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The European economy in 1998 and 1999

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319

The European Economy in 1998 and 1999

Joint report of the following European economic 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 Conjunctures Economiques, *Paris*

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The five European research institutes listed on the cover have joined in the project "European Business Cycle Analysis" (EBCA). They intend to publish a joint report twice a year including an analysis of the cyclical situation and a forecast for the European economy. In addition, they cooperate in basic economic research on medium-term issues.

I. Situation and Prospects for the European Economy

World economic activity remains relatively robust, although the Asian crisis casts a shadow over the picture. The rate of growth of world trade has slowed down since last fall, but is expected to remain above its trend level. International price developments remain quite moderate. Oil prices have declined substantially, and are among the lowest of the decade. Inflationary pressures are also limited in the industrial countries, as capacity constraints are not yet significant there and excess supply has materialized worldwide. The industrial countries show a sustained growth rate between 2½ and 3 per cent on average. However, the combination of strong growth and low inflation is the result of divergent developments between countries.

The US economy has been until recently particularly buoyant, as strong domestic demand has more than offset the dampening effect of falling exports to Asia. The Japanese economy remains in the doldrums. The threat of a deflation has recently prompted a substantial stimulation programme aiming at preventing a further deterioration of confidence.

Economic growth in Asia has been severely restricted, in particular in the ASEAN countries and Korea, although extensive rescue operations have brought the situation in the worst hit countries more or less under control. The impact on the European countries is as yet rather limited, as negative trade effects are largely compensated for by beneficial effects of lower imported inflation and lower interest rates.

Thus Western Europe is in a position to sustain the recovery that began in mid-1996. Prospects have been strengthened as uncertainties associated with the implementation of the EMU have now been dissipated. The time has now come to begin to view the EMU countries as a single entity from the viewpoint of economic management, even if differences persist in many fields.

1. External Environment

a. Relatively Small Effects on Europe of the Asian Crisis

The turmoil on the Asian currency and stock markets worsened in the final months of last year. The crisis spread from the ASEAN-4 countries (Indonesia, Malaysia, the Philippines, and Thailand) to other countries in the region, notably to South Korea. When the Japanese financial markets were subsequently hit as well, the problem took on a more than regional dimension. The financial crisis led to significant declines in exchange rates that were caused by a major reduction of capital flows into the region. This change has helped to reduce real interest rates and strengthen equity prices in the OECD, offsetting some of the effects of the crisis.

Extensive international rescue operations, led by the IMF, seem to have brought the situation more or less under control and to have helped to prevent the crisis spreading to other regions. In Indonesia, however, the situation remains worrying, while social unrest has recently developed in South Korea.

The depth and the duration of the crisis remain uncertain. In our projection it is assumed that during this year a basis will be established in the most affected countries for a restoration of confidence. Thus the crisis will be bottoming out, and the area will enter a gradual export-led recovery with positive growth returning to all countries involved. The volume of GDP in the ASEAN-4 will drop substantially this year and show only a marginal increase next year. In particular these countries have had to reduce their external deficits, at first mainly by a compression of domestic demand and drastic import cuts. An export boom has so far been hampered by credit shortages. However, those countries can profit from improved competitiveness. The impact of the crisis on other Asian countries is essentially smaller. Economic growth in Asia excluding Japan may pick up from 3½ per cent this year to 4½–5 per cent next year.

Weaker demand in the adapting countries has lowered the net exports of their trading partners. Developing and transition countries are most affected, because their goods compete directly with Asian goods. Moreover, they are most vulnerable to financial disturbances, whilst foreign investors and banks now are more aware of the risks in these markets. There have also been effects on industrial countries. The Asians economies are importing less, and their cheaper goods are driving out western products. The impact on output in the affected countries depends primarily on two factors, namely the importance of Asia as an export destination and the importance of trade for the national economy. The adverse effects on growth should not be overestimated. Trade with the ASEAN-4 and Korea accounts for less than 1 per cent of the industrial countries' GDP (Table 1). Moreover, the loss of output is compensated in most countries by lower inflation and lower interest rates. Europe is not very vulnerable to setbacks in Asia, as only a relatively small proportion of exports is destined for that region, and the share of Asia in imports is not large. The impact on GDP growth may be limited to about a quarter of a percentage point this year, as long as economic policy responses continue to be appropriate, and the crisis does not spill over to other Asian and developing countries.

The Asian crisis has a depressing effect on the prices of manufactures. The usual assumption is that Asian suppliers are price followers, which means that trade prices do not necessarily change with shifting exchange rates. But nominal depreciations vis-à-vis the dollar ranging from 40 to 75 per cent mean that this is not very plausible. However, the effect on prices will be much smaller than suggested by these depreciations. First, exchange rates have depreciated much less in effective terms, as these countries have significant trade with each other and with other countries with weak currencies. Second, the real effective depreciation is much smaller, as production costs of exportables will rise because of higher import prices (depending on the share of imported inputs), while inflationary pressure on domestic inputs will tend to erode the competitiveness gain. Third, Asian firms might prefer a widening of profit margins over market gains.

For the non-industrial world as a whole the effective depreciation is less than 10 per cent on average, but these shifts in exchange rates will have a significant impact on patterns of competitiveness. For the developing world excluding OPEC the terms-of-trade loss due to exchange rate changes is estimated at some 3 per cent. Of the industrial countries in particular the competitive position of the United States will have weakened. For Europe the impact is much smaller, given the smaller share of Asia in its trade. For Japan on the other end the boost to competitiveness from the depreciation against the industrial countries is broadly offset by the appreciation against the currencies in the Asian region.

Table 1 – Bilateral Trade Shares for European Union, United States, and Japan in 1997

Per cent

	Exports from:					
	European Union		United States		Japan	
	Share of exports	Share of GDP	Share of exports	Share of GDP	Share of exports	Share of GDP
Exports to :						
European Union	61.0	15.3	20.6	1.6	15.4	1.4
United States	7.7	1.9	—	—	27.5	2.5
Japan	2.0	0.5	10.9	0.9	—	—
Asia, excl. Japan	7.8	1.9	20.4	1.6	44.6	4.0
ASEAN-4 plus Korea	2.4	0.6	8.7	0.7	19.4	1.7
World	100.0	25.0	100.0	9.5	100.0	10.3

Source: European Commission.

Table 2 – South Korean Trade and Korea's Competitors in Industrialized Countries in 1994

Country	Share in Korean exports	Competitors in third markets
United States	21.40	19.74
Japan	14.08	13.82
Germany	4.49	9.66
United Kingdom	1.86	5.87
Canada	1.45	14.75
Australasia	1.44	4.12
Mexico	1.34	4.85
Netherlands	1.17	3.09
France	1.04	5.83
Italy	0.79	4.79
Spain	0.66	1.52
Belgium	0.43	2.59
Sweden	0.37	1.69
Austria	0.29	1.11
Switzerland	0.23	2.27
Norway	0.20	0.90
Denmark	0.18	1.21
Ireland	0.00	1.03
Finland	0.00	0.76
Portugal	0.00	0.41

Source: Econometric Model of NIESR (NIGEM).

However, direct patterns of trade are not the only thing to take into account in assessing the effects of the Asian crisis. Table 2 shows with whom Korea, for instance, competes in third markets. Although direct trade between Europe and Korea is low they are major competitors in US markets, for instance.

b. No Fundamental Improvement in Japan

There were strong recessionary tendencies in Japan during the second half of 1997 caused mainly by fiscal tightening, the consequences of the Asian crisis, and the implications of financial deregulation. Fiscal policy was tightened by over 2 per cent of GDP in the third quarter. The restructuring of financial markets made the problems of the banks and pension funds more transparent, and consequently affected consumer confidence and reduced spending. In March 1998, manufacturing production was 9 per cent below the peak level of mid-1997. Domestic demand was reduced by a sharp fall of the residential investment and household consumption (especially after December 1997, the period of distribution of bonus payments). These developments induced a decline of corporate profits (about 2.2 per cent among large non-financial companies, for the fiscal year which closes in March 1998), a downturn of productive investment, and a slowdown in wage growth. During the first quarter of 1998, domestic demand has stabilized at a low level. In addition, the slump in Asian imports since the beginning of 1998 has worsened overall demand. In these circumstances, inventory-sales ratios are shooting up and the decline in domestic production prices is picking up speed. In addition, the growing shakiness of the banking system has induced a credit squeeze, especially toward small and medium-sized enterprises.

The level of activity in Japan in past years has been strongly affected by large swings in the stance of fiscal policy. In April 1998, the government proposed amendments to the Fiscal Structural Reform Act, postponing the target for discontinuing deficit-covering bonds issuance, and removing caps on social welfare spending. The additional measures officially announced on April 24, amount to 16.65 trillion yen (3.3 per cent of GDP). However, the stimulating impact of the fiscal package is likely to be less pronounced than it might appear as the original

budget incorporated a significant negative impact on domestic demand. If one third of the public works package becomes effective this year, public investment might stagnate instead of decreasing by 7 per cent (as planned in the original budget). Next year public investment might experience only a small increase. In addition, half of the current 4 trillion yen fiscal rebate was already planned, and hence the additional 2 trillion rebate that will occur next year implies that tax policy will be neutral.

In a context of persistent deflationary tendencies, monetary policy will remain expansionary in 1998 as well as 1999. However, low interest rates will not stimulate credit demand because of the weakness of the banking system. As a consequence the credit squeeze will encourage companies to improve self-financing, which may imply further labour market and wage adjustment.

Nominal wage growth (including bonuses and overtime payments) has decelerated since mid-1997. In the first months of 1998 even regular wages were no higher than a year ago. Decreasing overtime and a reduction of bonus payments (indexed on company profits) have further worsened the situation. In addition, increasing unemployment (which has reached 3.9 per cent in March) has helped to prevent a decrease in the savings rate.

The expected stabilization of the exports to other Asian countries will help total exports to gradually recover. A slight depreciation of the yen vis-à-vis the dollar will also have a positive effect. Domestic demand is likely to be rather weak as the fiscal stimulation package will only have its full impact in 1999. Capital spending will decline this year and gradually increase thereafter. Consumption is likely to be weak as unemployment will pick up. Consequently there will be only a small increase in real GDP in 1998 and a somewhat faster growth in 1999.

c. United States: Growth Is Losing Momentum

According to the preliminary estimates for the first quarter of 1998, growth continued to be strong as compared to the fourth quarter of 1997. Real GDP increased at an annualized rate of 4.8 per cent. Personal consumption expenditures accelerated further and there was a sharp rebound in non-residential investment led by producers' durable equipment. Also residential investment performed rather favourably. Contrary to that, there was a negative contribution of net exports due to the impact of the Asian crisis and the appreciation of the US dollar. Imports were soaring while exports weakened significantly. Businesses have continued to increase inventories: they nevertheless remain in check with regard to sales. Inflation is still very moderate, with consumer prices in April increasing by 1.5 per cent over the preceding year. The fall of the unemployment rate to 4.3 per cent in April indicates that the labour market is getting tighter. However, the sharp decline from the level of March (4.7 per cent) is mainly due to a decline in the labour force rather than an increase in employment.

The Federal Reserve Board decided not to increase interest rates at its meeting in May. It believes that inflationary dangers are small, and that strong growth in GDP in the first quarter was mainly related to the mild winter weather. As declining net exports will put a further drag on the economy, an increase in interest rates is being given a low probability. The outlook for fiscal policy never appeared so good for the fiscal year ending next September with a surplus on the Federal Budget of the order of \$43–\$63 billion according to the last estimates of the Congressional Budget Office. The stance of fiscal policy is likely to be neutral in this fiscal year.

The US economy appears to be operating at or above capacity. As a result, tensions on wages have begun to materialize. Increases in labour costs accelerated at the end of 1997 and are now higher than the inflation rate. Real wages are likely to grow slightly faster than productivity over the next year.

Less favourable export prospects, following in part from the recent strength of the dollar, and rising unit labour costs will worsen the prospects for production and investment. Wealth effects will no longer have such a strong impact on consumption, and hence the savings rate may rise. These factors will lead to a modera-

tion of output growth in the course of this year. Real GDP will nevertheless increase on average by 3 per cent in 1998. In 1999, real GDP growth will slow down to 2 per cent. Lower profit growth will induce lower growth of corporate investment and we expect that inventories will be reduced. The projected slight depreciation of the US dollar, the recovery in Southeast Asia, and the broadening of the upswing in Europe together with a smaller increase in domestic demand will lead to a positive contribution of net exports to growth. The unemployment rate will gradually increase, but despite this inflation will be increased by the rise in import prices.

d. World Trade Slows Down and Raw Material Prices Remain Subdued

Last year the volume of world trade grew by about 10 per cent (Table 3). In particular North and South America recorded very dynamic trade developments. Asia, Western Europe, and the transition countries all recorded stronger growth than in the previous year. However, this rapid expansion will not be sustained because of the Asian crisis and the expected slowdown of the American economy. Although the impact of the crisis will be diminishing rather soon, next year's trade will also be affected, in particular flows within the Asian region will be reduced. Total world trade growth will slow to some 6½ per cent in 1998 and 1999, while international prices will move quite modestly.

The Asian crisis has caused a sharp deceleration in growth of world trade, and depressed prices. Asia including Japan accounts for about a quarter of total world trade (Table 4). The effects are most apparent for Asia itself, because the bulk of the trade of the Asian countries remains within the area.

In most Western European countries, exports are still booming, but growth is expected to moderate. The effects of last year's improved competitiveness are ebbing away, and the Asian crisis has intensified international competition. At the same time import demand is weakening in the United States and in Asia. However, exports are not very vulnerable to setbacks in that region, and the Asian share in European imports is not large.

Table 3 – World Trade, 1997–1999

Percentage change

	1997	1998	1999
World trade volume, goods	10	6 ½	6 ½
Export market growth EU[a]	9 ¼	6 ¾	6 ½
World trade prices, $	–7 ½	–5	1 ¾
World trade prices, nat. currencies	– ¼	0	1
[a]Including intra-EU trade.			

Source: EBCA estimates.

Table 4 – Importance of Asia

Percentage share

	World population	World GDP	World imports	EU-15 exports
Asia	56	34	25	10
Japan	2	8	7	2
ASEAN-4 plus Korea	7	6	7	2

In the past few years, Europe's cyclical recovery was substantially supported by exports, but the contribution of net exports is rapidly diminishing. Export growth of the area will develop largely in line with market growth, slowing from 9 per cent in 1997 to 7 per cent this year and some 6¼ per cent next year.

Western European imports are gradually decelerating, from 7½ per cent last year to 6½ per cent next year. Most countries show the same profile. Weakening domestic demand is reflected in slow import demand in the United Kingdom, Norway, and Denmark. In other countries a slight pick-up in domestic demand may lead to a smaller contribution of net exports to growth.

Primary commodity prices in dollar terms decreased sharply in late 1997 and early this year, in part because of the collapse in demand in East Asia. The potential spread of the Asian crisis has made manufacturers reluctant to replenish inventories. Also the rise of the dollar has depressed dollar-denominated prices. The sharp fall in oil prices was the result of weak energy demand because of a mild winter in the Northern hemisphere, and rising OPEC production. For 1998 and 1999 only a small rise in commodity prices is expected, given the slower pace of the world economy, especially in Asia. For crude oil, copper, and oilseeds the share of the five worst hit countries in world imports was 8 per cent, and for grains, sugar, and lead 10 to 12 per cent. Asian suppliers, on the other hand, will shift towards the industrial export markets, helping to reduce the prices of rubber and tin in particular.

Although weakening demand has led to overcapacity, dollar prices may pick up somewhat, supported by the recovery in the transition countries, and the continued upswing in Western Europe, who are major consumers of raw materials. Moreover, the moderating effect of the rising dollar will vanish. Year on year, commodity prices will still drop substantially in 1998.

The decline in energy prices became steeper at the end of last year. In November OPEC decided to raise production quotas by about 10 per cent starting January 1998. This is one of the reasons why in March the oil price dropped by 30 per cent to a level of around $13 per barrel. Other reasons were weak demand from Asia and the mild winter in the Northern hemisphere. In reaction, OPEC and non-OPEC countries announced a plan to reduce oil production by around 2 million barrels per day. However, the prospects for a strong price recovery are rather small. World activity is slowing this year, and oil stocks are above normal. Consequently, world oil demand will be only 2 per cent higher this year than in 1997. Assuming that the agreed supply reductions will come in time, prices may slightly recover in the second half of this year and remain at around that level next year.

e. Recovery in Transition Countries Broadens

In the transition countries in Central and Eastern Europe output growth slowed down somewhat in 1997. Tightening of monetary and fiscal policy has meant that growth of domestic demand has decelerated. On the other hand exports expanded more rapidly as the upswing in Western Europe gained momentum. The change in the driving forces helped to slightly reduce external deficits. High current account deficits, upward pressures on currencies, and weaknesses in the banking system make some of these countries vulnerable. In 1998 and 1999 output growth is likely to be in the order of 4 to 4.5 per cent, compared to 3.3 per cent in 1997. Countries like Romania and Bulgaria may show some positive growth. Labour markets there will show only a small improvement, and inflation will slow down further, but nevertheless remain high. Growth in the Accession countries Poland, Estonia, Hungary, Slovenia, and the Czech Republic has generally been strong, with the first two showing particular promise. Foreign direct investment has shown a strong upturn recently, in part because of closer ties to the EU.

In the CIS countries the decline of output has come to a halt in 1997 and there was remarkable progress with respect to reducing inflation while fiscal deficits became larger again. At present the Russian economy seems to be rather

fragile also because it is heavily dependent on oil revenues. The central bank had to raise interest rates dramatically, the lombard rate amounts to 150 per cent, now. However, with the expected stabilization of oil prices the present turmoil in the financial markets is likely to calm down again. All in all a small positive growth rate of real GDP may occur. Employment will fall further and unemployment will keep on rising.

2. Western Europe

a. The Upturn in Western Europe Continues

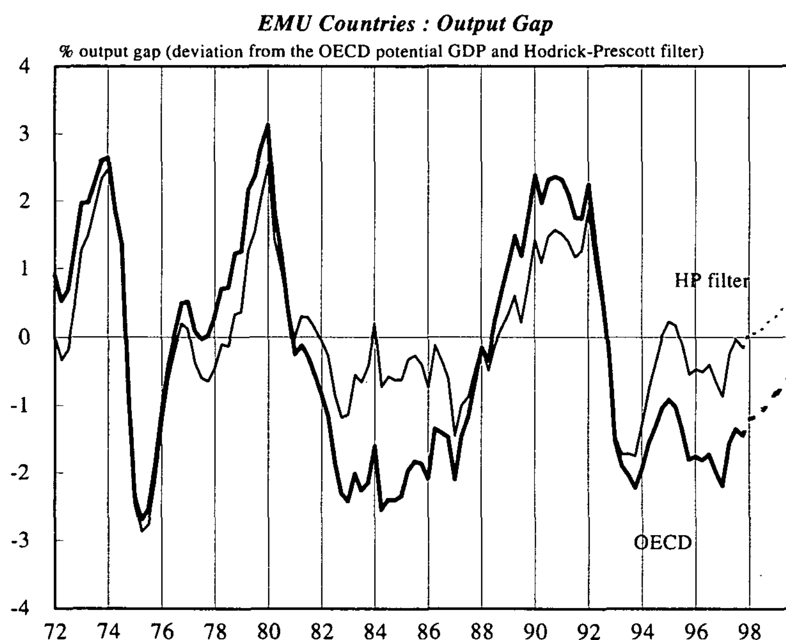
In the course of 1997 the cyclical upswing in Western Europe regained momentum after it had been interrupted in 1995 and 1996, due to a marked appreciation of most European curren-

Box 1 – Potential Output and Output Gaps in EMU Countries

The stage of the business cycle in the EMU area will be an important indicator for the European Central Bank (ECB) with respect to its interest policy. As long as there is sufficient slack in the economy an acceleration of inflation is not likely to occur. At present inflation risks are subdued, however, with output continuing to expand at a rapid pace inflationary risks might increase in the future. It would therefore be helpful to know the trend growth of EMU economies and the corresponding output gaps. This would also help to determine structural budget deficits.

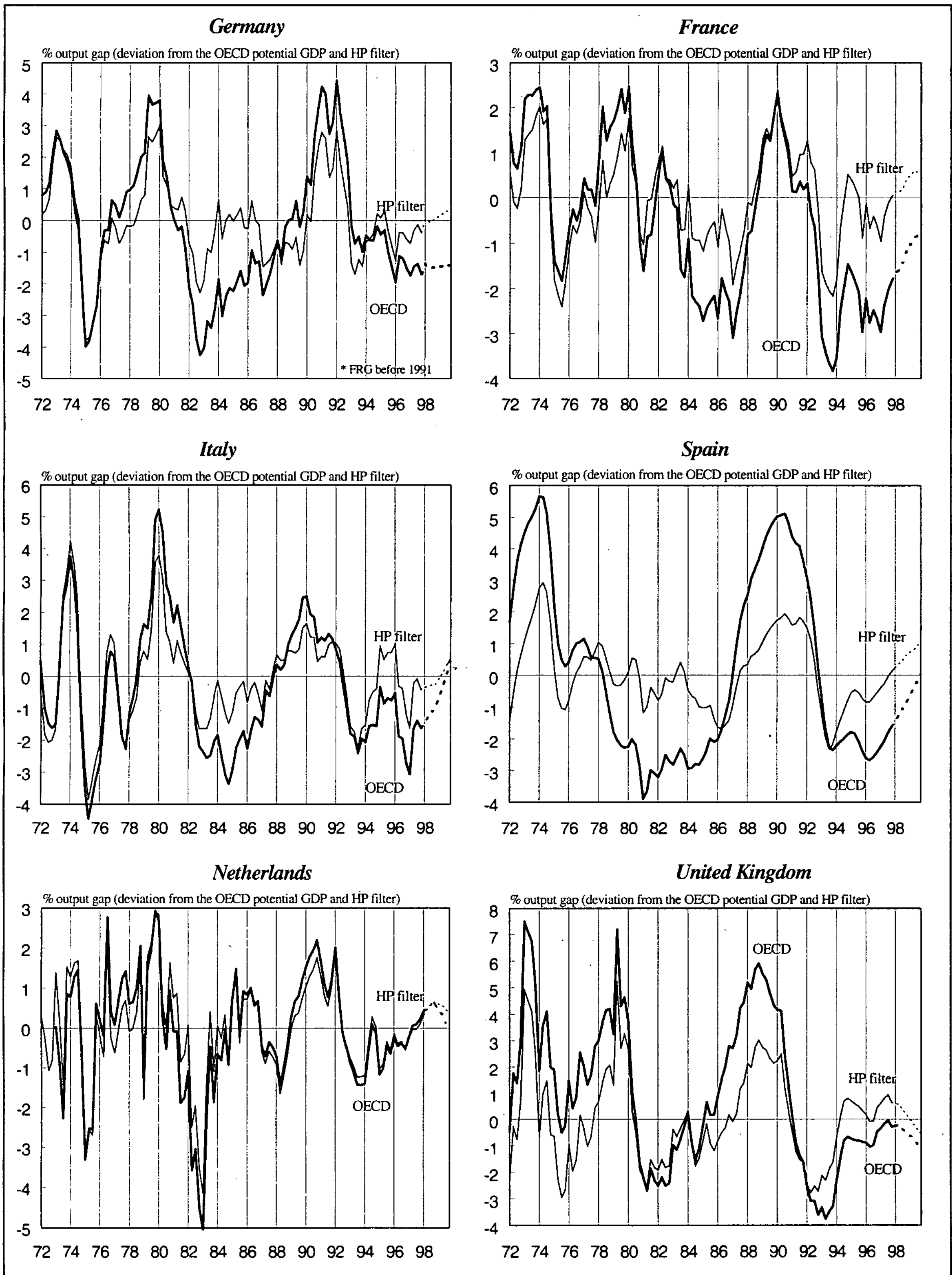
At present two different methods are used for this purpose. The first alternative involves smoothing real GDP using a Hodrick-Prescott (HP) filter, this is based on calculating a weighted moving average of GDP including a four-year forecast. The second approach, used for example by the OECD, is based on a production function relationship and the factor inputs that are available to the economy. At present both methods give slightly conflicting results. According to the HP filter method capacity utilization in EMU was back to normal already in the course of 1997. Contrary to that the production function approach still indicates a negative output gap of about 1.5 per cent at the end of 1997 (graph). Since no full cycle is included into the analysis the HP filter is likely to have a bias towards underestimating trend growth and thus overall capacity utilization seems to be exaggerated somewhat. The production function approach on the other hand seems to have a bias in the other direction as the utilization of factor inputs is not only affected by cyclical but also by structural elements. These calculations suggest that there is a wide margin of uncertainty.

EMU Countries : Output Gap



Source: OECD, EBCA estimates.

Box 1 continued



Source: OECD, EBCA estimates.

cies vis-à-vis the US dollar and a marked increase in long-term interest rates which had occurred in 1994. In the fourth quarter of last year real GDP was about 3 per cent higher than a year ago. The available information suggests that overall economic growth in Western Europe in the first quarter of this year was even stronger. However, due to the mild winter weather and specific factors, the first-quarter growth somewhat overstates the underlying pace of the recovery. The negative output gap for the EMU area as a whole has closed further, following a continuing rapid growth of industrial production (Box 1). Employment increased slightly and the number of unemployed decreased somewhat. Due to sharply declining energy and raw material prices, price increases almost came to a halt ; according to the new harmonized index of consumer prices set up by Eurostat the inflation rate on a year over year basis was down to 1.2 per cent in March.

Within the EMU area there are pronounced differences with respect to the current state of the business cycle. In some of the smaller countries, Ireland, Finland, Portugal, and the Netherlands, and also in Spain, demand is expanding more rapidly than in Austria, Belgium, Denmark, Germany, France, and Italy. The faster growth in the smaller countries does not only reflect a higher trend growth but also a more advanced position in the business cycle. In addition the reduction in interest rates in Ireland, Finland, and Portugal that is associated with the EMU process will raise consumer demand.

During the winter, exports continued to be the main driving force of the upswing although growth rates have slowed down, in large part due to declining exports to Southeast Asia. In addition the stimulating effects of the recent appreciation of the US dollar and the pound sterling are getting smaller. However, slower export growth was fully compensated by a more marked expansion of domestic demand. Improving labour market prospects and a cessation of the tightening of fiscal policy induced consumption to grow more rapidly, with car registration showing an especially strong increase. Corporate investment growth also picked up considerably, supported by low interest rates, rising capacity utilization, and improving sales and profit expectations. However, residential and public investment have not risen significantly, but there are indications that there has been some stabilization.

The short-term prospects are in favour of a continuing upswing in the EMU countries. The confidence of consumers and enterprises has been rising, and the inflow of new orders has remained in a clear upward trend. Even more important is that the underlying conditions, which are described below, remain favourable.

Monetary policy continues to support the upswing. The transition to EMU is likely to be smooth. Low inflation, slightly appreciating currencies, and continuing moderate wage increases suggest that interest rates in EMU countries will converge to the lower end of the range amongst the members. In Italy, Spain, Portugal, and Ireland short-term interest rates are likely to fall in the course of the year while in Germany, France, and other members there may be a minor rise in interest rates. At the end of the year, in all EMU countries the three-month money market rate will be close to 4 per cent. In the course of next year the Institutes expect the ECB to increase money market rates by half a percentage point as output gaps close (Table 5).

Long-term interest rates are expected to pick up somewhat already in the course of this year and remain stable afterwards. With 10-year bond yields edging up to 5.7 per cent next year the overall financial conditions remain favourable. The expected slight increase in long-term rates mainly reflects that with the stabilization in Southeast Asia capital flows to 'safe havens' in Europe and the US will reverse again.

As has been described above, conditions in markets outside EMU have worsened somewhat. Lower output growth in Southeast Asia and in North America will dampen export growth, although with an expected stabilization, the dampening effects will get smaller next year. After a slowdown of growth rates in 1998 world trade in 1999 will expand at the same rate. Despite the fact that the euro is expected to appreciate slightly vis-à-vis the dollar the competitive position of EMU countries will not deteriorate as unit labour costs will show only a small increase.

Table 5 – Assumptions for the Outlook

	1998				1999			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Interest rates								
US 3m	5.6	5.7	5.8	5.8	5.8	5.8	5.8	5.8
10y	5.6	5.7	5.9	6.0	6.0	6.0	6.0	6.0
EMU 3m	4.0	3.9	3.8	3.9	4.0	4.1	4.3	4.5
10y	5.2	5.1	5.3	5.5	5.7	5.7	5.7	5.7
Oil price[a]	14.2	14.5	14.5	15.0	15.5	15.5	15.5	15.5
Raw material prices[b]	–6.0	–1.0	0	0	1.0	1.0	1.0	1.0
Exchange rate $/euro[c]	0.92	0.91	0.91	0.90	0.90	0.89	0.88	0.88

[a]North-sea Brent in US$. — [b]HWWA Index excluding energy ($-based) quarter-to-quarter in per cent — [c]Vis-à-vis the US$.

Source: EBCA.

In 1997 fiscal policy has had dampening effects on economic activity as in a number of countries taxes were raised and expenditures were cut in order to meet the Maastricht criteria for the budget deficit. This year, governments are not likely to give up their consolidation efforts and they will continue to try keep expenditures in check in order to further reduce the level of public expenditures in relation to GDP. On the revenue side, contrary to last year, there will in only a few countries be increases in tax rates and social contributions rates. Some countries will even lower taxes and contributions in order to give some relief to the private sector. All in all fiscal policy in 1998 and 1999 will be more or less neutral.

In recent years wage growth has moderated substantially and productivity growth has been rather strong. In 1997 wages were 2.6 per cent higher than a year ago. With the upswing continuing and the improvement in the labour market the reduction in wage increases is likely to slow down this year. Only in Italy and France are pay increases expected to slow down somewhat. Next year wage growth will slightly accelerate towards a rate of about 3 per cent. Some of those countries which are more advanced in the business cycle may experience wage increases above the average rate. As productivity growth in EMU countries will slow gradually, unit labour costs which have been declining will again edge up slightly.

Against this background the upswing in EMU countries is likely to continue in 1998 and in 1999 at a rather solid pace (for the risks, see Box 2). Real GDP will increase by 2.9 per cent

Box 2 – Risks Associated to the Forecast

As usual this forecast incorporates certain risks. A significant downward risk is still that the stabilization in Southeast Asia will take longer than assumed in this forecast. This would mean that the related drag on European exports would be more pronounced. In addition, losses on loans to the East Asian economies could present some liquidity problems in the European banking system. It cannot be excluded that confidence in the progress in the transition countries could decline, creating financial turbulence in these countries and hampering recovery. Because of strong trade links this would significantly affect exports of EMU countries in a negative way. Another risk to the forecast is that, starting in the US, stock prices which have risen markedly in the last two years will decline. However, this would only be a correction of overly optimistic expectations and not bear a major risk for the recovery in Europe. The correction is likely to be smaller for Europe than for the US as the underlying conditions for profits remain favourable. Besides the downward risks there are also upward risks to the forecast. With the progress made in terms of price level stability and sounder fiscal policy, interest rates in Europe may stay low for a longer time than anticipated here. This would lead to a stronger acceleration of investment growth, consumer confidence and finally also real GDP growth.

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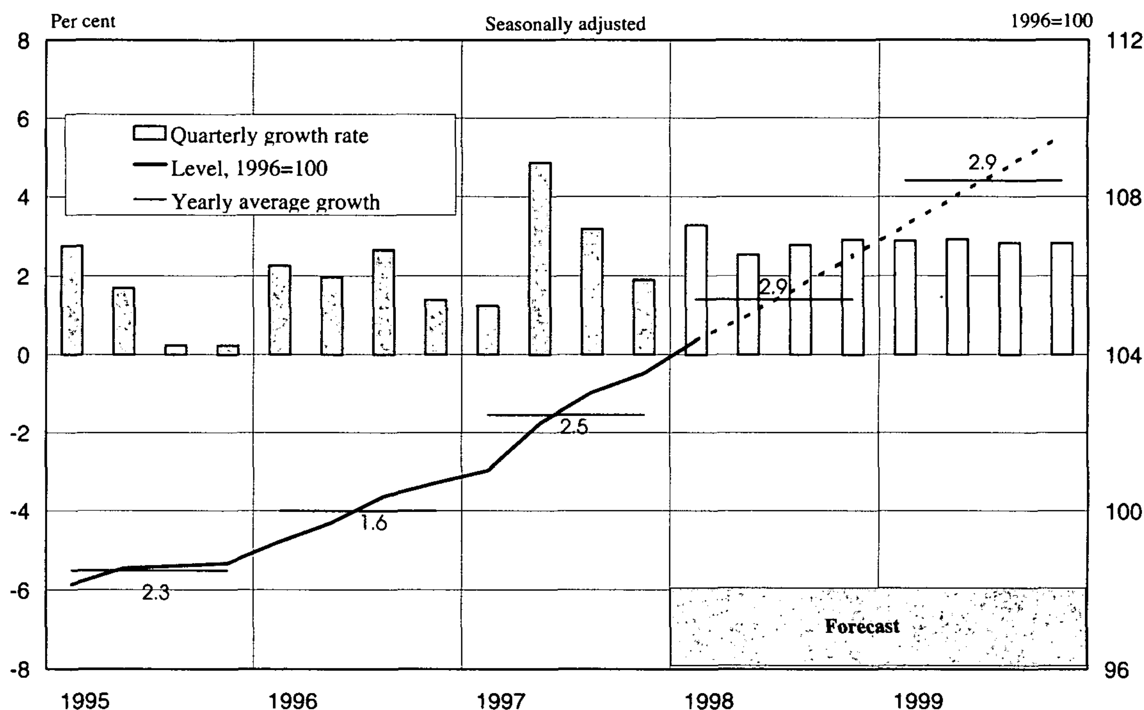
Figure 1 – Real GDP in EMU Countries[a]



[a]Excluding Ireland and Luxembourg.
Source: OECD, EBCA forecasts.

in both years compared to a potential output growth of slightly less than 2.5 per cent (Figure 1). Capacity utilization will thus rise further. However, even at the end of next year it will on average still be significantly lower than in the boom at the end of the eighties. In some of the smaller countries some tensions are likely to become visible as they are more advanced in the business cycle.

The upward momentum in the EMU countries will increasingly be driven by domestic demand. Export growth, in contrast, is likely to slow down somewhat as growth in main trading partner countries will be weaker than in 1997 and as the stimulus from the devaluation is fading. Domestic demand will continue to benefit from the stimulating effects of monetary policy. Those countries where interest rates are expected to be reduced further will get a strong impulse on domestic demand. In 1998 real disposable income of private households will be increased through the slight improvement in the terms of trade induced by lower raw material prices and the stabilization of European exchange rates. Together with the turnaround in the labour market consumer confidence in most of the countries has increased significantly. Private consumption will therefore support the upswing. In the presence of low interest rates, increasing capacity utilization, and improving profits corporate investment will remain brisk. The upturn will be largely confined to investment in machinery and equipment, whereas investment growth in structures will be dampened by the excess supply in office buildings.

In line with the continuing upswing employment will further rise. As a consequence unemployment will go down somewhat. The average unemployment rate is expected to go down by about half a percentage point in both years. Despite the improvement the number of unemployed will still be around 14.5 million in 1999.

The price climate in EMU countries in general will remain favourable throughout the forecast period. Capacity utilization is rising, but on average its level will still be too low to begin to expect tensions. Although wages will be increasing at a slightly faster pace next year they

will exert no significant pressure on price inflation. Energy and raw material prices are also expected to pick up only slightly in 1999. The main difference with respect to inflation in 1999 will be that labour costs and raw material prices will no longer put a downward pressure on prices.

b. Special Country Reports

Germany: Upswing Continues at a Moderate Pace

After a slowdown in the final quarter of 1997, economic activity picked up again in the first quarter of 1998. Real GDP expanded at an annualized rate of slightly more than 4 per cent, benefitting from mild winter weather and advance purchases of consumers due to the VAT hike on April 1. Besides consumption, also investment performed strongly as companies have started to enlarge capacities. The price climate remained rather favourable, in April consumer prices were only 1.4 per cent higher than a year ago. The labour market has shown clear signs of a turnaround; in the first four months unemployment fell by 139,000.

Fiscal policy in 1998 and in 1999 will be more or less neutral, contrary to 1997, when it had a strong dampening impact on economic activity. At the beginning of April, the VAT rate on most products was raised by 1 percentage point. However, there will be no additional burden for private households since at the beginning of this year the surcharge on the income tax was reduced and the tax-free subsistence level was raised. Next year, a tax reform is likely to be implemented; however, independent of the new government a sizable net tax relief is not likely to occur. Public expenditures which were stagnating last year will again show a slight increase this year as well as next year.

Table 6 – Real Gross Domestic Product, Consumer Prices, and Unemployment Rates, 1997–1999

Percentage change over previous year

	Weights in total[a]	Real GDP			Consumer prices			Unemployment rates in per cent[c]		
		1997	1998[b]	1999[b]	1997	1998[b]	1999[b]	1997	1998[b]	1999[b]
Germany	10.8	2.2	2.6	2.6	1.8	1.4	1.8	9.7	9.7	9.2
France	7.0	2.4	3.0	2.8	1.2	1.0	1.0	12.4	11.9	11.3
Italy	5.6	1.5	2.4	2.9	1.8	2.0	2.1	12.1	11.8	11.6
Spain	2.7	3.4	3.6	3.4	2.0	2.0	2.5	20.8	19.4	18.2
Netherlands	1.8	3.3	3.7	3.0	2.2	2.0	1.8	5.2	4.3	4.0
Belgium	1.2	2.7	2.7	2.7	1.6	1.5	2.0	9.2	8.8	8.4
Austria	1.0	2.5	2.7	2.8	1.3	1.3	1.8	4.4	4.3	4.1
Finland	0.6	5.9	4.2	3.0	1.2	1.9	2.1	14.0	11.9	10.5
Portugal	0.5	3.5	3.8	3.5	2.1	2.2	2.4	6.8	6.4	6.0
Ireland	0.3	10.5	7.5	6.5	1.4	2.5	3.0	10.2	9.3	8.5
Luxembourg	0.1	3.7	3.5	3.5	1.4	1.3	1.5	3.7	3.6	3.5
EMU countries	31.6	**2.5**	**2.9**	**2.9**	**1.7**	**1.5**	**1.8**	**11.3**	**10.8**	**10.3**
United Kingdom	5.3	3.3	2.2	1.6	2.8	2.5	2.5	7.1	6.8	7.2
Sweden	1.1	1.8	3.0	2.5	0.9	1.3	1.8	10.2	8.6	8.2
Denmark	0.8	3.4	3.0	2.5	2.1	2.4	2.5	6.1	5.2	4.7
Greece	0.6	3.5	3.0	3.5	5.6	4.7	3.5	10.4	10.4	10.2
EU countries	39.4	**2.6**	**2.8**	**2.7**	**1.9**	**1.7**	**1.9**	**10.5**	**10.1**	**9.7**
Switzerland	1.3	0.7	2.0	2.0	0.6	0.5	1.0	4.4	3.7	3.3
Norway	0.7	3.5	4.5	3.5	2.5	2.5	2.7	4.1	3.5	3.2
Western Europe	41.4	**2.6**	**2.8**	**2.7**	**1.8**	**1.7**	**1.9**	**10.2**	**9.8**	**9.4**
United States	34.9	3.8	3.0	2.0	2.3	1.8	2.2	4.9	4.6	5.0
Japan	21.0	0.9	0.3	1.6	1.7	0.9	0.5	3.4	4.0	4.4
Canada	2.7	3.8	3.3	3.0	1.4	1.5	2.0	9.2	8.6	8.3
Total	100	**2.7**	**2.4**	**2.2**	**2.0**	**1.6**	**1.7**	**6.9**	**6.7**	**6.8**

[a]1996 GDP weights. — [b]Forecasts. — [c]Standardized rates.

Source: OECD, EBCA estimates.

Wage increases which have decelerated markedly in the last two years will accelerate slightly this year and next year. After a mere 1.4 per cent rise in 1997 the increase in overall hourly contractual wages is likely to average 2.0 per cent this year and 2.6 per cent next year. Contrary to the previous years, non-wage labour costs will not rise faster than contractual labour costs. In line with the continuing upswing, in 1998 unit labour costs will again be somewhat lower than last year, in 1999 a small increase is likely to occur.

The overall conditions for a continued upswing in Germany are favourable. Real GDP in 1998 as well as in 1999 will expand at a pace slightly above the growth rate of potential output (2.3 per cent). The rather rapid export growth of last year is likely to slow down somewhat as the economic turmoil in Southeast Asia will cut exports over the coming 18 months by about 2 percentage points. However, this is more than compensated by a pick-up of domestic demand. Especially investment in plant and machinery is likely to expand more rapidly as profits continue to rise and more and more capacity constraints show up. Helped by faster rising real disposable income, private consumption will increase at a solid 2 per cent growth rate after having been virtually stagnant last year. In line with the ongoing recovery, employment is likely to rise again. Unemployment in 1999 will decrease significantly; this is partly due to a pronounced decline in the labour supply. Inflation will remain low this year and slightly pick up next year. The main reason for the higher inflation rate in 1999 (1.8 per cent instead of 1.4 per cent in 1998) is that the dampening impact of the decline in raw material prices and in unit labour costs will run out (Table 6).

Low Inflation in France

Foreign trade was the component driving the economy last year. It contributed to 1.5 out of 2.5 per cent of GDP growth. At the beginning of 1997 domestic demand was weak and net exports were the only GDP component to sustain growth. Households' income and hence consumption were hampered by past tax rises, sluggish employment growth, and efforts to control health expenditure. At the end of 1997 as the tax burden on households eased and confidence remained at a high level, private consumption sharply accelerated. Moreover, business confidence has stabilized at a high level since December 1997 in all sectors. Thus, all domestic demand components should show some growth in the first half of this year.

The public finance situation has changed much since summer 1997. New fiscal measures and the revival of growth have increased public receipts. Emergency measures of last August included a temporary contribution of 15 per cent on corporate taxes as well as the extension of the tax base to the long-term capital gains incurred with the sale of fixed assets. Also expenditures were cut to limit the public deficit to 3 per cent of GDP. The draft budget for 1998 assumes that stronger growth will be used to reduce the deficit, in order to regain margins of manoeuvre in case of future recessions The revival of growth should allow for stronger fiscal receipts, at unchanged fiscal pressure. Benefitting from lower interest rates and smaller deficits, the debt burden will grow more slowly than in the past. On the whole, the public deficit on EMU definition could reach 2.6 per cent of GDP in 1998 and 2.2 per cent in 1999.

Since 1994, unit labour costs in the whole economy have grown only very slowly at an annual growth rate of 0.5 per cent. Although the return of net job creation in 1995 put for a while a brake on productivity gains, labour costs have continually slowed down since the first quarter of 1996 and diminished in 1997. More job creations in 1998 would raise labour costs in 1998 albeit moderately: the real average hourly wage would grow by 1.6 per cent in 1998 and slightly less in 1999.

Consumer price inflation is moderating despite the cyclical upturn. Prices will rise by 1.0 per cent in 1998 and 1999. The sustained competition, fairly stable labour costs, and no pressure from raw material prices considerably lighten production costs.

In 1998 and 1999, the contribution of net exports is expected to turn slightly negative as exports slow down and imports accelerate. The

smaller contribution of external demand to growth will be largely compensated by stronger domestic demand. GDP growth is projected at 3 per cent this year, slowing down to 2.7 per cent in 1999. The purchasing power of the households will increase this year and next year at the same rate (2.3 per cent). The most dynamic component of income will be wages, in 1998 as in 1999, especially due to job creation. In this favourable environment, the financial savings rate is expected to fall to around 6 per cent in 1998 and 1999.

As the impeding factors for investment (wait-and-see posture of entrepreneurs remembering the shocks of the early 1990s and looking for a higher profitability) will be lifted by the strengthening of demand, a more significant upturn is expected soon. The investment volume will grow by 5.6 per cent in 1998 and 7.6 per cent in 1999. This revival will remain broadly self-financed.

As growth develops, the number of new jobs may reach 370,000 in 1998 and 230,000 in 1999, after 155,000 in 1997. Given a continuing increase in labour supply, unemployment will be reduced by only 90,000 and 30,000 persons in 1998 and 1999, respectively. Still this is a large reduction as compared to recent history. The last time that unemployed diminished appreciably was in 1988-1989, that decline amounted to 80 000 persons in two years.

Recovery in Italy Is Developing

Italian economic activity continues to recover: real GDP growth is expected to increase by about 2.3 per cent in the first half of this year. Once the special incentives for car purchase end, consumption (which rose by 2.4 per cent in 1997) will be sustained by high consumer confidence. The most dynamic component of domestic demand, however, has become fixed investments, both in plant and machinery and in buildings. Stockbuilding now seems at a normal level. In the first months of 1998, imports grew strongly, while exports stabilized at the level of year-end 1997, partly reflecting the Asian crisis. In spite of the recovery in demand inflation remains low: the average increase of consumer prices between January and April was 1.7 per cent at annual rate. Although very slowly, the labour market is improving, with rising employment and falling unemployment.

The 1998 Budget Law and the stabilization programme for the years ahead do not imply any change in the fiscal policy stance. Rather it is aimed at consolidating the results achieved so far, by making permanent the temporary measures from the 1997 budget (about 1 per cent of GDP) and reinforcing structural adjustment. For 1998 a budget deficit is projected at 2.8 per cent of GDP, obtained with a reduction in expenditures and an increase in revenues. Nevertheless, thanks to falling interest rates and increasing GDP, budget policy will not be more restrictive than in 1998. The public current balance is expected to show a surplus of 0.9 per cent of GDP (a government saving for the first time since the beginning of the seventies), in spite of interest expenditures amounting to 8 per cent of GDP. This could imply a reduction in the fiscal pressure of around 1 percentage point. The public debt-to-GDP ratio is expected to reach 114 per cent in 1999, which means a reduction of 7 percentage points in two years, thanks to lower interest rates, stronger economic activity, and privatization and sales of public real estate.

Nominal wage growth could remain at some 3.5 per cent both this year and next, given the weak labour market and the expectation of sustained low inflation. An acceleration of labour productivity will allow labour cost increases well below 2 per cent in 1998–1999. Lower real interest rates will foster a GDP growth of around 2.5 per cent in 1998 and 3 per cent in 1999, without strong inflationary pressures. With low imported inflation and moderate growth in unit labour costs consumer price inflation will fluctuate around 2 per cent. In 1999 consumption should increase again as strongly as GDP, stimulated by gains in real disposable income, low interest rates, and improving labour market conditions. Employment will grow at 0.6 per cent in the next two years. Standardized unemployment will fall gradually from 12.1 per cent in 1997 to 11.6 per cent in 1999.

Investment in machinery and equipment will rise by nearly 6 per cent this year and 9 per cent in 1999, supported by strengthening demand, a

high level of capacity utilization and declining interest rates. Moreover, financial stability has improved the situation in Italy: less uncertainty about public deficit reduction, more favourable conditions in the capital markets accompanied by a strong performance in the equity market, and the implementation of reforms aimed at increasing competition and productivity, especially in the non-tradeable sectors. Growth in housing investment is expected to show a marked recovery, thanks to incentives for restructuring residential buildings, while also public investment in infrastructure will rise again significantly. On the external side, the current account surplus is expected to remain stable, and Italy will become a net international creditor this year.

The United Kingdom: Slowdown of Economic Activity

The UK has now enjoyed five years of strong economic growth following the sharp recession of 1990–92. Unemployment has fallen markedly over this period from 10.4 per cent in 1993 to 5.7 per cent last year. The rapid growth has not been accompanied by any marked pick-up in inflation. Indeed inflation, as measured by the consumption deflator, has eased markedly from 7.5 per cent in 1991 to 2.1 per cent last year.

The rapid decline in unemployment has led to concerns that labour shortages may begin to put upward pressure on wages and prices. Thus monetary policy was tightened following the election of the Blair administration in May 1997. One of its first acts was to give greater independence to the Bank of England. Since then its monetary policy committee has steadily raised short-term interest rates from 6 per cent to 7.25 per cent. The bank has been particularly concerned about the strength of consumer spending which grew by 4.6 per cent last year, supported by the gains in consumers' net wealth stemming from the windfall profits from building society conversions and the generalized rise in equity prices.

There are mixed signals coming from the labour market with regard to inflationary pressures. Average earnings growth has picked up as unemployment has fallen with average earnings rising by around 4.8 per cent last year, the fastest rate of growth since 1992. However, some of this increase is due to higher overtime payments and bonuses, reflecting the overall buoyancy of the economy. The rate of growth of pay settlements remained around 3 per cent, although recent figures suggest that pay settlements may now be beginning to accelerate somewhat. Measured inflation is also giving confusing signals. The retail price index (RPI) has recently accelerated to 4 per cent but underlying inflation, once temporary factors have been removed, is growing far more modestly.

Fiscal policy has tightened significantly in recent years. The public sector borrowing requirement (PSBR) has been reduced from approaching 8 per cent of GDP in 1993 to virtual balance last year (although the EMU deficit was 1.9 per cent last year). The recent improvement has been particularly marked with the PSBR improving by 2.8 per cent of GDP over the last year. Half of the improvement is due to budgetary measures introduced by 1997 budget plan. The remainder comes from previous measures and from lower-than-expected government spending.

Overall the UK is likely to enjoy a soft landing with growth slowing to around 2 per cent this year and 1.5 per cent in 1999. Inflation should remain close to the target of 2.5 per cent. However, there is a significant chance that the economy will slow more quickly than expected under the combined influence of tight monetary and fiscal policy and a high exchange rate. It is unlikely though that there will be a marked pick-up in unemployment. The government's Welfare to Work Programme should reduce the number of claimants without putting too much upward pressure on wages. This is because the policy, which involves providing training and work experience, is targeted at the long-term unemployed who may not fully participate in the labour market. However, the beneficial effects of the Welfare to Work Programme may be partially offset by the introduction of the national minimum wage in the spring of next year. Depending on the rate chosen this may push up wages and reduce employment.

Strong Growth in Spain

The good economic performance since 1997 continued in the first quarter of 1998. GDP rose by 1.3 per cent with a strong acceleration in domestic demand. Consumer confidence remained at a high level, while business surveys became more optimistic. Industrial production rose by 10.7 per cent year on year; also qualitative indicators suggest a buoyant investment behaviour this year. The unemployment rate fell to 19.6 per cent in March, contributing to consumer confidence. The stable inflation in the first quarter of 1998 (1.9 per cent on average) has permitted a further cut in the discount rate.

Fiscal policy is expected to be accommodating this year, after several years of tightening. Thanks to the continued decrease in interest rates and the increase in revenues due to the favourable cyclical development the general government deficit target for this year is reduced to 2.2 per cent of GDP. The main factors affecting revenues are a raise of tax rates on oil and insurance premiums, an increase in advance payments of self-employed, some cuts in income tax are also to be introduced along with private pension allowances; public spending will be held in check by wage increases for civil servants in line with the inflation target (2.1 per cent).

In 1997 nominal wages rose by 2.7 per cent, while the private consumption deflator increased by 2.5 per cent. In 1998 wage rises are expected to be moderate, given the low inflation. Collective bargaining in January involving around two and a half million workers resulted in an agreement on a wage increase of 2.5 per cent.

GDP growth is projected to remain strong in 1998 and 1999 at around 3.5 per cent, supported by a decline in interest rates and a less tight fiscal policy. Private consumption should accelerate, as wages increase in real terms and unemployment falls, and consumer confidence is improving. Private investment should also accelerate in the light of a further reduction in interest rates, improved profitability, and high rates of capacity utilization. Stronger demand from the Euroland countries, which represent around 60 per cent of Spain's export markets, should sustain Spanish exports in spite of slower demand outside Europe and the weaker dollar. In 1998 inflation should remain near the target (2.1 per cent), thanks to low international commodity prices. With economic activity growing by over 3 per cent on an annual basis, labour market conditions should improve. Unemployment should gradually come down.

The Netherlands: Soft Landing of the Economy

The Netherlands' economy expanded by 3.3 per cent last year accompanied by a considerable job creation. Employment rose by 2.5 per cent and the unemployment rate reached 6.5 per cent of the labour force. However the Dutch figure for the labour market is not as good as it looks, because there is a considerable hidden unemployment. Unlike in most European countries, Dutch growth in 1997 was driven by domestic demand, while net exports were seriously affected by the outbreak of swine fever. Private consumption grew around 3.5 per cent, with a particularly strong demand for consumer durables. Real disposable income of households rose substantially, largely because of the strong employment growth. Positive wealth effects through the surges in house and share prices supported consumption as well.

The public sector deficit fell to 1.3 per cent of GDP in 1997. Government expenditure, as a percentage of GDP, follows a downward trend, mainly due to lower interest payments and lower transfers to the unemployed. Both in the past and the present year the burden of taxes and social security premiums has been lowering substantially, for 1998 a reduction of about 1 percentage point of GDP is expected. However, this is not likely to continue, as a hike in social security contributions is needed to strengthen the capital base of the public insurance system. The public deficit is expected to rise to about 1.75 per cent this year, but to fall back again to below 1.5 per cent in 1999, largely reflecting the improved balances of the social funds. Gross public debt will fall steadily to below 70 per cent of GDP in 1999.

Wage and price movements will remain moderate. There are yet no clear signs of tensions on the labour market. Despite falling unemploy-

ment the rise in contractual wages was just over 2 per cent last year, and in the present and coming year the increase will be edging up to 3 per cent.

GDP growth is projected to be above 3.5 per cent this year and around 3 per cent in 1999. A gradual slowing down of economic growth is projected from the second half of this year onward until late next year a quarterly rate of 2.5 will be reached which is about the potential growth rate of the economy. Next year's easing of economic growth will take place on the export as well as the domestic side. On the export side this is due to slower market growth and some weakening of Dutch price competitiveness. This year consumer demand will be boosted by job growth and a substantial increase in purchasing power, while in 1999 consumption growth will slow for several reasons. First, fewer new jobs are expected. Second, purchasing power will rise much slower, as — on present policies — there will be no more burden relief from the fiscal side. Third, the wealth effects on consumption growth will decline. This year the cyclically sensitive investments will accelerate, given improved profitability and rising capacity utilization. This will not show up in the total investment figures, however, because major energy projects were completed last year, while investment in aircraft will also be significantly down. In 1999 investment will weaken in line with lower output growth.

Employment is expected to rise by 2.5 per cent this year and a still respectable 1.7 per cent in 1999; the unemployment rate will reach 4.0 per cent in 1999 (as regards the standardized rate). The expected low level of unemployment is not seen as an obstacle for sustained economic growth. Bottlenecks can be avoided at least for a while, thanks to the increased flexibility of the labour market, and the expectation that the strong employment growth will encourage more people to enter the market and part-timers to work longer hours.

3. Some Facts about Euroland

European Monetary Union and United States in Comparison

The economies that from 1 January 1999 will share the euro as common currency constitute an economic area comparable in size to the United States. In 1997, Euroland's population was slightly larger than that of the United States, whereas the GDP amounted to roughly 80 per cent of the US level as can be seen from Table 7. The GDP composition shows some differences in the allocation between domestic and net foreign demand. In Euroland, private consumption and investment were around 80 per cent of GDP, whereas in the United States the weight was higher at around 88 per cent. Euroland's economy is more open, with the sum of exports and imports over GDP coming to roughly 23 per cent as compared to 19 per cent for the US. This result is partly due to trade between Euroland and those countries like the United Kingdom, Greece, Denmark, and Sweden which will not join the European Monetary Union, but are important trade partners. These countries absorb more than 25 per cent of EMU exports and are the suppliers of around 23 per cent of EMU imports. Hence from 1999 the de facto euro area will presumably be larger than that associated with the eleven official members.

It is interesting to compare the geographical composition of trade for Euroland and the United States. Asia, as a whole, represented around 30 per cent of the US export market, but only 17 per cent for Euroland. On the other hand, Asia covered nearly 40 per cent of US imports and only 22 per cent of Euroland's. Central and Eastern Europe absorb 15 per cent of Euroland exports but less than 2 per cent of US exports. The same proportion applies to them as the origin of imports.

Noticeable differences between Euroland and the United States are also evident in the labour market and in the general government budget. Unemployment in Euroland was more than 12 per cent in 1997, whereas the United States is close to full employment at 5 per cent. The differ-

Table 7 – Euroland and United States: Key Indicators, 1997

	Euroland	United States
Population (mill.)[a]	285.2	265.5
GDP (bill. ecu)	5684.9	7127.6
Private consumption as a % of GDP	59.6	65.6
Total investments as a % of GDP	21.0	22.3
Inflation (consumer prices)	1.7	2.3
Employment rate	56.6	72.8
Participation rate	64.6	77.0
Unemployment (standardized rate)	11.3	4.9
Trade balance as a % of GDP	2.9	–2.5
Current account balance as a % of GDP	2.0	–2.1
Share in world exports[a]	18.5	14.0
Share in world imports[a]	16.6	17.6
Degree of openness [a,b]	22.9	18.9
General govern. net borrow. as a % of GDP	–2.5	–0.3
General government debt as a % of GDP	75.3	61.5

[a]1996. — [b]Sum of exports and imports of goods in relation to GDP in nominal terms. For Euroland, exports and imports are net of infra-area flows.

Source : European Commission, IMF, OECD, EBCA estimates.

ferent structure of the two labour markets is clearest in participation rates which are around 13 percentage points higher in the United States than in Euroland. The possible reasons vary from the different welfare states in the two regions to differing degrees of flexibility in the respective labour markets. The situation in Euroland is worse than in the United States with respect to the general government budget. According to the European Commission statistics, in 1997 the public deficit for the euro region was around 2.5 per cent of GDP, with a cumulated debt approximately equal to 75 per cent of GDP, compared with a roughly balanced budget in the United States and a debt of around 60 per cent of GDP.

II. Economic Policy in Europe for the Short and the Medium Term

1. On the Implications of the European Monetary Union for Economic Policy

At the beginning of May, the heads of state decided to start the Third Stage of EMU on January 1, 1999 with eleven countries participating. Bilateral exchange rates will be fixed on the basis of present ERM central rates, i.e. these rates will be the conversion rates on December 31, 1998. The ecu will then be replaced by the new currency, the euro, at a rate 1:1. Since June the governing council of the ECB is *de facto* in charge of monetary policy in Euroland, although *de jure* monetary policy remains in national sovereignty until the end of the year.

The European Central Bank has a clear mandate to ensure price level stability in the European Monetary Union. According to the Maastricht Treaty, the ECB is independent. The personal independence of the members of the ECB council is an important element. However, the dispute among the heads of state about the presidency has created concerns about political interference.

With the introduction of the single currency, the individual countries give up their national sovereignty concerning monetary policy and the

possibility to use this instrument in domestic stabilization policy. It will also, for example, not be possible for individual countries to pursue an expansionary monetary policy with the intention of stimulating the economy. By the same token, it will not be possible to use exchange rate policies influencing real wages after an external real shock. For many countries, however, the transition into EMU does not imply a major change because they have more or less followed a unified monetary policy and have held nominal exchange rates fairly stable vis-à-vis the D-mark in recent years. All in all, the European Monetary Union will function as an economic entity. This will leave the necessary adjustments in case of disturbances to the markets and to other areas of economic policy.

Monetary policy in the EMU will be conducted according to the economic conditions in the whole currency area, so the ECB will not be able to take regional differences in the development of income, prices, and employment into consideration. A common monetary policy does not imply that the business cycles of the participating countries will be fully synchronized in the future. Fiscal policy and wages will continue to be determined in the individual economies and will therefore differ from country to country. In addition, shocks from outside will affect the individual economies differently because of differences in economic structure. Last but not least, some economies are more sensitive than others to interest rate changes because of a higher share of lending at short-term or variable interest rates and because of the diversity of current financial structures. The single currency will over time reduce the differences between countries as a Euroland market for credit is created and will hence make them similar in terms of the impact of the common monetary policy on output and on other macroeconomic variables.

It will be very important that the ECB will explain its policy not only to politicians but also to the broad public and to financial markets. Transparency can be achieved in various ways, one being regular publications. In addition, both the British and the US experience has shown that, for example, the publications of the minutes of the council meetings may help to increase the central bank's credibility. Also regular meetings with policymakers and the European Parliament can be helpful. Its accountability does not mean, however, that there is political interference or even political control.

The current ERM bilateral central exchange rates of the EMU currencies have for most currencies already prevailed for several years without creating major structural problems, indicating that they are consistent with a sustainable economic development in the EMU area as a whole. Also, there has not been any speculation against one of the participating currencies. However, the irrevocable fixing of nominal exchange rates within EMU does not mean that the real exchange rates which are important for the competitiveness will remain unchanged. In particular, differences with respect to productivity growth as well as different price and wage developments will lead to differences in inflation and thus to real exchange rate changes, although they are limited in size.

Apart from the consequences for the monetary conditions, there are implications of EMU for fiscal policy. The Stability Pact implies a constraint for fiscal policy. Public sector deficits will have to be reduced so that in the case of recession the deficit-to-GDP ratio does not exceed the level of 3 per cent. Therefore, in a number of countries, among them the two largest economies of Germany and France, the structural deficits will have to be reduced further. In addition, the Pact calls for a balanced budget or a surplus in the medium term. All in all, these targets have the purpose to let the automatic stabilizers work, i.e. to avoid, for example, a restrictive policy in the case of a recession. Beyond these limits for the overall measure of budget deficits, the introduction of EMU does not have any major consequences for fiscal policy. In particular, it does not call for a harmonization in the field of, for example, tax policies or social policies.

The introduction of a single currency will not have a major impact on employment. High unemployment will continue to be the greatest challenge for economic policy in Europe. For a number of countries it will be necessary to continue

their efforts in reducing unemployment for example by means of reducing the growth of real wages in the medium term and by raising the flexibility of the labour markets. It would be counterproductive to impose a common wage policy for Europe, for example, in the form of wage standards, because this would aggravate the unemployment problems in countries with a relatively low level or growth rate of productivity.

2. Monetary Policy

The European Central Bank will start to operate at a time when the overall economic conditions in Euroland are quite favourable and do not call for drastic interest rate moves to counter major imbalances. The capacity utilization in the EMU area appears to be close to its historical average; furthermore, the average inflation rate is quite low and there is no immediate danger of an acceleration of inflation.

According to the Maastricht Treaty, the ECB has to keep the price level in the European Monetary Union stable. Similar to the policy of the Bundesbank and other central banks, the ECB is likely to announce a target of 2 per cent as being compatible with this goal. A higher rate is not likely as it could easily be interpreted by markets that the euro would be less stable than major currencies in the recent past. With a present inflation rate of about 1.5 per cent on average for the EMU area, this would also imply that the slight acceleration of inflation expected for 1999 will not call for a substantial tightening. The ECB is likely to nevertheless raise interest rates somewhat in order to demonstrate its commitment. The expected increase does not, however, mean that monetary policy becomes restrictive but rather moves in the direction of a neutral policy stance.

The ECB will have to decide quickly how to turn its mandate for price stability into a concrete strategy for monetary policy. According to the EMI, there are two possible strategies, an intermediate monetary target and a direct inflation target. A monetary target would follow the long-standing strategy of the Deutsche Bundesbank. In the past, it allowed for an annual money supply growth (in terms of M3) which after taking into account the growth of potential output and the medium-term change in the income velocity of money would limit the increase in the price level to 2 per cent. The monetary target is based on a stable long-term relationship between money and prices. While this stability obviously did not exist in a number of European countries, for example Italy, it seems — according to various empirical investigations — to have prevailed in Germany. Other countries have more or less followed the policy of the Deutsche Bundesbank by fixing the exchange rate of their currency against the D-mark. By means of this policy, they have also achieved a low rate of inflation. Whether the demand for money in the EMU will be as stable as in Germany is uncertain as in several countries, the demand for money showed structural breaks. However, there are empirical studies indicating that the money demand has been more stable for groups of European countries than for individual countries. Nevertheless, in the start-up phase of EMU a greater volatility in the money stock cannot be ruled out for several reasons: with the enlargement of the currency area there might be a reduction of currency holdings; also, changes in the financial structures are likely to lead to shifts in the portfolio; and finally, it is uncertain which role the euro will play outside the EMU countries or as an international reserve currency.

In view of these problems, the ECB is likely not to focus on a monetary target alone but also follow a direct inflation target. That means that the ECB will monitor a set of indicators which have a close correlation to future inflation. The central bank has to have reliable information how a change in these indicators will affect the price level or to what extent the ECB has to change its key interest rates in order not to miss its inflation target. In practice, there is a lot of common features between the two strategies, with direct inflation targeting taking into account additional variables.

With respect to ensuring that monetary conditions will be adequate to achieve price stability, the ECB will face a lot of problems at the

start. First, the statistical data basis for the new currency area is less reliable than that for individual countries. Second, the new monetary policy regime can lead to portfolio shifts which especially in the beginning might affect monetary aggregates. Third, most importantly, interest rate changes affect the individual economies with different speed and different intensity. This makes it difficult to estimate the impact on overall economic activity and prices. In addition, it can lead to tensions in the decision-making process of the ECB. However, most of the problems will be transitory. There will soon be harmonized statistical data comparable to the standards in the individual countries. Increasing competition in the financial sector will narrow the differences in the financial structures and thus in the transmission process in EMU countries.

In the meantime, the ECB will carefully look at all factors affecting the price climate. With monetary aggregates likely to be influenced by portfolio shifts, the development of short- and long-term interest rates will be of special importance for a judgement on the current stance of monetary policy. It is the level of real and not of nominal interest rates that matters, but that cannot be influenced by central bank in the long term. Since it is difficult to calculate real interest rates and as there is no clear indication what their "normal" level is, the yield curve has become a very common indicator with respect to assessing the impact of monetary policy on economic activity. If the difference between the 10-year bond yield and the 3-month money market rate is above (below) its long-term average this normally indicates an expansionary (restrictive) stance of monetary policy. In order to get an estimate of the neutral yield spread, the ECB may take the experience in Germany as a guideline. Here, the long-run difference between long- and short-term interest rates amounted to about one percentage point on average. Some of the other European countries show a significantly lower long-term average. This is mainly due to the fact that from time to time they had to raise short-term interest rates significantly in order to defend their exchange rates in the EMS; also, the strong convergence of long-term rates in the advance of EMU reduced the spread in a number of countries. At present, the difference between long- and short-term interest rates in the D-mark bloc amounts to about 1.3 percentage points thus indicating a relatively relaxed stance of monetary policy.

Real long-term interest rates are central to investments and thus to the growth trend. These rates are the results of market forces but economic policy may influence them. It will thus be highly desirable that the ECB and the governments give clear messages to borrowers and lenders. This implies a reciprocal knowledge of intentions, an understanding of the interactions of expected policy stances , and as high as possible an agreement about the cyclical position of countries.

A single interest rate in the EMU area will have quite different consequences for the cyclical development in the individual countries because the situation, for example, in terms of inflation and the output gap differs considerably. Calculations using the "Taylor-rule" for monetary policy suggest that the average short-term interest rate in the EMU countries of 4 per cent is too low for countries that are ahead in the business cycle (e.g. Ireland and the Netherlands) and too high for those countries that are lagging behind (e.g. France and Germany). Therefore the common interest rate prevailing in EMU may turn out to be stimulative in some countries and dampening in others (Table 8).

The ECB will also watch the real sector of the economy. In the case of emerging tensions, indicated by a high level of capacity utilization and faster growing labour costs, an acceleration of inflation is likely to occur sooner or later. At present there are hardly any signs of substantial bottlenecks in the EMU countries as a whole. However, in some countries, notably Ireland and Spain, there is a risk of strong growth turning into an overheating.

In order to achieve its monetary goals the ECB will act in a way similar to the national central banks in the past strongly relying on open market operations to control liquidity growth, steering interest rates and signalling the stance of monetary policy. According to a proposal of the EMI, the ECB will conduct differ-

Table 8 – Short-term Interest Rates in Europe, According to a Taylor Rule[a]

Per cent

	1998	1999
EMU countries	3.6	4.1
Austria	3.9	4.5
Belgium	3.4	4.5
Finland	6.5	5.7
France	2.6	2.8
Germany	3.0	3.8
Ireland	10.4	10.0
Italy	3.7	4.7
Netherlands	5.8	4.8
Portugal	5.9	6.1
Spain	4.9	5.8

[a]Assumption is being made that the ECB will refer to a Taylor's rule such as : $r = \pi + y + 0.5 (\pi - 2) + 0.5$ gap where : π stands for the rate of inflation, measured as the consumer price index; y: GDP growth in real terms (according to EBCA forecasts); gap, the gap between production and potential output (as estimated by OECD).

Source: OFCE estimates.

ent types of open market operations. The most important instrument will be a two-week tender with repurchase agreement which allows the ECB to influence daily money market rates. In addition to that, standing facilities like a marginal lending facility and a deposit facility will determine the upper and the lower range of the short-term interest rate spectrum. Changes in the respective interest rates will have a signal character.

It is not decided yet whether the European commercial banks will be subject to minimum reserve requirements. There may be good arguments in favour of minimum reserve requirements. They act as a buffer and thus stabilize money market rates. In addition, they strengthen the control of the ECB on banking liquidity and thus make it easier for the central bank to achieve its goals. However, in the past minimum reserves in Germany have given incentives to shift banking activities to offshore centres outside the country where no minimum reserves were required. Such a loss of competitiveness can be avoided if market interest rates are paid on minimum reserves.

The European Central Bank is likely to introduce a minimum reserve requirement, characterized by a reserve requirement on deposits of between 2 per cent and 3 per cent, with a reserve remuneration close to money market rates. This will create, for example, in Italy a transition problem, as at present the minimum reserve rate in Italy amounts to 15 per cent. The new requirement rate would imply reducing reserves by approximately 60 thousand billions of lira, slightly less than 30 billion ecu. Huge amounts of liquidity would then be released in a single move at the beginning of 1999. However, it would be easier to sterilize the freed liquidity and thus to avoid a swing in short-term interest rates if the minimum reserve rate were reduced in *tranches*. The best timing for this would be June and December when there is normally a strong demand for liquidity due to major tax and social security payments.

3. Exchange Rate Policies of the Non-EMU Members of the EU

The decision of the eleven member states to press ahead with the single currency raises important questions for the four countries outside the monetary union. The UK, Sweden, Denmark, and Greece need to decide when and if they should join the EMU and what their exchange rate policies should be in the intervening period. They have to take account of both real developments and the progress of inflation. Joining EMU at an overvalued exchange rate, or at one where inflation would rise relative to the rest of the Union would have

undesirable long-run consequences for markets share and import penetration. Joining at too low a rate would induce inflation and defeat one objective of a stable and independent monetary authority. Although inflation rates will not diverge significantly in EMU, they can do so for long periods as some regions overcome undervaluations and others change the balance of demand in response to lower interest rates.

It seems most likely for the UK that a bid to join EMU will be made following the next general election, likely in 2001/02. Current market expectations suggest an entry rate with respect to the D-mark of a little over DM 2.60. Sweden and Denmark are likely to try to join EMU if and when popular support can be secured. Greece, which failed to meet the Maastricht convergence criteria, is likely to join EMU when it has made sufficient progress towards reducing inflation and improving the fiscal position.

These four countries face differing questions about the appropriate exchange rate policy in the period before they join. Two countries are likely to participate in the successor to the Exchange Rate Mechanism, ERM II, namely Denmark and Greece, whilst Sweden and the UK may stand outside, at least for the time being. It would appear likely that the Danish authorities will seek to maintain their currency's parity with the euro until they choose to join the single currency. Long-term interest rates are slightly above those for the ecu, suggesting that the markets expect short-term interest rates to move in line with those in the rest of Europe. Moreover, the European Monetary Institute has indicated that it will take account of conditions in the Danish economy when it sets euro interest rates. All in all Denmark is likely to be a de facto member of the monetary union right from the start, and will become a de jure member as soon as the population is ready for it to do so.

Despite improvements, Greece is not expected to be so successful in maintaining parity with the euro. The authorities will continue to follow a policy of using a relatively strong exchange rate to put downward pressure on inflation, but it will take some time for inflation to be reduced to the euro area rate of below 2 per cent. During this period short-term interest rates in Greece are likely to be above those in the rest of Europe, and hence the exchange rate can be expected to decline steadily. Exchange control to the drachma market makes it easier for the authorities to manage the exchange rate. However, EMU membership will require the prior removal of these controls, and possibly more exchange rate instability before entrance.

The UK and Sweden are likely, for the time being, to stand aside from both the euro and the ERM II. The UK is unlikely to rejoin the ERM at least in the short term. It would be politically and economically difficult for the UK not to delay re-entry into the ERM, even though the present administration shows a much more positive attitude to Europe than its predecessor. Institutional change has begun in preparation for potential membership. The Bank of England has been made genuinely independent, and financial sector regulation is to split of, much as is required for membership of EMU.

There are major economic obstacles in the way of immediate entry. Cyclical positions differ. The economies of continental Europe are possibly below capacity output, but are recovering. The UK economy is operating at or above full capacity, and in recent months the inflation rate has been at or above its median target. In these circumstances we would expect the Bank to be raising interest rates, but this might cause the exchange rate to appreciate, and sterling is overvalued already.

The situation in 1998 is worrying. Estimates of the equilibrium exchange rate suggest that a bilateral rate of DM 2.5 to 2.6 per pound would be the maximum that would be sustainable given current price levels. Joining at rates seen in early 1998 would have meant that the exchange rate would have been 15 per cent or more overvalued.

The UK cannot go into EMU at the present rate. If it devalues then all the inflationary pressure held in check by the appreciation of 1996 will re-emerge. Inflation would rise, and if the exchange rate fell to 2.5 DM, it could well exceed 4 per cent for several years, and hence a real overvaluation would re-emerge. Contractionary monetary policy would be counterproductive, as it would raise the exchange rate

again. The only option left appears to be a tightening of fiscal policy. Calculations by NIESR suggest that a substantial fiscal tightening would be necessary to ensure that the exchange rate was sustainable upon entry into EMU in 2002.

The other major outsider faces a much less onerous choice. Sweden left the ERM soon after the UK, and experienced a larger subsequent devaluation. In late 1995 it appreciated a little against other currencies, and since then it has maintained an approximately stable exchange rate at around what appears to be a sustainable level. Sweden's exchange rate policy is based on making all the necessary preparations so that it can join the euro at a year's notice. This will require certain legislative measures, including increased independence for the Riksbank (due in 1999) and a stable exchange rate against the euro.

Exchange rate developments in the two northern outsiders will of course be subject to the vagaries of the market. Both countries have maintained inflation targets around the same as those set in Germany or to be set by the ECB. The effects of the targeting regime on the exchange rate depends, inter alia, upon the credibility of the Banks and the degree to which they will allow inflationary or deflationary shocks to affect the price level in the long run. If they accommodate inflation shocks, we cannot be certain where the exchange rate will end up, but if they do not, then the current rate may be a good indicator of the long-run rate. This would appear to be wise in the case of Sweden, but to be of limited value for the UK. The former country is at about its equilibrium exchange rate, and has the same inflation target as the ECB. Hence membership is sustainable. The UK has a more complicated choice to make.

4. Fiscal Policy

a. On the Consequences of the Stability Pact

In 1997, fiscal policy in the prospective EMU countries was struggling to keep the budget deficit within the 3 per cent limit set in the Maastricht Treaty. With the exception of Greece, all countries which wanted to participate succeeded. To accomplish this task, taxes and social security contributions were raised and expenditures were cut. However, several countries have adopted one-time measures, for example special taxes were levied and expenditures were postponed into 1998. In addition, most of the countries benefitted from the cyclical upswing and declining interest rates. In Italy and Belgium, the debt-to-GDP ratio declined but is still twice as high as the reference value in the Treaty. All this has created fears that the fiscal adjustment in the EMU member states will not be sustainable.

In order to avoid that large fiscal deficits in one country have negative externalities for other EMU countries, the member states have committed themselves to keep budget deficits within 3 per cent of GDP unless there are exceptional circumstances such as a severe recession. Furthermore, the Pact calls for a balanced budget or even a slight surplus in the medium term. The practical implication of the Pact is that in order to avoid fines in the case of a downturn the countries in a normal cyclical situation have to have a budget deficit that is well below 3 per cent. Otherwise there would be no room for the working of the automatic built-in-stabilizers. With the loss of monetary autonomy of member states, the importance of fiscal stabilizers has increased.

In the past, the individual countries have shown differences in the size of output variations, also the present position in the business cycle varies. In general, the actual and the structural deficits in 1997 were below 3 per cent (Table 9). In many countries, the structural primary balance was significantly positive, because of the restrictions implied by the Stability Pact. However, in most countries structural deficits were still significantly higher than would be sufficient to allow for a working of the automatic fiscal stabilizers in the case of a recession. As a consequence, further consolidation efforts are necessary in most of the countries.

Table 9 – Indicators of Fiscal Position in EU Countries, 1997

Per cent of GDP

	Public balance	Public debt	Structural primary balance[a]	Required primary public balance[b]
Austria	– 2.5	65.2	1.7	0.9
Belgium	– 2.1	122.4	6.5	2.4
Denmark	+ 0.4	61.8	3.2	0.8
Finland	– 1.0	55.8	1.1	0.0
France	– 3.0	57.7	1.5	0.9
Germany	– 2.6	61.3	1.4	1.0
Greece	– 4.0	108.4	6.3	2.2
Ireland	+ 0.9	65.3	3.0	1.3
Italy	– 2.7	121.6	5.9	2.2
Luxembourg	+ 1.7	6.7	1.9	0.1
Netherlands	– 1.4	71.4	3.0	0.9
Portugal	– 2.5	65.3	2.7	1.3
Spain	– 2.6	69.3	2.9	1.1
Sweden	– 0.4	76.9	2.9	0.4
UK	– 1.9	53.3	1.1	0.9

[a]Primary structural deficits as estimated by OECD. — [b]To stabilize the debt-to-GDP ratio. It is assumed that in the future the interest rate will be 2 percentage points above the average GDP growth.

Source: OECD, EBCA estimates.

Trying to reach balanced budgets as soon as possible is widely recognized as a pre-requisite for recapturing margins of manoeuvre in case of future slumps. However, in the long run, balanced budgets are not necessarily, from an economic point of view, the best of all worlds.

Although in many countries the debt-to-GDP ratio was above 60 per cent, the heads of state decided at their meeting in early May that the debt criterion was satisfied in all countries. According to the Maastricht Treaty, the reference is that "the ratio is sufficiently diminishing and approaching the reference value at a satisfactory speed". In their convergence reports the EMI and the central banks shared this view. However, with respect to the highly indebted countries Italy and Belgium with a debt to GDP ratio of approximately 120 per cent, there was some skepticism about the sustainability of the fiscal position. Without additional efforts, it would take about 15 to 20 years before the debt-to-GDP ratio is back to the target value of 60 per cent. In the meantime, the budgets of the two countries will be very sensitive to interest rate changes.

The risk that the high indebtedness will have negative consequences for the stability of the euro and for other countries is low. With an independent ECB it will not be possible to reduce the real value of long-term government liabilities through inflating the economy. Also, the effect on interest rate will be limited as both countries have relatively high savings. The "no-bail-out clause" in the Treaty stipulates that neither individual member states nor the community shall be liable for the commitments of other government bodies. Furthermore, it is in the interest of the countries themselves to reduce their debt ratio, this would not only lower the risk premium in the interest rate, lower interest payments would also give more scope for fiscal policy in general.

Judging the fiscal sustainability is a difficult task, particularly because all government liabilities should be taken into account, not only those explicit in the statistics. In almost all countries the population is ageing. In the future, state pension systems which operate on a pay-as-you-go basis will face huge additional outlays which cannot alone be financed through a reduction in benefits or an increase in contributions. Like the explicit debt, the implicit debt will therefore put a further strain on public finances. As a consequence, not only Belgium and Italy will have to take additional measures in order to further consolidate public budgets.

Box 3 – A Minority View on Policy Coordination in EMU (By NIESR and OFCE)

Fiscal and Monetary Policy in Europe

The economic debate over policy has contained two strands. Some economists advocate that the monetary and fiscal authorities should follow simple and transparent rules. These views stem from Milton Friedman in the 1950s, and he described them as advocating a 'monetary constitution' for the USA. At the same time other economists, such as James Meade, advocated a more discretion-based approach, where the authorities did not act in isolation and attempted to maximize welfare over time. At present the European institutions are following the current trend and moving toward a rule-based solution to policy setting. It is, however, generally recognized that Europe is in a completely new situation, and we should expect the authorities to proceed with caution. The original debate on rules and discretion had one fiscal and one monetary authority 'playing a game' to determine outcomes. The conduct of economic policy in EMU will raise some new problems as there will be 1 ECB and 11 fiscal authorities. The 'game' is much more complex, and its progress will have to be monitored carefully.

The Relationship between the ECB and National Governments

It cannot be denied that discordant monetary and fiscal policies may have harmful consequences, and they should be guarded against in political discussions. A Euro Council has been set up to facilitate the dialogue amongst the euro countries and between these countries and the ECB. Although the ECB is an independent body, it is not advisable that monetary policy should be conducted completely independently of the fiscal authorities, and dialogue within the Council should help to co-ordinate the actions of the authorities. They will have a difficult task in co-ordinating demand because a given level of demand may result from various policy-mix, so choices have to be made.

There are a number of situations to consider. A negative shock may simultaneously hit all countries of the area, and then monetary policy should help to sustain activity. However, the extent to which it may do so may depend upon the average fiscal stance, and some countries may take on more of the burden of adjustment than others. As a result we may see some 'free riders' who allow others to adjust whilst they do not. The Stability Pact does not give any prescription in that case.

The ECB will fix a single interest rate that will apply to 11 countries even when there are asymmetric developments. The average rate may not fit to the specific situation of the different countries, and hence the Euro-11 Council will have to play an important role to reconcile the objectives of differing European countries. If some countries are overheating then they should take appropriate fiscal action rather than ECB increase euro interest rates. In the reverse case a country hit by a specific negative shock will have to act alone with expansionary fiscal policy whilst respecting the constraints of the Stability Pact. Given the loss of monetary autonomy the member states will clearly have a greater need for counter-cyclical fiscal policy, and this will have to be carefully monitored by the Euro Council, who should not encourage aberrant behaviour. However, cohesive fiscal policy setting is not the only problem that a new Europe may face. We are in a new world with many uncertainties.

The setting of fiscal targets will have to fulfil three roles, and they may conflict, and hence there is a debate that must continue as the monetary and fiscal constitution of the new Europe is constructed. Fiscal policy must respect the Stability Pact, and it must also take account of the maintenance of optimal government finance in the long run. Finally, in our new world with harmonized monetary policy we see a need for more active counter-cyclical fiscal policy. All three objectives need to be transparent. There are few reasons why governments should borrow (or lend) except to finance investment, and prudence requires an acknowledgement of longer-term commitments to pensions and other expenditure. The Stability Pact sets sensible opening guidelines for the setting of fiscal policy as EMU is built, but as the years pass and the regime settles, we would expect there to be a discussion on sensible fiscal polices that is wider than the current discussion. It is best if such a discussion start now so that debt can be restrained to acceptable levels quickly.

Monetary Policy Targets

It is widely agreed that the ultimate target of monetary policy is price stability, but we are aware that the ECB will take account of other developments in the short run. Those who believe in rules often argue for the publication of relatively simple and transparent rules, where the interest rate would vary with inflation, output and unemployment. However, the ECB may choose to have a target for the money supply, and also take account of inflation developments in the short run. Clearly the ECB will act with caution. It appears that European-wide money demand is stable, but targeting it has not been tried before. We all know that money demand is subject to shocks that may only be due to portfolio reallocations resulting from financial innovations or from changes in taxation. These shocks may be more common in the transition phase after EMU is set up. The ECB should be cautious when setting money supply target as it may have to permanently modify them, and it should make it clear that its ultimate goal, price stability, will dominate its commitment to an uncertain intermediate target. It has to accept the uncertainties in the new situation.

b. On Tax Harmonization

The single market and the common currency could strengthen fiscal competition in Europe. Some countries could decide to lower tax rates to attract capital and qualified labour. Firms, workers, and the high-income earners have the opportunity to choose in which country they are going to pay taxes, while benefitting from public expenses in a more generous country. Such a fiscal competition may force nations to choose between cutting back on public spending, and taxation exclusively based on immobile factors (like real estate or unqualified workers). In face of this problem, three views can be presented.

According to the *decentralized approach*, the fact that a single currency exists for Europe and that monetary policy is now harmonized does not imply that fiscal harmonization is necessary as well. The choice of the appropriate system should be left to the individual countries and not be limited by a "European standard". In each country, there are — to a different degree — distortions in the tax and welfare benefit systems, which are an impediment for higher growth and higher employment. Successful strategies of reducing these distortions can be copied by other countries with a positive effect on growth and employment. Such a process of learning can therefore be productive for the individual countries and for Europe as a whole. This process would not be possible if there was a far-reaching harmonization of tax rates or tax systems. If tax systems were more or less the same, it would also be more difficult for countries with a relatively low income to catch up with richer countries. Tax competition would therefore be favourable for integration in Europe. *De facto* there has already been tax competition in Europe but the tax burden in most economies is nevertheless high. Also in the future, competition with respect to tax levels will not lead to a "race to the bottom". The government as well as the population in each country have an interest that public goods such as investment in infrastructure are provided at a scale which is supportive for economic growth. The introduction of social standards, unless they are set at the lowest possible level, would hamper the economic development of countries with a relatively low level of productivity. These countries with a relatively low living standard could not afford paying high social expenditures without having to accept lower economic growth and higher unemployment. In the European Monetary Union, it will and should be possible to have different levels of government expenditures, different tax systems as well as different social systems. They are the natural result of different preferences among the countries on the one hand and different levels of income and productivity on the other.

From a *federalist point of view*, an optimal tax system and a social security system should be settled at the European level to which countries would have to conform. Europe, as a relatively closed economy, could determine its social model. However, social, economic, and political integration have not reached a degree at which European peoples will accept taxation and social security be defined at a European level. The present differences in living standards do not permit a single social legislation: the poorer countries cannot be forced to adopt the living standards of the richest countries, in terms of wages or minimum income. In the long run (that is to say, roughly in 20 years), this question will be raised. A higher degree of labour mobility may force social legislation harmonization (for instance pension systems and unemployment benefits). If political union in Europe were to develop, common taxation and public spending would have to be settled to increase the European citizenship. Yet, such a requirement is only to appear in the future.

A more *pragmatic approach* can be a gradual harmonization. This process would try to preserve national sovereignty as much as possible at each step towards European unification, both on taxation and on spending policy, while coordinating taxation on the most mobile factors to avoid that tax payers individually choose taxation. According to this view optimal taxation cannot emerge from a market process, since when totally free, each tax payer behaves as a free rider. For instance, young people, educated in France, where education is free, and having received family allowances, may decide to

work in the United Kingdom, where taxes on labour are low, while their parents benefit from the French public retirement system. A German resident with savings in Luxembourg could keep on benefitting from public expenditures in Germany. The rich could escape any redistribution tax, even if assistance dedicated to the poorer has, socially speaking, to be considered in terms of social cohesion. National systems may be subject to competition, but this competition shall not be biased. Some would be satisfied if states were obliged to abandon public spending and redistribution. But this opinion may not be broadly shared in Europe. Following this approach, some guidelines could be proposed. Countries should remain sovereign as regards labour and real estate taxation; the use of tax havens should be kept under strict rules. Capital income taxation should be harmonized, either on the principle of declaration in the country of origin, or with minimal tax rates on non-resident savings. The European Union should promote tax reforms, like increasing ecotaxes while lowering employers' social contributions on low wages. The VAT system may remain unchanged as long as the differences in national tax rates do not lead to significant cross-country purchases. Taxes on profit should be harmonized (minimum rate, taxation on profits abroad); areas in difficulty could however be entitled to have a lower tax rate.

5. On Social Policy and Wage Setting in Europe

The introduction of the euro raises questions about the need for reform of national labour markets and social institutions. It removes one of the last remaining barriers to the mobility of capital, and hence changes the relative isolation of individual labour markets. In particular it raises questions about whether wages could be harmonized across Euroland, or at the very least should there be a co-ordination of wage bargaining and the emergence of Euroland bargaining institutions ?

a. Harmonizing Wages?

Wage rates differ substantially between the members of the euro area. These differences reflect varying levels of productivity and national income and differences between national institutions. If wage increases are harmonized but productivity is not then production will move between countries, and non-national multinationals will find it easier to move than most domestic firms.

In the service sector where wages are often more strongly related to national income than measures of physical productivity it is clear that less affluent countries pay their hairdressers and school teachers less than in wealthier countries. There would clearly be a great danger that if pay rates were forced up in lower-wage economies, a large fall in employment could be engendered. If there were a desire to raise wages in lower-productivity countries then the appropriate policy response would be to follow policies which raise productivity. These might include greater investment in education and training and perhaps incentives for physical investment. For the most part these would seem to be questions for national governments, although structural funds can help smaller and poorer countries adjust, much as they have in Ireland. It cannot be expected that productivity can be raised significantly in a short period of time.

However, national labour market and social institutions also matter in the determination of wages. They affect the level of wages, the flexibility of the labour market, and the speed of response to changes in the external environment. In the UK and the US, where institutions such as trade unions, minimum wages, and social security have been weakened in recent years, there has been a widening in earnings dispersion and a decline in the labour share of national income. Both economies show considerable labour mobility, with individuals moving between firms more frequently than they do in, say, France or Germany. This gives the US and the UK more flexibility to respond to developments that change the number and size of firms that can survive in an industry. However, in other countries where such institutions have

been maintained or enhanced we have not seen the same developments in the distribution of earnings. In addition, the continued existence of employment protection has meant that employment levels are potentially higher but that actual hours worked per person are lower and essentially more variable than they are in the UK, for instance. Other labour market institutions can also compensate for a lack of labour turnover, and these have meant that in Germany hours per person and real wages per person hour have varied more over the cycle than they have in the UK, giving the economy a different form of flexibility. Therefore, the question of harmonizing institutional practices, rather than wages, may be of greater interest.

b. Harmonizing Institutions and Common Standards

There are forces at work that may lead to the harmonization of some institutions in labour markets. The Social Chapter, for instance, requires some common approaches to non-wage labour costs and to social protection. It is, however, questionable as to whether it is practical to harmonize labour market and social institutions across Europe. Member states have evolved different institutional frameworks and practices to reflect national preferences and different cultural and historical traditions. These may be hard to change as they are not reflected in legislation and may not respond to it. Many countries have centralized bargaining systems covering almost all employees whilst other countries, most notably the UK, have adopted much more decentralized approaches to pay determination. Social safety nets, employment protection, and minimum wage provisions also vary considerably between countries. It is clearly not possible to harmonize such institutions in a short period of time but it would be possible to perhaps set some common standards and begin a process of gradual harmonization.

There would appear to be two different and apparently contradictory approaches to the question of whether this would be a desirable direction in which to go. One view would be that the single currency will require a greater degree of harmonization of wages and social institutions. The case for this is in some ways similar to the arguments put forward for the Social Chapter of the Maastricht Treaty, as a necessary counterbalance to the competitive pressures emerging from the creation of the Single European Market. It is argued that without common standards multinational employers, when bargaining with disparate national trade unions, may be able to drive down wages, as the threat of relocation becomes more realistic. However, there are clearly limits to the extent to which such a threat is realistic. Wage rates within the multinational will reflect different national productivity levels that depend upon the skills and capacities of the workforce and on the general infrastructural environment in which they work. However, the existence of the forces of relocation is one of the factors that will quickly help make changes in nominal wages move more coherently than they have done over the last decade. National institutions affect national wage levels, and in turn affect participation and unemployment levels, but they are not immutable.

For instance, it is sometimes suggested that countries may try to gain a competitive advantage within the monetary union by lowering wages and social benefits relative to other member states. Supporters of this view point to the Netherlands as an example of a country which has pursued such a strategy. Following the Wassenaar agreement in 1982, when Dutch employers and trade unions agreed to moderate pay increases in order to create more jobs, employment growth has been 1 per cent a year faster than in the rest of the EU. Over this period, whilst the ERM parity has been maintained, the real effective exchange rate in terms of unit labour costs has depreciated by 10 per cent. It is suggested that countries participating in the euro may decide to follow the Dutch route to competitive devaluation through lower wages. If monetary union and a single currency lead to the gradual breakdown of institutions that restrict choice within countries and concentrate the benefits of high productivity amongst specific "insider" groups, then it may have served a purpose in increasing welfare in the euro area.

The alternative view would be that greater labour market flexibility is essential if the single currency is to function effectively. Once the safety valve of national exchange rates has been removed and restrictions are placed on fiscal policy through the Stability Pact, national labour markets will need to function more effectively to ensure that unemployment is kept low. For example, if unit labour costs and prices grow more quickly in one country compared with the euro area, then this country may rapidly become uncompetitive as it faces an appreciation in its real exchange rate. Relocation of activity both within multinational firms and within industries will result, and the combination of the removal of barriers in the Single Market and the existence of a common currency will speed these processes up. We have already begun to see such forces at work in the automotive industry, and they will spread quickly.

There is clearly a danger for some countries at the start of EMU, such as Ireland, who are growing much more rapidly than other countries in the euro area. To the extent that this growth is driven by excess demand it will lead to a rise in prices and wages relative to those in the rest of Europe. Countries who find themselves in this position will need to demonstrate considerable flexibility in both labour and product markets if they are to avoid a long and painful period of high unemployment. With the considerable language and cultural barriers that exist within the EU it is unlikely that these problems will be solved by migration as has been seen within the US. Supporters of this view would argue that any attempt to harmonize wage bargaining within Europe is likely to restrict national labour market flexibility and may condemn some countries to protracted spells of high unemployment. Had common European institutions existed in the early 1980s, then it may not have been possible for the Netherlands to address its then very serious unemployment problem through a national agreement on wages and employment. Moreover, it is often argued that the introduction of the euro strengthens the case for deregulation of European labour markets and reform of social safety nets so that they do not create poverty traps.

It is clear from the above discussion that any attempt to bring about a convergence in labour market institutions must proceed with great caution. The framework of the Social Chapter provides a mechanism for providing a baseline of common standards for all member states. Also if European trade unions and employers wish to develop stronger international ties, then they will be free to do so. However, any attempt to harmonize wage rates across countries, not accompanied by a corresponding rise in productivity, should be resisted as this could jeopardize the employment position of workers in lower-wage economies. Also national bargaining systems should remain, and arguably develop further the ability to respond to local labour market conditions. Without this national flexibility, individual countries may be left with no policy remedy for rising unemployment. This could threaten the cohesiveness and ultimately the continuation of the monetary union.