of capital will also stimulate total investment. The negative contribution of the external sector is going to worsen in the course of 1999. Export growth will slow further, as the effects of the Brazilian devaluation and lower imports in Latin America will completely materialise. The share of merchandise exports from Spain to this region is approximately 6.4 per cent. Robust domestic demand growth and some loss of

competitiveness, due to relatively high inflation as compared to the rest of Europe, is likely to keep import growth strong in 1999, although it will fall significantly from the 13.2 per cent seen in 1998. There are few signs of inflationary pressures emerging in the economy. The slight increase in the first quarter of the annual inflation rate to 1.9 per cent mostly reflects some specific domestic factors. On average, inflation is expected to be around 2 percent in 1999, as a result of opposite forces: the output gap is closing rapidly, but on the other side, weak exports will help decreasing upward pressures on demand. Employment is expected to grow further as reforms reducing labour market segmentation and the costs of job creation continue.

6. The Netherlands

In the middle of last year, the upward phase of the business cycle came to an end in the Netherlands. The decline in world trade led to a sharp reaction in exports and, consequently, GDP growth. Whereas the export volume in the first half of 1998 was still over 10 per cent up on the previous six-month period, in the second half of the year, export growth was virtually zero. Exports are expected to pick up in the second half of 1999, which leads to a year on year growth rate of about 2 per cent, compared to 7.5 per cent last year. The modest export performance is offset by still highly buoyant household consumption this year. At 3¾ per cent consumption is growing less than last year (4.5 per cent), but this figure is still well above the long-term average. This high year-over-year increase is mainly due to the acceleration of consumer spending in the second half of 1998. Mainly thanks to the strength of consumption, the economic downturn remains in bounds, with GDP growth moderating from a very healthy 3.8 per cent last year to about 2 per cent in 1999.

In the central projection, GDP growth remains stable at 2 per cent in 2000. Exports will clearly pick up, but consumption growth will ease next year. The consumer willingness to buy is expected to become less dynamic in the near future, because job creation is losing momentum, purchasing power is increasing less, and the wealth effects of higher stock prices on consumption are ebbing away. All in all, the cyclical slowdown of the Dutch economy in 1999 and 2000 is, with twice 2 per cent GDP growth, milder than the previous downswing in the early 1990s.

In the March projection, we have forecasted inflation to fall from around 2 per cent in 1996–1998 to around 1 per cent in 1999–2000, on the back of the (delayed) knock-on effect of the lower import prices. However, the 1999 inflation rate is likely to exceed this forecast, since realisations for the January–April consumer price index are hovering in the 2–2¼ per cent range, import prices have bottomed out in the first quarter of 1999, and the dollar exchange rate is higher than projected two months ago. The March projection also provides for a fall in contractual pay increases to 1½ per cent next year (from 2¾ per cent this year). This forecast is based on the fall in inflation envisaged for 1999–2000, that is mentioned above, on the expectation that the prolonged strong downward trend in unemployment will come to an end, and the assumption of restraint by the social partners in pay formation. Recently concluded collective labour agreements point to substantial higher contractual wage increases than included in the March projection. Therefore, an upward revision of the contractual pay increases in 2000 is likely, and, as a consequence, inflation will also be somewhat higher next year.

Since the presentation of the Budget (September 1998), the short-term prospects for the Dutch economy have worsened considerably. Nevertheless, its negative impact on the general government balance will only to a limited extent be visible in 1999. Tax receipts on corporate profits will be lower than expected half a year ago, but indirect taxes and income tax- and premium receipts will by and large be the same. However, on the expenditure side, two additional expenses have emerged, i.e. compensation payments in connection with the heavy rainfall of last autumn and higher than en-

visaged outlays for asylum seekers. As a consequence, the EMU deficit rises this year to 1¾ per cent of GDP, whereas a deficit of 1¼ per cent of GDP was expected in September 1998. The lower economic growth will make itself felt in the year 2000 public finances. The number of persons without a job is expected to rise for the first time since 1994. At the same time, the tax receipts will be affected by the slowdown in household spending and lower corporate profits. Under these circumstances, the deficit of the central government is expected to rise, in the absence of additional budgetary measures. However, the EMU deficit will decrease marginally, due to the increasing surpluses of the social funds.