OECD Economic Outlook

DECEMBER 1998

© OECD, 1998.
© Software: 1987-1996, Acrobat is a trademark of ADOBE.

All rights reserved. OECD grants you the right to use one copy of this Program for your personal use only. Unauthorised reproduction, lending, hiring, transmission or distribution of any data or software is prohibited. You must treat the Program and associated materials and any elements thereof like any other copyrighted material.

All requests should be made to:
Head of Publications Service,
OECD Publications Service,
2, rue André-Pascal, 75775 Paris
Cedex 16, France.

OECD ECONOMIC OUTLOOK

64

DECEMBER 1998

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The Organisation for Economic Co-operation and Development (OECD)

was set up under a Convention, signed in Paris on 14 December 1960, which provides that the OECD shall promote policies designed:

- *to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries while maintaining financial stability, and thus to contribute to the development of the world economy;*
- *to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and*
- *to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.*

The original Member countries of the OECD are: Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The following countries became Members subsequently through accession at the dates indicated hereafter: Japan (28 April 1964), Finland (28 January 1969), Australia (7 June 1971), New Zealand (29 May 1973), Mexico (18 May 1994), the Czech Republic (21 December 1995), Hungary (7 May 1996), Poland (22 November 1996) and Korea (12 December 1996). The Commission of the European Communities takes part in the work of the OECD (Article 13 of the OECD Convention).

The French version of the *OECD Economic Outlook* is entitled *Perspectives économiques de l'OCDE.*

The *OECD Economic Outlook* is published on the responsibility of the Secretary-General of the OECD. The assessment given of countries' prospects do not necessarily correspond to those of the national authorities concerned. The OECD Secretariat is the source of statistical material contained in tables and figures, except where other sources are explicitly cited.

Photo Credit:
Jean-Louis Batt/Pix

© OECD 1998

Permission to reproduce a portion of this work for non-commercial purposes or classroom use should be obtained through the Centre français d'exploitation du droit de copie (CFC), 20, rue des Grands-Augustins, 75006 Paris, France, Tel. (33-1) 44 07 47 70, Fax (33-1) 46 34 67 19, for every country except the United States. In the United States permission should be obtained through the Copyright Clearance Center, Customer Service, (508)750-8400, 222 Rosewood Drive, Danvers, MA 01923 USA, or CCC Online: http://www.copyright.com/. All other applications for permission to reproduce or translate all or part of this book should be made to OECD Publications, 2, rue André-Pascal, 75775 Paris Cedex 16, France.

FOREWORD

This edition of the *OECD Economic Outlook* analyses prospective economic developments in OECD countries over the coming two years and provides recommendations on the economic policies needed to ensure sustainable economic growth. In addition, this volume puts forth an alternative scenario assessing what might happen if a number of downside risks materialise. It also delves into improvements in the operations of international financial markets in light of the crisis in emerging market economies.

The detailed country notes provide an assessment of the economic situation and the outlook for each Member country and certain non-member countries. The policy assessments presented in this edition are based on a set of projections which were finalised on 4 November 1998 and published in a preliminary edition in mid-November. These projections reflect the broad lines of both the financial package agreed upon between the Brazilian authorities and the IMF on 13 November and the supplementary budget adopted in Japan on 16 November.

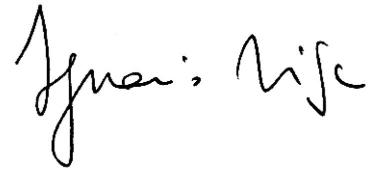
Beyond these issues a number of other themes are dealt with in more depth in three special chapters:

– *Challenges facing macroeconomic policies in European Economic and Monetary Union:* from 1 January 1999, the new European Central Bank will be responsible for the formulation of monetary policy for the new euro area. The fact that the euro area economy will be an entity consisting of eleven sovereign countries raises special issues with regard to the operational structure, monetary policy and communications strategy of the new bank. Euro-area governments will remain responsible for fiscal policy, but budgets will be constrained by the need to maintain sound public finances to underpin monetary union. This leads to issues of how much further consolidation will be required in order to leave budgets with adequate flexibility, and whether policies may need to be co-ordinated.

– *Recent stock market developments and implications:* the drops in equity market prices in the third quarter of this year stand out because of their size and their simultaneous occurrence in a majority of large OECD economies. Many of these markets have regained large parts of those declines and price levels appear high on a number of measures. This chapter discusses the nature of the third quarter drop and outlines some rough benchmarks for comparing current prices. It also provides some rough measure of the effects of equity price declines on OECD area activity.

– *Low-income dynamics in four OECD countries:* a surprisingly large proportion of the population faces low incomes at some point over a number of years. However, most stay poor for only a short time. The long-term poor tend to belong to groups with specific characteristics, such as single-parent families or

unemployed heads of household. Identifying the people at risk will help to target policies aimed at alleviating poverty. Improving the employment potential of these groups is one key to poverty exit. As a significant share of those on low incomes work, some form of work-conditional benefits could also help alleviate poverty.



Ignazio Visco

Head of Economics Department

TABLE OF CONTENTS

Editorial ix

I. General assessment of the macroeconomic situation 1

The global situation and outlook for the OECD area 1
Risks in a deteriorating global environment 9
Policy requirements in OECD countries 20
The role of financial liberalisation in the crisis in emerging markets 29
Appendix: Quantifying the downside risks 32

II. Developments in individual OECD countries 37

United States 37
Japan 42
Germany 48
France 53
Italy 57
United Kingdom 62
Canada 67

Australia 72
Austria 75
Belgium 77
Czech Republic 79
Denmark 81
Finland 83
Greece 85
Hungary 88
Iceland 90
Ireland 92
Korea 94
Luxembourg 97
Mexico 99
Netherlands 102
New Zealand 104
Norway 106
Poland 108
Portugal 111
Spain 113
Sweden 115
Switzerland 117
Turkey 120

III. Developments in selected non-member countries 123

Dynamic Asian Economies and China 123
Russia and Central and Eastern Europe 130
South America 133

IV. Challenges for monetary and fiscal policies in the euro area 137

V. Recent equity market developments and implications 163

VI. Low-income dynamics in four OECD countries 171

Annex 187

Country Classification 188
Weighting Scheme for Aggregate Measures 188
Annex Tables 189

Boxes

I.1. The implications of the millennium bug for the macroeconomic outlook 6
I.2. Policy and other assumptions underlying the projections 7
I.3. Strengthening the international financial system 10
I.4. Government plans for bank restructuring in Japan 14
I.5. The consequences of the 1998 fall in oil prices for some oil-producing countries 18
I.6. A downside scenario 19
I.7. A comprehensive data set for the euro area 26
III.1. Brazil's Programme for Fiscal Stability 136
IV.1. The decision-making structure of the ESCB 139
IV.2. Asymmetric shocks and shock absorbers in EMU 154
VI.1. Data issues and definitions 173

Tables

I.1. Output growth projections 1
I.2. World trade and payments summary 4
I.3. General government financial balances 7
I.4. Unemployment and inflation 8
I.5. Trade exposure of major OECD countries to emerging markets 11
I.6. Bank lending to emerging markets 13
I.7. Conditions in the banking sector and the effect of an equity price drop 15
I.8. Main features of a more pessimistic outlook 20
I.9. Recent fiscal packages in Japan 22
I.10. Downside scenario with unchanged real interest rates in Europe and the United States 34
I.11. Downside scenario with lower real interest rates in Europe and the United States 35
III.1. Projections for selected Asian economies 125
III.2. Projections for European Economies in transition 131
III.3. Developments in the Baltic states 132
III.4. Projections for selected South American countries 135
IV.1. Empirical assessments of the impact of monetary policy on output in various European countries 144
IV.2. Financial position of the private sector in selected euro area countries 145
IV.3. Transparency of central banks 147
IV.4. Fiscal targets in EU countries 150
IV.5. "Tax gaps" needed to achieve alternative fiscal targets over the period 1998-2030 151
IV.6. Sources of budget consolidation in EU countries in the 1990s 152
IV.7. Effects of automatic stabilizers 156
V.1. Some stylised facts in G-7 equity markets 166
V.2. Evaluations of current dividend yields 167
V.3. Macroeconomic effects of an equity market correction 168
VI.1. Time spent in low income over a six-year period 176

VI.2. Low-income dynamics: "hazard rates" 177
VI.3. Characteristics of individuals above and below the low-income threshold 179
VI.4. Frequency of "events" associated with low-income transitions 182
VI.5. Changes in probability of entry and exit when an "event" occurs 183

Figures

I.1. Some economic indicators reflecting the crisis in emerging markets 3
I.2. Increasing risk aversion in financial markets 17
1.3. Money supply growth in Japan 23
I.4. United States: yield curve and future growth 24
1.5. Private sector leverage ratios in Asian crisis countries 30
III.1. Financial market reactions in selected non-OECD contries 128
V.1. Implied volatility of stock prices 165
VI.1. The share of the population on low income 175

Conventional signs

$	US dollar	.	Decimal point
c	US cent	I, II	Calendar half-years
£	Pound sterling	Q1, Q4	Calendar quarters
mbd	Millions barrels per day	Billion	Thousand million
. .	Data not available	Trillion	Thousand billion
0	Nil or negligible	s.a.a.r.	Seasonally adjusted at annual rates
–	Irrelevant	n.s.a.	Not seasonally adjusted

Summary of projections[a]

Seasonally adjusted at annual rates

	1998	1999	2000	1998 I	1998 II	1999 I	1999 II	2000 I	2000 II
				Percentage changes from previous period					
Real total domestic demand									
United States	4.9	2.0	2.2	5.8	3.5	1.3	1.9	2.2	2.4
Japan	–3.3	–0.1	0.6	–4.3	–1.6	0.5	0.5	0.6	0.8
Germany	2.6	2.1	2.4	4.6	0.9	2.5	2.8	2.1	2.6
European Union	3.3	2.5	2.6	4.2	2.3	2.6	2.7	2.6	2.7
Total OECD	2.4	2.0	2.5	2.7	1.7	2.0	2.4	2.5	2.6
Real GDP									
United States	3.5	1.5	2.2	4.0	2.2	0.9	1.9	2.2	2.4
Japan	–2.6	0.2	0.7	–3.8	–1.3	0.6	0.6	0.7	0.8
Germany	2.7	2.2	2.5	3.6	1.4	2.2	2.9	2.2	2.7
European Union	2.8	2.2	2.5	3.0	2.3	2.1	2.4	2.5	2.7
Total OECD	2.2	1.7	2.3	2.1	1.6	1.6	2.1	2.3	2.5
				Per cent					
Inflation[b]									
United States	1.0	1.2	1.8	0.9	0.9	1.1	1.7	1.9	1.9
Japan	0.7	–0.4	–0.5	1.1	–0.3	–0.2	–0.8	–0.3	–0.6
Germany	1.1	1.3	1.4	1.4	1.3	1.3	1.3	1.4	1.4
European Union	1.8	1.8	1.8	1.6	1.9	1.8	1.8	1.8	1.8
Total OECD *less* high inflation countries[c]	1.3	1.3	1.5	1.3	1.2	1.3	1.4	1.5	1.5
Total OECD	3.3	2.6	2.4	3.5	2.8	2.5	2.4	2.4	2.3
				Per cent of labour force					
Unemployment									
United States	4.6	5.0	5.4	4.5	4.6	4.9	5.2	5.4	5.5
Japan	4.2	4.6	4.9	4.0	4.4	4.6	4.7	4.8	4.9
Germany	11.2	10.8	10.3	11.5	11.0	10.9	10.8	10.5	10.2
European Union	10.6	10.3	10.1	10.7	10.4	10.4	10.3	10.2	10.0
Total OECD	7.1	7.3	7.3	7.1	7.2	7.3	7.3	7.3	7.3
				Per cent of GDP					
Current balances									
United States	–2.7	–3.1	–3.1	–2.5	–2.9	–3.1	–3.1	–3.1	–3.1
Japan	3.2	3.3	3.6	3.0	3.4	3.2	3.4	3.6	3.7
Germany	0.4	0.7	0.9	–0.3	1.0	0.7	0.8	0.9	0.9
European Union	1.4	1.3	1.3	1.2	1.6	1.3	1.3	1.3	1.3
Total OECD	0.0	–0.1	–0.1	0.0	0.1	–0.1	–0.1	–0.1	–0.1
				Per cent					
Short-term interest rates[d]									
United States	4.7	3.8	4.0	5.0	4.3	3.8	3.8	4.0	4.0
Japan	0.7	0.5	0.5	0.8	0.6	0.5	0.5	0.5	0.5
Euro area	3.9	3.0	3.1	4.1	3.7	3.1	2.9	3.0	3.2
				Percentage changes from previous period					
World trade[e]	4.6	5.3	6.1	2.5	3.5	5.8	6.1	6.1	6.0

a) Assumptions underlying the projections include:
– no change in actual and announced fiscal policies,
– unchanged exchange rates from 27 October 1998; in particular $1 = Y 119.25 and DM 1.66;
– the cut-off date for other information used in the compilation of the projections was 4 November 1998.

b) GDP deflator, percentage changes from previous period.

c) High inflation countries are defined as countries which have had, on average, 10 per cent or more inflation in terms of the GDP deflator during the 1990s on the basis of historical data. Consequently, the Czech Republic, Greece, Hungary, Mexico, Poland and Turkey are excluded from the aggregate.

d) United States: 3-month Treasury bills; Japan: 3 month CD; Euro area: 3-month interbank rates.

e) Growth rate of the arithmetic average of world import volumes and world export volumes.

EDITORIAL

Some calm has recently returned to international financial markets following eighteen months of sharp, and widening, turbulence. Actions taken by authorities in several countries since the middle of the year have contributed to this abatement of tensions. If calm in financial markets persists, the outlook is for a further slowdown in the OECD area as a whole in 1999 followed by a moderate rebound in 2000. However, there are downside risks and further policy actions may be necessary to ensure a satisfactory outcome.

Until the middle of the year, economic developments remained rather favourable in North America and Europe, despite financial turbulence in emerging market economies. By September, however, it became increasingly evident that financial turmoil was also adversely affecting OECD countries' financial markets, especially following the financial collapse in Russia, with significant falls in equity markets, a widening of spreads between corporate and government bonds in some OECD countries, and trading losses by some large investment funds. At the same time, indications that the economic situation in Japan was deteriorating and that banking sector problems were not improving added to market uncertainty. Finally, the US dollar started to depreciate *vis-à-vis* other major currencies.

These developments led to a change in perception about the balance of risks affecting future economic prospects in OECD countries. In particular, fears emerged that a possible credit crunch and negative wealth effects might affect private investment and consumption in the United States. There was also increasing evidence that financial market disorder was adversely affecting confidence in many OECD countries. As well, there were marked risks of further turbulence, with many focused on Brazil. These concerns have led authorities in several countries to take a number of actions over the past two months:

- Monetary policy has been eased in the United States and the United Kingdom. On three occasions since early September the Federal Reserve cut the federal funds rate by 25 basis points while the Bank of England reduced its official interest rate twice by a total of 75 basis points since early October.
- Central banks in a number of countries set to participate in the European Economic and Monetary Union on 1 January 1999 also decided to significantly reduce their interest rates, implying that the convergence of interest rates will now occur towards the lower levels prevailing in the region.
- In Japan, a broad agreement was achieved in the Diet to revitalise the financial system. The new legislation includes important measures to deal with financial sector problems. To support this, the Government has made an unprecedentedly large sum of public funds available to recapitalize the banking system, amounting overall to around Y 60 trillion, or about 12 per cent of GDP.
- In Brazil, the Government announced an ambitious programme to restore its budget and current account positions and a financial package involving about $40 billion to help protect the exchange rate has been agreed with the IMF.

- In late October, the Leaders of the countries of the Group of Seven formally endorsed the specific reforms announced by their Finance Ministers and Central Bank Governors to strengthen the international financial system.

Following these actions financial market turbulence has tended to calm: financial tensions appear to have abated in emerging market economies while equity markets in most OECD countries have rebounded significantly. Under the assumption that the situation in financial markets stabilises, the OECD now projects a slowdown in real GDP growth for the OECD area, from above 3 per cent in 1997 to about 21/4 per cent in 1998 and then to 13/4 per cent in 1999, before a recovery to around 21/4 per cent in 2000. This reflects different economic situations across the major OECD regions:

- In Japan, strong deflationary forces are expected to continue acting on the economy. As a result, even taking into account the effects of the fiscal packages announced in April and November and assuming that rapid progress is achieved in solving financial sector problems, output is expected only to edge up in 1999 and a very mild recovery is projected for the year 2000.
- In the United States, the economy is projected to slow to below potential growth over the next two years, reflecting lower business profit expectations, the widening in credit spreads and the stabilisation, if not a reversal, of equity prices. Nonetheless, the level of capacity utilisation should remain high in 2000.
- In the euro area, real activity is also expected to decelerate somewhat, although growth should remain around potential in both 1999 and 2000, reflecting the continued momentum for recovery in domestic demand, and especially consumption.

In most emerging market economies, the outlook is for continued weakness. Adjustment processes currently underway in the five Asian countries most severely hit by the crisis are likely to persist through much of 1999, and given the degree of economic integration, spillover effects will significantly reduce growth prospects in other economies in the region. A slowdown is also expected in South America, in part reflecting tighter fiscal and monetary policies in response to the crisis, while prospects for stabilisation in the short run appear bleak in Russia.

Notwithstanding recent policy moves, there remains substantial uncertainty as to how a number of announced measures will effectively be implemented and to what extent they will affect world economic prospects. Overall, while the probability of a generalised recession may have diminished, a number of the downside risks to the outlook are still present. Against this background, policy makers of OECD, as well as non-OECD, countries need to take actions that minimise the likelihood of a global downturn:

- In general terms, it will be important that OECD countries do not resort to protectionist measures as a means to counteract negative cyclical developments. Recourse to anti-dumping actions has risen markedly over the past two decades in both the United States and the European Union and this behaviour appears to have been increasingly related to macroeconomic conditions. Given the external adjustments which must take place, OECD markets need to remain open to exports of emerging countries affected by the crisis and any adverse consequences for trade positions must be accepted.
- In Japan, resolution of domestic banking-sector problems is essential to heading off the risk of global recession. The highest priority should therefore be rapid implementation of the plans aimed at restructuring the banking system that have received agreement in the Diet. Fast resolution of the financial sector problems is key to improving business and consumer confidence in the short run. Flanking this, it is important that fiscal support to demand not be withdrawn prematurely;

the supplementary budget announced at the time of writing is reassuring in this regard. Faster progress in other structural areas is also needed to improve economic performance, which is all the more important as in the longer run action will be necessary to ensure that government debt returns to a sustainable path.

- In the United States and in the euro area, monetary policy should remain biased towards easing, as inflation risks have been considerably reduced or become non-existent. On the other hand, on present projections there is no case for an activist fiscal policy, as there is still a need to reduce public debt to levels sustainable over the longer term. However, in the event of a rapidly deteriorating environment, monetary authorities in both regions should stand ready to act promptly and if recession looms, the United States and a few other countries would have some room to take fiscal action; in any case, automatic stabilisers should be allowed to work.
- Authorities in emerging market economies need to take policy measures to contain the vulnerability of these countries to contagion risks and to set the stage for sustained recoveries. In emerging Asian economies, the most critical task is to restore quickly the viability of the financial and corporate sectors. In most countries in South America, and in Brazil in particular, the strong commitment to address underlying fiscal and current account sustainability problems needs to be demonstrated. In Russia, the achievement of sustained growth will not be achieved without developing institutions which strengthen the rule of law, public governance and civil society.

17 November 1998

I. GENERAL ASSESSMENT OF THE MACROECONOMIC SITUATION

The global situation and outlook for the OECD area

Financial turbulence has intensified and spread

The financial turbulence in emerging markets has intensified since the summer and has now, in varying degrees, affected most OECD countries. Although financial conditions in the Asian countries experiencing the most severe pressure appeared to stabilize during the early months of 1998, underlying economic conditions did not improve and the situation has continued to deteriorate.[1] At the same time, Russia has suffered a serious crisis and several Latin American countries have been affected by contagion. In this environment, nervousness and uncertainty in financial markets in OECD countries have been reflected in volatile equity prices and, especially in the United States, sharply increased spreads in credit markets. The balance of risks in OECD countries in Europe and North America, where economic conditions have generally remained good, has shifted appreciably toward the down side. In Japan the economy has continued to weaken sharply.

Most OECD economies outside Asia have performed well until now…

For the OECD area as a whole, the result has been a slowdown in growth from just over 3 per cent in 1997 to an estimated 2¹/₄ per cent in 1998 (Table I.1), mainly reflecting developments in Japan and Korea. Taking account of the crisis outside the OECD area, the slowdown in world output has been rather sharper, from 4 per cent to 2 per cent. Most OECD economies outside Asia have performed well until now, although there has been considerable variation in cyclical conditions across countries. The level of activity in the United States and the United Kingdom remains high but expansions

Table I.1. **Output growth projections**

Percentage increase in real GDP over previous period

		Current projection			Revisions since March 1998[a]		
	1997	**1998**	**1999**	**2000**	**1998**	**1999**	**Cumulative revision 1998-99**
United States	3.9	3.5	1.5	2.2	0.8	–0.6	0.2
Japan	0.8	–2.6	0.2	0.7	–2.3	–1.1	–3.4
European Union	2.7	2.8	2.2	2.5	0.1	–0.6	–0.5
OECD	3.2	2.2	1.7	2.3	–0.2	–0.8	–1.0
Memorandum items:							
Non-OECD area[b]	5.0	1.7	2.5	3.8	–	–	–
World[b]	4.0	2.0	2.1	2.9	–	–	–

a) See *OECD Economic Outlook 63*, June 1998.
b) Constructed from OECD, IMF and World Bank projections for non-OECD regions, using 1997 GDP weights in world GDP based on 1997 purchasing power parities.

1. For a discussion, see Chapter III, "Developments in Selected Non-Member Countries", and the note on Korea in Chapter II, "Developments in Individual OECD Countries".

there are clearly past their cyclical peaks and signs of slowdowns which could prove to be abrupt have begun to emerge. In the euro area,[2] the expansion has been robust during 1998, although it may be starting to mature. While most other OECD countries have been negatively affected to varying degrees by the Asia crisis, activity has so far remained relatively buoyant except in the Czech Republic and New Zealand.

… but financial turmoil is having an effect

The crisis in emerging markets and the associated financial turmoil are affecting OECD countries through different channels (see Figure I.1):

– A negative impact on trade arising as the counterpart to adjustments in crisis countries has been visible in Europe and the United States.
– Lower oil and commodity prices, to a large extent generated by weaker demand in Asia, have contributed favourably to the terms of trade in most OECD countries. However, they are negatively affecting countries (including some OECD Members) where oil or primary products are important sources of export revenue, and in some cases (notably Russia) have contributed to the spread of the crisis.
– A redirection of global financial flows away from emerging markets has led to sharply lower long-term interest rates in many countries. Throughout much of 1998, this has been a powerful compensating positive force in the countries benefiting from it. However, since July, the flight to quality has become more selective and increasingly focused on sovereign debt.
– Confidence in many countries has begun to be adversely influenced by the extent and duration of crisis, as well as the diminishing prospects for any early turnaround.

World trade has slowed sharply

The direct trade impact has been apparent since the early part of this year, both in the geographical breakdown of the trade statistics and in financial reports of enterprises whose businesses have substantial exposure to Asian markets. It is reflected in a contraction of exports from the OECD area to non-OECD countries, a major factor contributing to the sharp slowdown in world trade (Table I.2) which occurred abruptly during early 1998. Given the continuing liquidity squeeze affecting emerging markets, an early recovery of exports to these countries will remain relatively weak. However, at least some recovery will probably occur and growth of world trade is projected to be slightly faster during the coming two years than in 1998.

Oil and commodity prices will remain low

Oil and commodity prices have weakened substantially since the outbreak of the Asia crisis, helping to sustain low inflation throughout nearly all of the OECD area and bolster purchasing power of consumers. Though oil prices are above their low point for the year, they are still down by 30 per cent compared with their 1997 average; they are expected to rise gradually over the projection period.

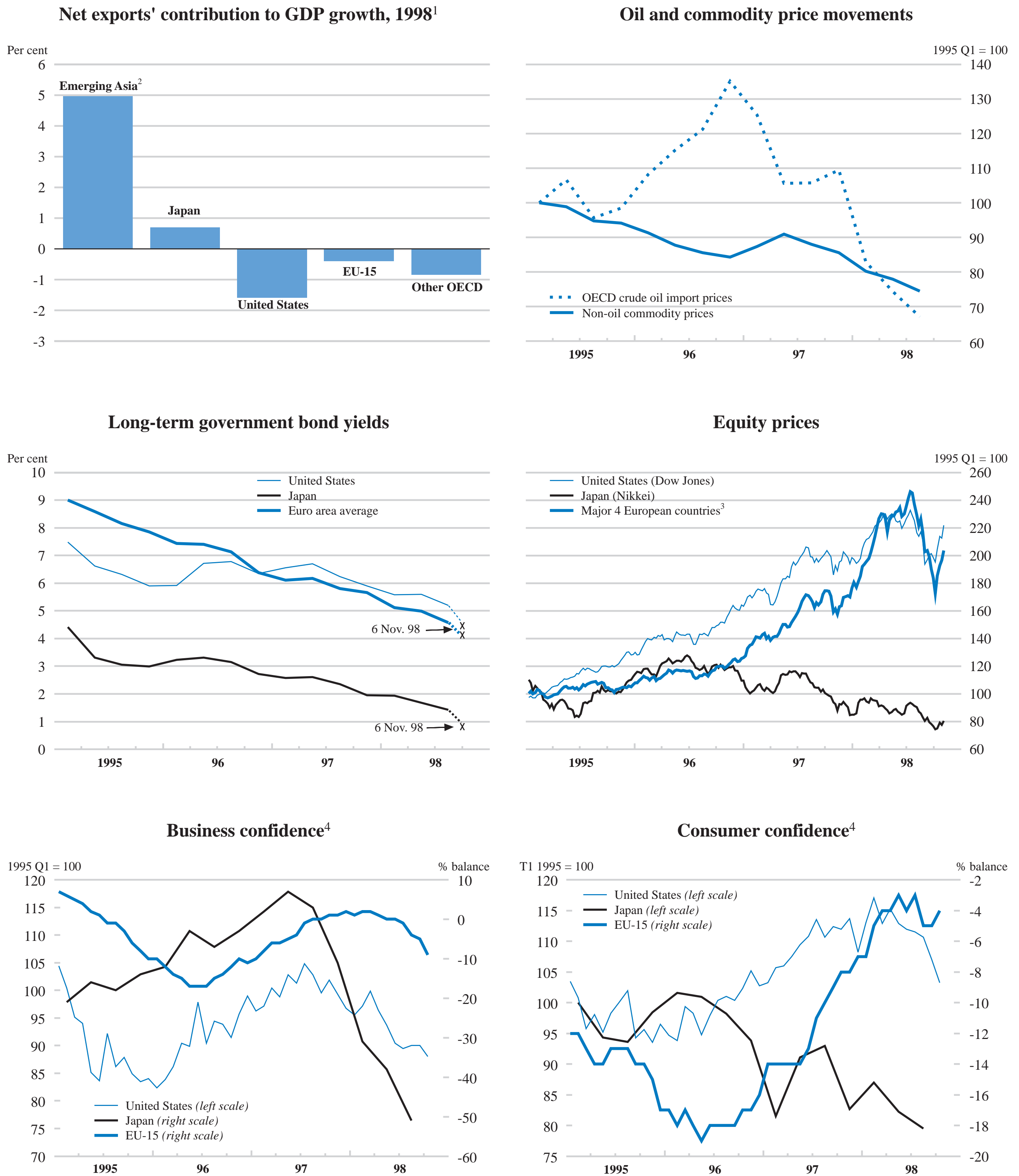
Long-term interest rates have fallen…

The redirection of financial flows has been strikingly apparent in the United States and Europe. Long-term interest rates both in the United States and Europe have declined significantly since the Asia crisis began to unfold (see Figure I.1). Falling bond yields in these regions were accompanied by rising equity prices until the recent correction which occurred between mid-July and early October; the dollar and most European exchange rates have been firm throughout the year, although the dollar has now fallen by around 6½ per cent in effective terms from its August peak as the monetary easing

---

2. "Euro area" refers to the eleven countries that will participate in European Economic and Monetary Union as from 1 January 1999: Germany, France, Italy, Austria, Belgium, Finland, Ireland, Luxembourg, Netherlands, Portugal and Spain.

Figure I.1. Some economic indicators reflecting the crisis in emerging markets



1. As a percentage of GDP in the previous period.
2. Includes China; Chinese Taipei; Hong Kong, China; Indonesia; Korea; Malaysia; Philippines; Singapore and Thailand.
3. Simple average of the German Dax, French CAC 40, Italian Mibtel and British FTSE 100.
4. Data from *OECD Main Economic Indicators* for the United States and Japan, and Eurostat, *European Economy* for EU-15.

Table I.2. **World trade and payments summary**

	1997	1998	1999	2000
	Percentage changes from previous period			
Merchandise trade volume				
World trade[a]	9.8	4.6	5.3	6.1
of which: Manufactures	11.4	5.1	5.5	6.2
OECD exports	11.3	5.1	4.8	6.0
OECD imports	9.9	6.9	6.2	6.4
Non-OECD exports	7.6	3.8	6.3	6.0
Non-OECD imports	7.7	–2.1	3.2	5.3
Memorandum items:				
Intra-OECD trade[b]	11.6	7.4	5.5	6.4
OECD exports to non-OECD	7.0	–2.2	4.0	5.2
OECD imports from non-OECD	7.5	4.1	6.5	5.7
Trade prices[c]				
OECD exports	0.7	0.6	0.1	1.1
OECD imports	1.4	–1.1	–0.4	1.0
OECD terms of trade with rest of the world	–1.2	3.9	1.3	–0.2
Current account balances				
	Per cent of GDP			
United States	–1.9	–2.7	–3.1	–3.1
European Union	1.4	1.4	1.3	1.3
Japan	2.3	3.2	3.3	3.6
Korea	–1.7	12.5	9.9	6.1
	$ billion			
United States	–155.2	–228.6	–271.9	–281.0
European Union	117.1	115.2	119.5	120.4
Japan	94.5	121.1	138.7	150.8
Korea	–8.2	37.6	32.3	21.3
4 non-OECD Asia crisis countries[d]	–16.5	28.5	32.3	27.4

a) Growth rates of the arithmetic average of world import volumes and world export volumes.
b) Arithmetic average of the intra-OECD import and export volumes implied by the total OECD trade volumes and the estimated trade flows between the OECD and the non-OECD areas. Data are based on the 1994 structure of trade values, deflated by total OECD export prices.
c) Average unit values in local currency.
d) Indonesia, Malaysia, Philippines and Thailand.

which has now taken place appeared increasingly likely; and exchange rate tensions among euro area currencies have generally been absent.

The rest of the OECD area has benefited much less from the flight to quality. Given the poor economic situation and the banking sector problems in Japan, long-term government bond yields there have fallen to extremely low levels. But both equity prices and the yen have faced recurrent downward pressure, although the yen has strengthened sharply since August. In countries where oil or other primary products are important sources of income or of export revenues, exchange rates have been weak. In Canada, this has at times contributed to upward pressure on interest rates and a premium over comparable US rates has re-emerged, following a sustained period in which Canadian yields were below their US counterparts.

… but investors have become more risk averse…

After July, the flight to quality became considerably more selective as financial market participants displayed increasing risk aversion and a strong premium on liquidity emerged. "Prime quality" borrowers (usually governments) have continued to benefit from low yields. However, risk premia in other segments of the market have risen in recent months and raising new money in capital markets has generally been difficult.

In equity markets, prices fell sharply in all OECD economies in late August and September, reflecting a deteriorating outlook for profits, growing fears in Europe and North America that these regions may not continue to be as insulated from the crisis in emerging markets as they have been to date, and deepening recession in Japan. Since early October, as monetary policy has been eased in many countries, including the United States, there has been some reversal of these developments. Equity prices have recovered substantially and capital markets have re-opened to new issues, although mainly to those of above average quality. But conditions in financial markets remain tighter than they were during the first half of 1998.

… and confidence may be fragile

Forward-looking business and consumer surveys suggest that global turmoil has impacted on confidence in North America and Europe. If this continues, some retrenchment in domestic spending could add to the direct trade impact in slowing area-wide economic growth. In the United States business confidence had already peaked before the end of 1997 but it is only since the second quarter that consumer confidence has started to decline. In Europe, a similar pattern can be observed. Mainly reflecting a deterioration of export prospects, business confidence began to weaken during the early part of 1998 and has fallen sharply more recently, although consumer confidence has remained fairly buoyant.

Central projections assume no deterioration in crisis countries and progress resolving Japanese banking problems…

The global environment is more uncertain at this stage than usual and many of the risks to the outlook are interdependent and operate on the down side. The central projections reported in this issue of *OECD Economic Outlook* are based on the assumptions that:

– economic conditions in the countries most severely affected by the crisis remain difficult but do not take a serious turn for the worse;
– visible progress in resolving Japanese banking problems takes place; and
– the “millennium bug”, *i.e.* a potential inability of computers to read dates after the beginning of the year 2000, will not seriously disrupt activity economy-wide (see Box I.1).

These projections are judged to describe the most likely scenario, conditional in the usual way on assumptions about fiscal and monetary policies and exchange rates (see Box I.2), but many of the downside risks could interact in ways that reinforce each other and lead to a substantially different – and more negative – outcome. These are considered in the next section, and the broad outlines of a more pessimistic alternative scenario are reported there.

… low interest rates in the main OECD regions…

The recent reductions in the federal funds rate in the United States are incorporated in the projections and, given the absence of inflation pressures, two further 25 basis point reductions are assumed by mid-1999. The Federal Reserve is assumed to keep it steady thereafter. In the euro area, money market rates are assumed to converge at current German levels. This implies a reduction in these rates, on average for the area, before the European Central Bank takes over responsibility for monetary policy on 1 January 1999. These rates are assumed to decline somewhat during the first half of 1999 and to stabilize for the rest of the year before edging up slightly during 2000 as the expansion in the euro area strengthens again. In Japan, short-term interest rates should remain low throughout the projection period.

… and fiscal stimulus in Japan

Fiscal policy is not expected to be a major factor affecting the outlook, although Japan (where it is stimulative) is an important exception in this regard. In terms of the overall OECD general government balance, slower economic activity will contribute

Box I.1. **The implications of the millennium bug for the macroeconomic outlook**

Many computers and other date dependent systems (communication networks, industry control systems, consumer electronic devices and safety systems) are programmed to identify years by a two-digit code and may recognise 00 as the year 1900, instead of the year 2000. This possibility has led to very costly investments of financial and human resources by business and governments to avoid disruptions that could range from temporary and isolated to severe and widespread.[1] No one really knows what might be involved, but worst case scenarios are thought to include generalised utility failures, financial crashes, bank runs, shut-down of hospital life-support systems, and world recession. The range $300-$600 billion is perhaps the most widely quoted figure for the world-wide cost of dealing with the problem before the millennium, while worst case scenarios for the years after 2000 suggest a 70 per cent chance of a serious global recession.[2]

The macroeconomic consequences of the millennium bug may be far smaller than many of these estimates would suggest, and no explicit account is taken of them in the projections. For most organisations, the expenditures prior to the year 2000 to prevent failures largely fall into three categories: the allocation to this problem of existing resources devoted to computer service support while other projects are delayed; new investments to replace existing hardware or software that would be too expensive or impossible to fix; and the cost of additional information technology support hired from outside. The bulk of expenditures falls into the first of these categories, which involves little of macroeconomic consequence beyond productivity losses due to the deferral of other work. Given that the work deferred will usually be that whose priority is lowest, and that new investments to replace systems being scrapped will accelerate modernisation, the overall productivity losses should be small and short-lived.[3] Expenditures on new investment and outside computer service personnel clearly add to aggregate demand in the economy – demand for specialised information technology personnel is rising fast and so are salaries in the sector – but there is no need to take explicit account of this to assess overall macroeconomic trends. To the extent that it is large enough to have a macroeconomic effect, then at this stage it is probably already affecting standard indicators of wage and salary behaviour, employment changes and investment intention surveys. These are all taken into account in the assessment of the macroeconomic situation reported here and are reflected in the projections.

For 2000 and beyond, the uncertainty surrounding possible scenarios involving widespread failures to prevent problems precludes any meaningful estimates of possible costs. Provided that there is a continuing acceleration of the substantial efforts now under way to ensure that systems are ready to cope and that awareness of the problem continues to increase, a scenario in which most problems are successfully addressed before 2000 and that such failures as occur have little or no macroeconomic impact is probably more likely than any other single outcome. It is therefore implicitly assumed in the projections reported here. Given that where the problems are most serious, incentives to deal with them before failures occur are high, and that the real time test which the millennium involves will quickly make remaining problems transparent so that they can be addressed quickly, there is at least some basis for this rather sanguine assumption. Furthermore, past experience suggests that people are resilient and adapt well to serious disruptions in ways that minimise overall macroeconomic effects. A seven-month closure of clearing banks in Ireland in 1970, for example, resulted in a major disturbance to the payments system but had very little effect on overall spending or activity; similarly, a three-day working week during the winter of 1974 in the United Kingdom, imposed due to power restrictions during a coal miners' strike, was disruptive but any overall macroeconomic effects are difficult to identify. More recently, major power disruptions in Auckland, New Zealand, and Quebec, Canada, have caused dislocation and, in Quebec, considerable damage, but have had few macroeconomic implications.

1. See OECD, "The Year 2000 Problem: Impacts and Actions", 1998, for a review of economy-wide and sectoral impacts of the year 2000 problem and the role and actions of governments (available on Internet site *http://www.oecd.org/puma/ gvrnance/it/y2k.htm*).
2. An estimated $300 billion would be the equivalent of around 1 per cent of 1998 world GDP. See Gartner Group, *World-wide and Industry Readiness*, 1998; and Yardeni, E. "Could Y2K Cause a Global Recession?", *Fortune*, 12 October 1998.
3. Edward Kelley, member of the Board of Governors of the Federal Reserve reported an estimated output loss of 0.1 per cent per year over the next two years for the United States; also for the United States, DRI's Standard & Poor's estimated a 0.3 per cent loss of GDP in 1999 and 0.5 per cent in the two following years; Oxford Economic Forecasting estimated around 0.3 per cent per year loss of GDP for the United States, Japan, Germany and the United Kingdom.

to a moderate worsening by about $1/2$ percentage point in 1999 and no further change is projected for 2000 (Table I.3). In underlying structural terms, the OECD general government balance will not change much during 1999 and 2000, as fiscal expansion in Japan and some decline in the surplus in the United States nearly offset continuing fiscal consolidation in the European Union.

Box I.2. **Policy and other assumptions underlying the projections**

Fiscal policy assumptions are based on measures and stated policy intentions, where these are embodied in well-defined programmes. Details of assumptions for individual countries are provided in the corresponding country notes in Chapter II "Developments in Individual OECD Countries". Generally speaking, the outlook is for fiscal stances, as measured by structural budget balances, to be mildly restrictive during 1998 and to change relatively little in 1999 and 2000. An exception is Japan, where fiscal policy is expansionary. Policy-controlled interest rates are assumed to be set in line with the stated objectives of the national authorities with respect to inflation (and, in some cases, to supporting activity) or exchange rates. In the case of the United Sates, for which the two recent cuts in the federal funds rate are incorporated in the projections, this is interpreted to imply that policy determined interest rates will decline by another 50 basis points during the first half of 1999, while in Japan short-term interest rates should remain very low. European Economic and Monetary Union (EMU) will proceed from 1 January 1999 with eleven participating countries, leading to the elimination of differentials between comparable short-term interest rates across participating countries[1] and of exchange rate related risk premia in long-term interest rates. Short-term interest rates in the euro area are assumed to converge towards the German rate. The European Central Bank is assumed to lower short-term interest rates twice in the course of 1999, from 3½ to 3 per cent, before raising them again somewhat in 2000.

The projections assume unchanged exchange rates from those prevailing on 27 October 1998; in particular, one US dollar equals ¥ 119 and DM 1.66. The fixed exchange rate assumption is modified for Hungary, Poland and Turkey to allow for continuous depreciation, reflecting the OECD interpretation of "official" exchange rate policies.

The dollar price of OECD oil imports (cif) is estimated to average $13.00 per barrel in the second half of 1998, and is projected to rise somewhat thereafter to average $13.75 per barrel in 1999. Non-oil commodity prices are estimated to decline by nearly 11 per cent in dollar terms in the second half of 1998 and they are projected fo futher decline by 2¾ per cent on average in 1999. They are projected subsequently to move in line with OECD manufactured export prices.

The cut-off date for information used in the projections was 4 November 1998.

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

Table I.3. **General government financial balances**[a]

Per cent of GDP

	1996	1997	1998	1999	2000
United States					
Actual balance	–0.9	0.4	1.6	0.8	0.6
Structural balance	–0.9	–0.1	0.8	0.4	0.5
Japan					
Actual balance	–4.3	–3.3	–6.1[b]	–7.8	–8.3
Structural balance	–4.2	–3.0	–4.1[b]	–5.4	–5.7
European Union[c]					
Actual balance	–4.3	–2.4	–1.9	–1.7	–1.4
Structural balance	–3.4	–1.6	–1.4	–1.1	–0.9
OECD[c]					
Actual balance	–2.6	–1.1	–1.0	–1.5	–1.5
Structural balance	–2.4	–1.1	–0.8	–1.0	–1.0

a) Actual balances are per cent of nominal GDP and structural balances are per cent of potential GDP.
b) Excludes the budgetary impact of the debt take-over of Japan National Railways Settlement Corporation and National Forest Special Account (5.4 percentage points of GDP).
c) European Union figures exclude Luxembourg. Total OECD figures for the actual balance exclude, in addition, Mexico, Switzerland and Turkey and those for the structural balance further exclude the Czech Republic, Hungary, Iceland, Korea and Poland.

Growth should resume very slowly in Japan, fall sharply in the United States and continue at a modest pace in the euro area

Growth in Japan is expected to resume in 1999 and 2000, even though very slowly, given the persistently weak self-correcting forces at work. In the United States, growth of output is projected to fall sharply, mainly reflecting a sharp deceleration of business investment and less buoyant consumer spending. Economic growth appears likely to weaken slightly in the euro area during 1999 but should strengthen again in 2000, as domestic demand growth continues as the driving force of the expansion. The economic situation in Korea and many of the non-OECD countries most seriously affected by the crisis should stabilize by next year. Overall, growth in the OECD area will slow somewhat to around 1¾ per cent in 1999 before picking up to around 2¼ per cent in 2000. At the world level, it will continue at 2 per cent in 1999 and might rise to around 3 per cent in 2000. In these conditions, prices will remain reasonably stable nearly everywhere in the OECD area, while unemployment might drift upward as rises in the United States and Japan more than offset declines in Europe (Table I.4).

Table I.4. **Unemployment and inflation**

	1997	1998	1999	2000
	Per cent			
Inflation[a]				
United States	1.9	1.0	1.2	1.8
Japan	0.6	0.7	–0.4	–0.5
European Union	1.8	1.8	1.8	1.8
Total OECD less high inflation countries[b]	1.5	1.3	1.3	1.5
Total OECD	3.7	3.3	2.6	2.4
Employment growth				
United States	2.2	1.3	0.4	0.8
Japan	1.1	–0.7	–0.6	–0.1
European Union	0.6	1.0	0.7	0.8
Total OECD	1.7	0.7	0.5	0.9
	Percentage of labour force			
Unemployment rate				
United States	4.9	4.6	5.0	5.4
Japan	3.4	4.2	4.6	4.9
European Union	11.2	10.6	10.3	10.1
Total OECD	7.2	7.1	7.3	7.3
	Millions			
Unemployment levels				
United States	6.7	6.3	7.0	7.6
Japan	2.3	2.8	3.2	3.3
European Union	18.7	17.7	17.4	17.0
Total OECD	35.5	35.4	36.4	36.8

a) Percentage change in the GDP deflator from previous period.
b) High inflation countries are defined as countries which have had 10 per cent or more inflation in terms of the GDP deflator on average during the 1990s on the basis of historical data. Consequently, the Czech Republic, Greece, Hungary, Mexico, Poland and Turkey are excluded from the aggregate.

Risks in a deteriorating global environment

Downside risks are considerable

Financial turbulence has now spread to the point where few, if any, countries remain untouched. While markets have calmed somewhat since mid-October, the extent to which turbulence might again intensify and the degree to which financial instability will be reflected in weaker economic activity in affected countries remain highly uncertain. Indeed, the most important risks to the outlook that have been at the root of the deterioration of confidence since July are still present, even if policy action in response to the turbulence has been taken in a number of areas – monetary easing in several countries, the passage of new legislation to resolve banking problems in Japan, likely agreement between Brazil and the IMF on a financial support package and commitment by the Group of Seven to seek reforms that promote stability in the international monetary system (see Box I.3) – and the symptoms of financial market nervousness which have threatened to reinforce deflationary forces have receded.

In particular, the risks to the overall outlook arising from a further deterioration of the situation in Asia, or in non-OECD regions elsewhere, continue to exist. Furthermore, as economic expansions in some countries have matured, balance sheet excesses which would increase vulnerability may become increasingly apparent. The global economy is highly interdependent as a consequence of trade and financial relationships, which in the event that any downside risks materialise, creates potential for them to interact with each other to amplify their effects. This section explores some of the possibilities.

Downside risks in emerging markets

Attention has recently focused on Brazil

The main risk now facing emerging markets is that further setbacks in individual economies, which need not be domestically generated, could accelerate the investor flight from risk and have spillover effects across all emerging markets. Attention has recently focused on Brazil, where the overriding need is to restore a sustainable budgetary position. The Government has announced an ambitious programme designed to do this, and a financial support package to help protect the exchange rate is being arranged by the IMF. Against the background of the failure to follow through with the package announced in November 1997, it will be important to build the credibility needed to make the present exchange rate policy sustainable by ensuring a rapid and decisive implementation of the programme. A sharp depreciation could work to reverse the progress toward price stability that has been made in recent years and, as occurred in Asia crisis countries, could adversely affect some financial institutions and other businesses who have borrowed heavily in foreign currency. Furthermore, should this occur, pressure on other countries in the region would almost certainly increase. Very high interest rates could persist throughout the region and financial markets in other regions such as Asia could be affected.

Asia remains exposed to further shocks

A further shock in Asia cannot be excluded. In particular, failure by Japan to resolve its banking problems and a further decline in domestic demand there could lead to renewed downward pressure on the yen, thereby setting off another wave of currency depreciations and upward pressures on interest rates in other countries in the region. These would aggravate their internal and external debt problems. Intensified political or social turmoil, or any other developments, that interrupted the reforms now underway in Asia crisis countries, or raised serious doubts about whether they would be

Box I.3. **Strengthening the international financial system**

On 30 October 1998, the Group of Seven countries welcomed positive steps that have been taken toward implementation of the IMF quota increase and the New Arrangements to Borrow. They called for implementation to proceed rapidly and committed themselves to supplementing the Fund's resources where necessary, through activation of the New Arrangements to Borrow and the General Arrangements to Borrow. They also announced agreement on a number of steps to strengthen the international financial system, which are summarised in a declaration of their Finance Ministers and Central Bank Governors.[1] The main steps and reforms, which will be implemented as rapidly as possible, are the following:

- establishment of an enhanced IMF Facility, accompanied by appropriate private sector involvement and, in some case, by bilateral contingent financing, to provide a contingent short-term line of credit for countries pursuing strong IMF approved policies;
- commitment to deliver greater transparency in economic policy-making and in disclosure of economic statistics and key indicators and to endeavour to ensure that private sector institutions comply with principles, standards and codes of best practices;
- establishment of a process for strengthened financial sector surveillance by drawing on national and international regulatory and supervisory expertise and bringing together key international institutions and key national authorities to co-ordinate their activities, to foster stability and to exchange information more systematically on risks in the international financial system;
- commitment to strengthen the regulatory focus on risk management systems and prudential standards in financial sector institutions in G-7 countries, in particular where leverage is high. Other countries are called upon to take similar action and appropriate means are to be sought to encourage off-shore centres to comply with internationally agreed standards;
- calls to private sector to facilitate "collective action clauses" in bond issues to allow more orderly workout arrangements; to the World Bank to work with other international financial institutions and their members to put in place effective insolvency and debtor-creditor regimes; to the IMF to move ahead carefully with a policy of lending into arrears; and to the private sector to develop market-based contingent financing mechanisms and to be involved appropriately in crisis management and resolution;
- agreement to support a broader range of reforms to improve the effectiveness, transparency and accountability of the IMF, including a presumption in favour of release of information and a formal mechanism for systematic evaluation, involving external input, of the effectiveness of Fund operations, programmes, policies and procedures.

The Ministers and Governors also agreed to initiate further work to identify additional concrete steps to strengthen the international financing architecture. Areas where they promised to focus include: the scope for better prudential regulation in both industrial and emerging market countries; consideration of the elements necessary for maintenance of sustainable exchange rate regimes in emerging market countries; developing new ways to respond to crises; assessing ways to strengthen the IMF; and minimising the human cost of financial crises. They committed themselves to consult widely throughout the international community, to build a broad consensus in support of the steps they proposed to take and to encourage others to take similar action.

1. See the G-7 Leaders' Statement on the World Economy and the accompanying Declaration of G-7 Finance Ministers and Central Bank Governors, 30 October 1998.

sustained, would also pose risks. The viability of the currency board arrangement in Hong Kong, China, could be jeopardised if renewed falls in confidence about emerging markets, or internal developments such as a further severe downturn in property prices, were to lead to an intensification of capital outflows. If any of these situations arose, a devaluation by China to avoid a deterioration in competitiveness might occur. They could also lead to further turmoil in Latin America as the problem of contagion became more severe.

Emerging OECD economies in Europe may be less vulnerable

The OECD emerging market economies of Europe appear to be relatively well placed to contain the risks of any further financial contagion, although in some of these countries trade exposure to Russia may have an impact, even if this exposure is generally much lower than it was several years ago. Indeed, the main risk to these countries may be the possibility of a slowdown in the European Union. In the transition countries, fiscal policies appear to be sustainable, inflation is not a serious problem

and, in Hungary and Poland, banking systems appear to have strengthened considerably since the transition began. Czech banks have improved their risk management somewhat after the May 1997 exchange rate turbulence, when unhedged currency and interest rate exposures in banks played a large role, although further balance sheet adjustment is needed. At the same time, these countries are less dependent on short-term capital inflows than are countries in either Latin America or Asia, while the prospect of future EU accession may also boost confidence. Turkey faces special risks due to large public sector imbalances, high inflation and strong trading links with Russia. However, banks play a relatively small role in the private allocation of credit, which may help to insulate the economy to some extent from external financial shocks.

Exposures of the major OECD regions to turbulence in emerging markets

Risks arise from trade linkages…

Macroeconomic developments in the major OECD regions to date reflect the trade adjustments in the Asian countries hit by crisis in 1997, but any further adjustment arising from the subsequent intensification and spread of the crisis is largely to come. Since the full impact of financial turbulence on Latin America and the extent of spillovers from the events in Russia to transition economies in Central and Eastern Europe are not yet clear, the ultimate extent of direct trade impacts is highly uncertain. Table I.5 provides some perspective, however, of the possible exposures in terms of existing trade structures. It shows that in overall terms, trade exposure to emerging Asia is far more important than is exposure to other regions, since all the largest OECD economies have strong trade links there. Russia and neighbouring economies in transition are of similar importance only to the European Union, while Latin America is of similar importance only to the United States.

In addition to the risks arising from direct trade linkages, financial turbulence in emerging markets may affect OECD countries by threatening the solvency of exposed financial institutions. Given the balance sheet problems that currently exist in Japan, any significant deterioration in the assets of exposed institutions would be a source of

Table I.5. **Trade exposure of major OECD countries to emerging markets**

Exports of goods and services as a per cent of GDP, 1997[a]

	Total trade exposure	*of which:* Emerging markets			
		Asia[b] [1]	Former Soviet Union, Central and Eastern Europe[c] [2]	Latin America[d] [3]	Total [1 + 2 + 3]
United States	11.9	2.1	0.1	2.2	4.4
Japan	11.1	4.5	0.1	0.5	5.1
Germany[e]	15.4	1.8	2.6	0.7	5.1
France[e]	13.2	1.7	0.9	0.6	3.3
Italy[e]	13.9	1.6	1.8	1.0	4.3
United Kingdom	28.4	2.0	0.8	0.5	3.3
Canada	40.2	1.6	0.1	0.9	2.6
Euro area[e]	16.2	1.8	2.1	0.8	4.6

a) The implied services trade flows were estimated using direction of trade information for goods.
b) China; Hong Kong, China; Indonesia; Korea; Malaysia; Philippines; Singapore; Chinese Taipei and Thailand.
c) Including Czech Republic, Hungary and Poland.
d) Including Mexico.
e) Excluding trade within the euro area.
Source: OECD.

… from financial exposures…

concern. On the one hand, losses would aggravate financial problems in Japan. On the other hand, efforts by Japanese banks to retrench by cutting their international operations back could worsen credit availability problems in affected countries. In the United States and most of Europe bank balance sheets appear generally strong, particularly in countries where banks experienced sustained periods of retrenchment and restructuring during the late 1980s and first half of the 1990s.

Table I.6 reports the lending positions of banks in major countries at the end of 1997 *vis-à-vis* emerging markets. Exposure of US banks is quite limited and while Japanese banks have lent significant amounts to Asia, their exposure to other regions is minimal. European banks, on the other hand, have substantial credits outstanding to all three regions. The debt moratorium in Russia has called particular attention to the exposure to that country and to the comparatively high share of total exposure to Russia (around 40 per cent of total Russian bank borrowing) held by German banks. An appreciable part of these German claims, which total around DM 60 billion, is covered by German government guarantees (around DM 20 billion) and some may well be held by the *Landesbanken*, hence also ultimately covered by state government guarantees. This lending amounts to 2 per cent of total loans, and it must be measured against a capital base in the sector of nearly DM 400 billion, a figure widely thought to be understated. To a considerable degree, therefore, while there may be some unpleasant fiscal surprises in store (and these may be spread out over a period of several years), it is unlikely that bank losses in Russia will impact on the macroeconomic situation in Germany.

… which are not fully transparent…

However, the transparency of the overall situation is poor. No good statistical overview of exposures of financial institutions other than banks to emerging markets is readily available, and many exposures are regarded as proprietary information and are not reported. Exposures may also be indirect and largely unknown, as with lending to hedge funds, some of which have been facing major liquidity or solvency problems in the wake of the Russian default and other trading losses. Furthermore, off-balance sheet exposures are thought to be high.[3] Even though many of these off-balance sheet positions are used to hedge on-balance sheet positions against market risk, credit exposures remain which, in the current environment, could be important.

… and from the general impact on confidence

Perhaps the main channel through which developments in the emerging markets can affect the major OECD regions is through their impact on confidence. The mood has been poor in Japan since 1997, but in the United States and the euro area it remained buoyant until recently. Events during 1998 have eroded this mood, both in financial markets and, increasingly, in the business sector. Most important of these events have been:

- the severity of the Asian crisis in affected countries and the lack of evidence of a significant recovery;
- the deterioration in the Japanese economy and continued concerns about the health of the financial system there;
- the impact of developments in Asia on profitability of many manufacturers in advanced OECD countries;
- the need for repeated revision to IMF programmes and the possibility, until the recent favourable action by the US Congress, that the IMF might be approaching the limits of its financial resources and hence its ability to manage any new crisis situations which might emerge; and

3. Data from the US Federal Financial Institutions Examination Council, which include local lending in local currencies and exposures resulting from revaluation of foreign exchange and derivatives positions, show a 45 per cent higher exposure to Asian emerging markets than do the BIS data. See IMF, *International Capital Markets*, September 1998.

Table I.6. **Bank lending to emerging markets**[a]

	United States	Japan	Canada	European Union[b]
	$ billion, December 1997			
Asian emerging markets	39.0	244.7	15.1	348.7
5 crisis countries[c]	22.0	86.7	4.1	98.6
China	2.5	19.6	1.1	32.5
Chinese Taipei	2.2	3.5	1.8	15.8
Singapore and Hong Kong, China	12.3	134.9	8.1	201.9
Central and Eastern Europe and Turkey	14.1	6.3	0.6	102.2
of which: Russia	7.1	1.0	0.0	49.6
Latin America	63.4	14.7	11.5	154.9
Total emerging markets	116.5	265.7	27.2	605.9
	As a percentage of bank capital[d]			
Asian emerging markets	10.4	132.7	48.4	52.1
5 crisis countries[c]	5.9	47.0	13.1	14.7
China	0.7	10.6	3.4	4.8
Chinese Taipei	0.6	1.9	5.8	2.4
Singapore and Hong Kong, China	3.3	73.2	26.1	30.2
Central and Eastern Europe and Turkey	3.8	3.4	2.0	15.3
of which: Russia	1.9	0.5	0.2	7.4
Latin America	16.9	8.0	36.9	23.1
Total emerging markets	31.1	144.1	87.3	90.5

a) Exposure may be overestimated as a result of double-counting.
b) Germany, France, Italy, the United Kingdom, Austria, Belgium, Finland, Luxembourg, the Netherlands and Spain.
c) Korea, Indonesia, Malaysia, the Philippines and Thailand.
d) Capital and reserves of commercial banks for the United States, Japan, the United Kingdom, Canada and Luxembourg and of all banks for the rest. Due to unavailability of more recent data, capital and reserves figures refer to 1996 while the lending figures are for end-December 1997.
Sources: BIS, *The Maturity, Sectoral and Nationality Distribution of International Bank Lending, Second Half 1997*, June 1998; and OECD, *Bank Profitability, Financial Statements of Banks*, 1998.

– the uncertainty about implications of the unilateral Russian moratorium in terms of the size of off-balance sheet exposures, who is exposed and how serious the consequences will be.

Key risks within the largest OECD economies

Continuing deterioration of the Japanese banking system could threaten the global outlook

The major risk to the outlook for OECD countries now concerns the possibility that banks in Japan could fail to take full advantage of recent legislation designed to facilitate their restructuring (see Box I.4). If the banking system there is not strengthened and confidence does not recover, domestic demand is likely to remain weak. This could lead to a vicious circle, as sustained recovery would be difficult to achieve, which would work against improving public finances and lead to further worsening of bank's asset quality. Continued deterioration in the Japanese banking system could negatively affect crisis countries in Asia, given the important role Japanese banks play in the region, and there could be important spillovers to North America and Europe.

Excessive stock market corrections could be damaging…

A second risk arises from the possibility that renewed downward pressure in equity markets could occur, leading to adjustments that go too far. By early October, a less buoyant outlook for profits and the growing negative impact of the crisis in emerging

Box I.4. **Government plans for bank restructuring in Japan**

In the summer of 1998, the government announced a "total plan" which included: *i)* establishing an infrastructure for dealing with bad loans, including improvements in disclosure, supervision, and property market liquidity;[1] *ii)* giving enhanced powers to the new supervisory body, the Financial Supervisory Agency (FSA), to order bank restructuring; and *iii)* establishment of a system of temporary public "bridge banks" to take over the operations of any institution deemed to be insolvent, channelling bad loans to a public resolution agency and trying to find a private bank buyer for good assets, while continuing to lend to sound borrowers. The bridge bank facility was perceived as a mechanism to limit any further negative spillovers to the economy from bank-sector restructuring. Around the same time, a proposal was made for a merger of the troubled Long Term Credit Bank (LTCB) with Sumitomo Trust, with the government planning to inject some of the (former) ¥ 13 trillion bank recapitalisation fund into LTCB to facilitate this merger.

An intense public debate soon emerged, in particular regarding the use of public money for recapitalising LTCB, and the government's proposals were stalled in the Diet for several months. The government was concerned that with (gross) financial derivatives exposure of around $360 billion, LTCB's failure could have led to a chain reaction of defaults elsewhere, posing systemic risks to the domestic economy and even abroad. Against this, the parliamentary opposition was concerned that public money might be used inappropriately to protect shareholders, management, and favoured borrowers. In the end, a compromise between the ruling and opposition parties was reached under which LTCB would be put under temporary special public management with the purchase by the government of shares in the bank – effectively nationalised – and a new independent body, the "financial revitalisation committee", would be established to oversee the process.[2] Agreement was also reached on how to deal with weak but still solvent banks (bank rehabilitation). The government will be allowed to buy common stock in "under-capitalised" or "extremely under-capitalised" banks, who would be obliged in turn to carry out drastic restructuring and recognise losses at shareholders' expense, while healthier banks could also apply for funds in view of the present need to avoid a large-scale credit crunch. A ¥ 43 trillion fund was approved for the new approaches (¥ 18 trillion for special public management and bridge banks, of which ¥ 5 trillion is expected to be committed to LTCB, and ¥ 25 trillion for bank rehabilitation). Together with the ¥ 17 trillion already allocated for depositor protection, this doubles the total amount of public funds committed from ¥ 30 trillion to ¥ 60 trillion.

This legislation importantly broadened the menu available to the government for dealing with failed or failing banks: while smaller banks' business would be taken over by a publicly owned bridge bank, the larger banks would be nationalised to facilitate their orderly liquidation. An important condition for success of this approach, however, will be that the new administrative agency set impartial rules clearly distinguishing good from bad banks, and good assets from bad assets, while defining how bank shares will be valued in the event of nationalisation. New lending must be made strictly on the basis of prudent commercial lending criteria. Also, competent public sector bank administrators and bank supervisors will need to be found. Regarding bank recapitalisations, the unclear nature of the conditionality raises the risk that such funds could be provided indiscriminately and could do little to promote bank rationalisation. Effective implementation of the new framework will also require more transparent disclosure of the actual situation in banks; to this end, it has been argued that the government should rescind the option of valuing banks' equity portfolios at historical book value.

1. These measures include improved mechanisms for the disposition of bad loans: the easing of regulations covering asset-backed securities and on creating special purpose corporations for holding such securities, in order to establish a market for them; the creation of an arbitration panel to quickly settle disputed claims on real estate collateral, the allowance of private debt collectors, and more favourable tax treatment of selling problem loans at a loss. Much of the required legislation was voted into effect during October 1998.
2. This committee will deal with the resolution of failed financial institutions under special public management and jointly assume with the Ministry of Finance the responsibility for research, planning, and drafting with regard to both financial failure resolution schemes and pre-emptive financial crisis management. In addition, a Japanese version of the US Resolution Trust Corporation will be established by merging the two existing public debt collection bodies (the Resolution and Collection Bank and the Housing Loan Administration Corporation).

markets on confidence had already contributed to sharp corrections – ranging from around 20-35 per cent compared to July peaks, depending on country. As financial markets have calmed, there have been significant rebounds in most countries. But since the earlier price declines generally appeared to be warranted on the basis of many estimates of equity price overvaluation, the risk of renewed falls is considerable. Such substantial falls from July peaks would reduce the risk that a prolonged asset bubble will occur, and in the United States this would help to ensure that overheating is avoided. However, should such corrections recur and be sustained, there are a number of channels by which they could have deleterious effects on the real economy:

- Adverse wealth effects on consumption could emerge insofar as households hold equities. The effects are largest in the United States, where market capitalisation is highest and share ownership widest. Just as the long boom in the stock market may have contributed to a low household saving rate, so sharp equity price declines or even just an end to the boom could raise it, at least for a time, as households strengthen their financial positions; in particular, ageing baby boomers may sharply step up their saving in order to maintain expected retirement wealth. Household confidence could also be adversely affected in Europe and Japan, although direct equity holdings are not so high.
- Investment could be adversely affected to the extent that lower stock market prices imply a higher cost of capital, make new issues more difficult or encourage take-overs as a means of expanding capacity.
- Credit availability could be affected. In Japan the credit crunch could be exacerbated because further falls in equity prices would worsen the weak capital positions which already exist in many of the largest banks. Many European banks may also be exposed to share prices, although capital ratios and hidden reserves (associated with unrecognised capital gains) are generally higher. US banks, however, would not be affected directly since they hold virtually no shares (Table I.7).

Ready reckoners reported in Chapter V, "Recent Equity Market Developments and Implications", suggest that – in the absence of offsetting policy action – for every 20 per cent decline in equity prices relative to the level of wealth that equity holders had become accustomed to, there could be a decline of 0.7 per cent in GDP in the OECD area in the following two years arising from the negative impact on consumption alone.

... while higher spreads reflect risk aversion in credit markets

Finally, as the increased perception of risk and greater risk aversion noted earlier lead to substantially tighter lending standards, the terms and conditions on which credit is available to private borrowers can be expected to worsen substantially irrespective of any declines in interest rates on government debt. The lack of transparency concerning risks and exposures noted earlier is not a problem confined to risks associated with emerging markets, as the recent Long-Term Capital Management rescue has

Table I.7. **Conditions in the banking sector and the effect of an equity price drop**[a]

As a per cent of assets, 1997[b]

	United States	Japan	Germany	France	Italy	United Kingdom	Canada
Profits[c]	1.85	0.03	0.53	0.18	0.50	1.15	0.88
BIS capital adequacy ratio[d]	12.40	9.19	10.15	11.12	11.00	12.50	10.16
Holdings of equities	0.11	5.43	3.50	2.75	2.13	1.74	3.52
Estimated effect of 20 per cent equity price drop:[e]							
Resulting change in assets	–0.02	–1.09	–0.70	–0.55	–0.43	–0.35	–0.70
Resulting BIS capital adequacy	12.38	8.10	9.45	10.57	10.58	10.58	9.46

a) Commercial banks for the United States, Japan, Canada and the United Kingdom, and all banks for the other countries.
b) Fiscal year for Japan.
c) 1997 for the United States and 1996 for the rest.
d) Asset size-weighted average of individual banks' BIS capital adequacy ratios as of end-1997, as reported in *The Banker*.
e) Assuming that changes in equity prices are reflected in proportional changes of the book value of equity.
Sources: OECD, *Bank Profitability – Financial Statements of Banks*, 1998; *The Banker*, "Top 1 000 Banks", July 1998; Board of Governors of the Federal Reserve System, *Quarterly Flow of Funds Accounts*; Office of the Superintendent of Financial Institutions (Canada), *Bank Assets and Liabilities*; United Kingdom Office for National Statistics, *Financial Statistics*.

demonstrated.[4] Following recent events, not knowing risks and exposures of counterparties to swaps, credit derivatives, and other off-balance sheet agreements has contributed to making banks more cautious, as it has made it difficult for them to assess the risks they have already assumed. Furthermore, as expansions mature, new borrowers may be increasingly marginal and problems related to outstanding loans may rise, which often leads lenders to become more cautious. Despite the calm that has returned to financial markets in recent weeks, far more discriminating behaviour and a premium on liquidity remain apparent (Figure I.2). Stocks of major banks have fallen disproportionately nearly everywhere (notwithstanding the recent market corrections), there has been a slight widening of long-term bond yields against Germany within the euro area, spreads between corporate and sovereign instruments have widened, and dispersion among different qualities of corporate bonds has risen. The recent warning by the Office of the Comptroller of the Currency in the United States that lending standards of banks there have been deteriorating is likely to reinforce this trend to more prudent behaviour.

What might a downside scenario involve?

Risks are interdependent

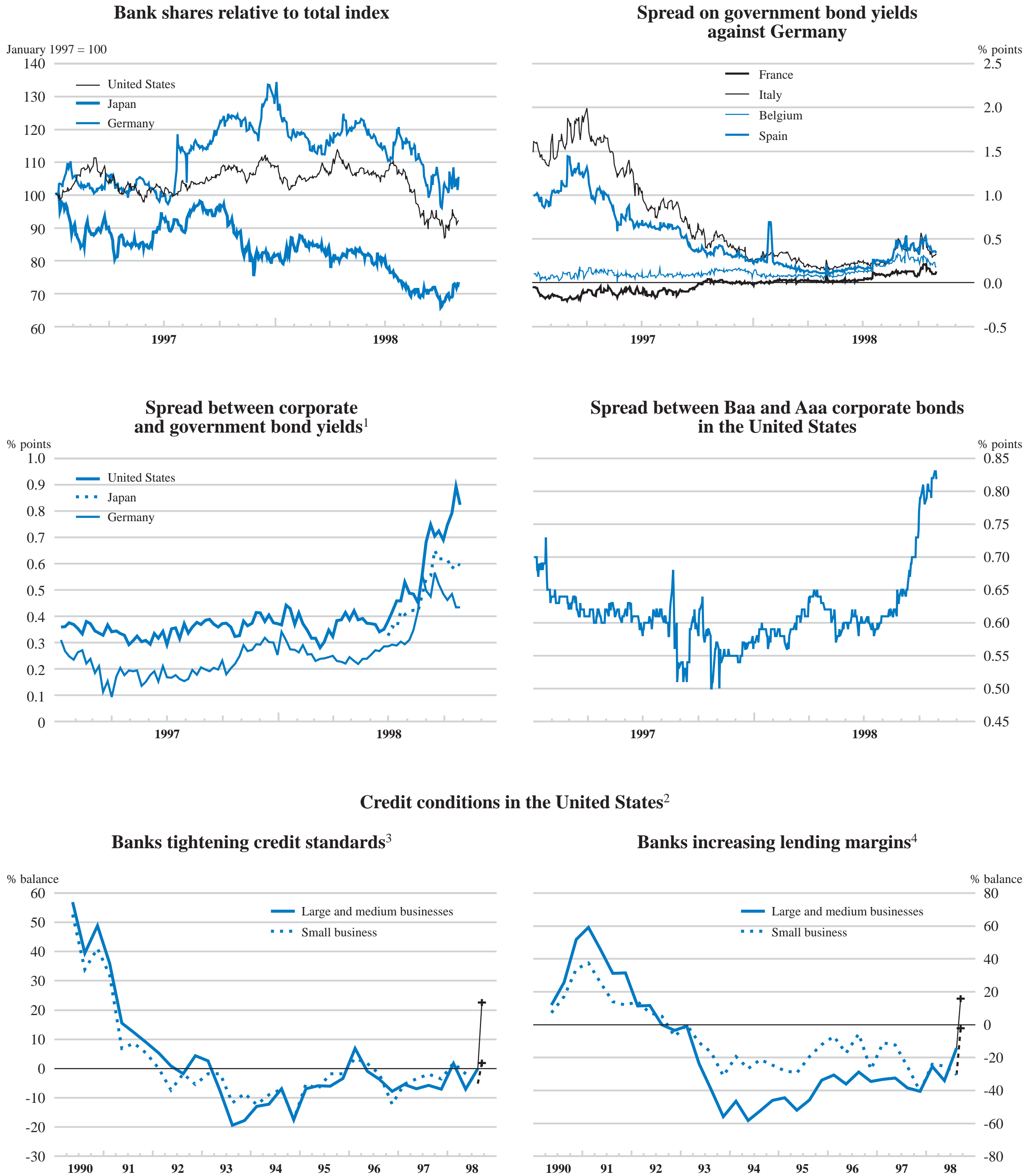
The risks described above are highly interdependent, and most of them, if they were to materialise, would make at least some of the others more likely. If several of these were to occur, either simultaneously or in rapid sequence, they would set further events in train, probably including:

– renewed declines in oil and commodity prices, due to a continuing fall in global demand, which would adversely affect producing countries (see Box I.5);
– a reactive easing of monetary policy, probably first in the United States but eventually also in Europe;
– a decline of both the dollar and the yen, reflecting monetary easing in the United States and growing economic weakness in Japan.

A scenario has been prepared which considers what might happen if some event, probably outside the OECD area, triggered some of these risks. The assumptions which underly it are described in detail in Box I.6 and in the Appendix at the end of this note. Two variants involving alternative monetary policy responses in the United States and Europe were analysed. In the first, the authorities in both regions are assumed to ease only cautiously, bringing interest rates down in line with inflation, but no more, so that real interest rates evolve as in the central projections. In the second, the authorities of both regions ease more aggressively in response to developments so that real interest rates fall. This latter response is generally in line with past behaviour during periods of recession. In Japan, nominal interest rates are so low in the central projections that there seems to be little scope for further easing of monetary conditions, apart from what would be implied by yen depreciation.

4. At the end of September, Long-Term Capital Management – a fund open only to large investors – had been adversely affected by unfavourable movements in the prices of a number of securities in its portfolio. According to some estimates, at the end of the previous month, LTCMs borrowings amounted to over $100 billion, at time when its capital was just over $2 billion. In addition, according to some estimates, the off-balance sheet national value of its derivative and swaps position may have reached over $1 trillion. In order to avoid systemic market risk stemming from rapid forced liquidation of these positions, its major creditors, acting under the aegis of the Federal Reserve, agreed to inject $3.5 billion in new equity into LTCM and assumed control of the firm.

Figure I.2. Increasing risk aversion in financial markets



\+ indicates data from the special September survey.

1. United States: AAA-rated paper; Japan and Germany: all non-bank corporations. Option-free fair-market yields.
2. *Cf.* “Senior Loan Officer Opinion Survey” on bank lending practices, Federal Reserve Board, September 1998.
3. Per cent balance of banks tightening credit standards for commercial and industrial loans.
4. Per cent balance of banks increasing spreads of loan rates over banks' cost of funds.

Sources : Bloomberg, *Financial Times* and Federal Reserve Board.

Box I.5.

The consequences of the 1998 fall in oil prices for some oil-producing countries

During 1998, the average price of crude oil has fallen by around 30 per cent from its 1997 level. This is one of the largest declines on record, and has only been exceeded four times this century: in 1921, 1927, 1931 and 1986 (see table below). It has largely been due to weak demand in Japan and emerging economies affected by the financial turbulence, mild weather conditions, the increase in Iraqi exports under the UN food for oil agreement and rising supply as new projects have come on stream.

The ten largest oil price falls in the twentieth century

Amount (per cent)	Date	Amount (per cent)	Date
51.1	1986	27.9	1906
45.4	1931	23.0	1933
43.6	1921	22.1	1988
30.9	1927	21.0	1915
29.6	1998[a]	19.3	1901

a) January to October 1998.
Sources: G. Jenkins, *Oil Economists' Handbook*, 5th edition, Vol. 1, Elsevier Applied Science Ltd, London and New York, 1989; International Energy Agency, *Monthly Oil Report*; and IEA and OECD estimates.

For most OECD countries, weak oil prices have added to real incomes and helped to restrain inflation pressures, although the effect of oil price declines on inflation is affected by the structure of oil product taxation, which varies significantly across the Member countries. Moreover, oil plays a far smaller role than it did in the 1970s, given the fall in energy intensity of modern economies since 1973. In response to the oil price shocks of the 1970s, energy efficiency in OECD countries increased substantially. Energy consumption per unit of output in the OECD area as a whole fell by around 24 per cent between 1973 and 1996, oil consumption per unit of output by 40 per cent, and net oil imports per unit of output by almost 55 per cent.

While lower oil prices are beneficial for oil-importing countries, important OECD oil-producing countries, such as Norway and Mexico, have experienced significant losses of budget and export revenue. A number of non-OECD oil-exporting emerging market countries, notably Venezuea, has been similarly affected and in some cases this has aggravated the crisis or contributed to its spread. An indication of the extent to which the fiscal and external payments positions in several oil-producing countries depend on oil revenues is provided in the table below. Although the degree of dependency varies significantly across countries, the reported shares suggest that both budgets and, especially, external finances rely heavily on oil-related revenues in most of these countries. In Mexico, where the oil sector is nationalised, and to a lesser extent, Indonesia, oil-related revenues contribute more to the budget than they do to exports. The last column of the table reports some estimates of the direct impact of the fall in oil prices in 1998 on the export revenues of the oil-producing countries considered here.

The impact of oil revenues on budgets and on exports

	1997[a]				1998
	Oil-related fiscal revenue		Oil-related export revenue		Impact of 1998 price decline[b]
	Share in total revenue (*per cent*)	Share in GDP (*per cent*)	Share in total goods exports (*per cent*)	Share in GDP (*per cent*)	Loss in export revenue (*per cent of GDP*)
United Kingdom	0.5	0.2	6.0	1.3	0.4
Canada	0.4	0.2	3.9	1.3	0.4
Norway[c]	16.2	8.0	47.6	15.1	4.6
Mexico	36.6	8.4	10.3	2.8	0.9
Russia	n.a.	n.a.	24.6	4.9	1.5
Indonesia	19.3	4.1	12.0	3.2	1.0
Malaysia	7.4	1.8	4.9	4.0	1.2
Venezuela	58.0	12.0	78.7	20.8	6.4

a) In some cases, the figures refer to 1996-97 average. For Indonesia and Canada budget revenues refer to fiscal year starting 1 April 1997.
b) Based on data for 1997 and assuming that *i)* export volumes are not affected by lower prices and *ii)* export prices for oil and other oil products all fall by the same amount, the impact varies significantly across countries.
c) Figures include revenues from gas sales.
Source: National sources, the IMF and OECD estimates.

The scenario suggests that in the case where monetary easing takes place cautiously, there would be essentially no growth next year in the OECD area as a whole (Table I.8). The United States would experience a recession, Japan's economy would continue to contract and growth in the European Union would fall to below 1 per cent. More aggressive monetary easing would mitigate the deflationary forces and produce a somewhat better outcome, but not enormously so.

A pessimistic scenario suggests that growth could nearly stop in 1999 if risks materialise

Box I.6.

A downside scenario

A more pessimistic scenario than described by the central projections has been constructed in order to examine the possible impact if some downside risks to the outlook were to materialise, either simultaneouly or in rapid succession. Three interdependent sources of risk were considered:

- There is assumed to be a deepening of the crisis in Asia and a widening to Latin America, reflecting renewed outflows of capital and further risk mark-ups on emerging market investments. This leads to further bouts of currency depreciation and demand shrinkage in these economies, and further global oil and commodity price declines, with associated downward exchange rate pressures on major OECD commodity producers.
- Economic decline in Japan is assumed to continue while bank restructuring there remains stalled or else proceeds and is disorderly. This causes the yen to fall and domestic demand and confidence to weaken further.
- Global equity markets are assumed to sustain another sharp correction. This weakens confidence and adversely affects internal demand in the major OECD countries. The US dollar falls under pressure from a massive outflow of capital from the US equity market.

Putting numbers on the size of these shocks is of course somewhat arbitrary, and these are mainly illustrative. The main assumptions used here are as follows:

- These developments occur during 1998 or early 1999, so that they have little or no effect on 1998 but affect full year outcomes for 1999 and 2000.
- Exchange rate declines are 30 per cent in non-OECD Latin America on average, and 20 per cent each in China, the dynamic Asian economies, Korea, and Japan, with the yen falling to 145 per dollar. The dollar falls 10 per cent against the euro and 5 per cent against pound sterling. Currencies of non-Asian OECD countries other than the United States or EU members decline by varying amounts up to 15 per cent against the dollar.
- Domestic demand falls, *ex ante*, by 2 and 8 per cent below baseline in OECD and non-OECD emerging markets, respectively, in 1999 and by about half as much in 2000. (In Mexico and Central and Eastern Europe, this includes a fiscal tightening to prevent a widening of fiscal deficits, while in Korea and Turkey real government expenditures are maintainted.) In Japan, domestic demand falls *ex ante* by 3¼ per cent below baseline in 1999 and reverts to baseline in 2000.
- Equity markets decline by 30 per cent relative to their levels at early November 1998, bringing the total correction since mid-July peaks to as much as 40 to 50 per cent, depending on the country.
- The price of OECD oil imports falls by around 30 per cent. Non-oil commodities fall 12 per cent.

A quantification of impacts of each of these shocks on OECD activity, which was made on the basis of simulations of the OECD's INTERLINK model and is described in the Appendix at the end of this chapter, in large part depends on the response of policy. Two alternative monetary policy reactions were assumed. In the first, a "cautious" policy stance assumes fixed real interest rates in the United States and Europe, and fixed nominal rates in Japan. Under the second, involving more "aggressive" policy easing, real interest rates are allowed to decline in line with a Taylor rule (giving equal weight to the output gap and inflation in the setting of nominal interest rates). In this case the net equity market decline is assumed to be limited to 20 per cent as the decline in real interest rates itself prompts a partial recovery of the equity market. In both cases, automatic fiscal stabilizers are allowed to work. Ready reckoners have also been made of the impacts of more aggressive fiscal policy responses.

Table I.8. **Main features of a more pessimistic outlook**

	Central projections		Downside scenario with alternative monetary policy responses			
			Unchanged real interest rates[a] in the United States and European Union		Lower real interest rates[a] in the United States and European Union	
	1999	2000	1999	2000	1999	2000
	Per cent					
Real GDP growth rate						
United States	1.5	2.2	–0.4	1.6	0.4	1.8
Japan	0.2	0.7	–2.4	1.9	–2.2	2.4
European Union	2.2	2.5	0.7	1.4	1.0	1.7
OECD	1.7	2.3	0.1	1.8	0.6	2.1
	$ billion					
Current account						
United States	–271.9	–281.0	–256.1	–263.8	–261.1	–297.5
Japan	138.7	150.8	137.8	156.2	140.1	164.9
European Union	119.5	120.4	84.9	28.4	83.8	31.5
OECD	–23.1	–33.2	–39.1	–92.9	–45.5	–112.3
	Per cent					
Short-term interest rates						
United States	3.8	4.0	2.1	1.9	1.1	1.2
Japan	0.5	0.5	0.5	0.5	0.5	0.5
Euro area	3.0	3.1	1.0	0.9	0.4	0.2

a) Relative to central projections.

Policy requirements in OECD countries

Japan

In Japan, dealing with banking problems should have the highest priority

OECD Economic Outlook 63, finalised in April 1998, called for a comprehensive approach to the problems afflicting the Japanese economy, involving structural reform, macroeconomic stimulus, and a programme to strengthen the financial sector. Much is indeed happening in the area of structural reform, although more is still needed in order to raise productivity in nontradeable sectors and to improve corporate governance.[5] Many of these reforms are conducive to stronger activity, and should be implemented faster, but others may be working in the opposite direction in the short run. Overall, the impact of these measures on the economic situation is unlikely to be felt in the near term. Macroeconomic stimulus is being pursued actively, but its effectiveness has been limited by the difficulties local authorities have experienced in financing their share of planned public investment. Furthermore, a profound lack of confidence, in large part due to the severe and prolonged crisis in the banking system, has depressed private spending. Economic weakness in turn makes the bad loan problem worse. The Asia crisis has further aggravated, and is aggravated by, financial paralysis in Japan. Addressing balance sheet problems in the banking sector is the key to breaking out of this vicious cycle, and it should now have the highest priority.

The failure to make progress has reflected a lack of a sense of urgency about the problem

The main features of the bad loan problem, which some market estimates put as high as 30 per cent of GDP, and the current status of efforts to deal with it are described in the country note on Japan (see Chapter II, "Developments in Individual OECD

5. See *OECD Economic Surveys, Japan*, 1998, for a full description of recent developments in structural reform.

Countries") and in Box I.4. The failure to make progress does not reflect a lack of money: the ¥ 30 trillion in public money (recently raised to ¥ 60 trillion) set aside earlier this year for protecting depositors and recapitalising banks remains nearly untouched.[6] Nor does it reflect a lack of understanding of what needs to be done in broad terms, since there is considerable international experience with similar problems on which to draw.[7] Rather, it appears to have reflected the lack of a sense of urgency about the situation that has allowed significant action to be delayed by the process of consensus building to resolve disagreements about details. If banks do not take substantial advantage of the scope that the existing plans offer for recapitalisation and restructuring in the near future, the Government will need to force the issue.

Three substantive issues underlie the debate: distribution of losses…

Partly because the 1996 *jusen* (housing loan corporation) rescue proved to be controversial, the specifics of the Government's proposals have been the subject of intense political debate. Much of the debate has turned on questions of whether banks should or should not be "closed", "nationalised" or "recapitalised", involving distinctions that are not fundamental to the core issues. Underlying this debate, there appear to be three substantive issues. First, there has been concern that public money might be used inappropriately, leading to unfair distribution of losses and moral hazard. So long as the losses are covered by shareholders' funds and management responsible for problems is replaced before any public money is provided, the risks in this regard should not be great, whatever specific processes and institutions are created.

… the international consequences…

Second, before the decision was taken to resolve the Long-Term Credit Bank (LTCB) situation within the framework of temporary nationalisation under the "Law for Emergency Measures to Revitalise Financial Functions", the Government expressed concern that closure of a large bank could pose systemic risks. Particularly given its cross-border operations, including those involving derivatives, this would have had implications internationally and for the credit standing of Japanese banks in international markets. Here the issue was not "closure" *versus* other ways of resolving the situation of LTCB (or any other large bank which needs to be recapitalised or wound up), but the recognition that the banking situation has reached a stage where any losses that cannot be absorbed by shareholders must be socialised. The Japanese Government must allow no doubts that the international commitments of Japanese banks will be honoured.

… and concerns that the immediate effect of positive action could be deflationary

Finally, in light of the deterioration of the economy in Hokkaido following the closure last November of Hokkaido-Takushoku Bank, there has been concern that resolving banking problems will be deflationary in the short term. While job losses are likely in the banking industry as it consolidates, any aggravation of the credit crunch should be avoidable. The Hokkaido problem appears to have arisen because the bank was a major lender in the region and because of its closure there was a reduction in the overall availability of credit in the region. Provided efforts are made to ensure that other lenders are ready to fill the gap when a bank is closed, this should not be necessary. In some cases, substantial competition may already exist and, if not, a publicly owned "bridge bank" along the lines envisaged in the Government's total plan can be put in place to take over the operations of the closed bank (possibly from the same physical premises).

---

6. Banks have reportedly been fearful of possible conditions that would be attached to capital injections and by the associated stigma in accepting such funding. As a result, only a small fraction of the ¥ 13 trillion fund intended for bank recapitalisation has been used – ¥ 1.8 trillion or about 5 per cent of banks' capital. As of 30 October 1998, only ¥ 1.4 trillion out of the ¥ 17 trillion made available to the Deposit Insurance Corporation has been used. Another ¥ 1 trillion is scheduled for disbursement on 16 November 1998 in connection with the disposal of Hokkaido-Takushoku Bank.
7. For a survey of recent international experience with similar problems, see the Box "Selected episodes of banking crises and resolution mechanisms in OECD countries", in *OECD Economic Outlook* 63, June 1998, pp. 28-29.

Fiscal policy must remain supportive

Resolving the banking system's problems will take time even if implementation of the recent necessary legislation proceeds rapidly. In the meantime, it will be important that macroeconomic policy be as supportive of activity as possible. Given the extremely low level of nominal interest rates now prevailing in Japan – call rates are only 1/4 per cent and ten year government bond rates are below 1 per cent – the issues that must be addressed are largely fiscal. In this regard, the package announced in the first half of 1998 is the latest of a series that started in August 1992 when the weakness of the post-bubble period economy started to become apparent (Table I.9). Well over half of these packages has consisted of infrastructure investment and temporary tax cuts, with much of the remainder involving outlays that have little direct impact on incomes or real spending such as land purchases and lending by public sector agencies. Overall, the results have been disappointing. Less public works spending has taken place than has been intended, partly due to local government financing problems. What has taken place has, by and large, produced poor value for money, led to the creation of a large and inefficient construction sector, and involved substantial increases in government debt. While these packages may have helped the Japanese economy to avoid a more severe recession, they have not succeeded in generating a sustained recovery.

However, as public works projects are completed and temporary tax cuts expire, the prospect inevitably looms of a sharp fiscal tightening which, as in 1997, the economy is not ready to absorb. As earlier in 1998, the political and economic case for ensuring continuing fiscal support becomes compelling, notwithstanding the need for a medium-term correction in light of rising indebtedness and demographic trends. The stimulus from the April package should soon be felt and plans have been made to ensure that it is not withdrawn. Indeed, a new economic package to be announced in mid-November is expected to make temporary household income tax reductions permanent and to introduce sizeable new corporate tax cuts. It is also likely to provide for substantial new public works spending by the central government. As announced, this will involve suspending the Fiscal Structural Reform Law. This in turn will provide the Government with more flexibility in issuing deficit finance bonds.

Table I.9. **Recent fiscal packages in Japan**

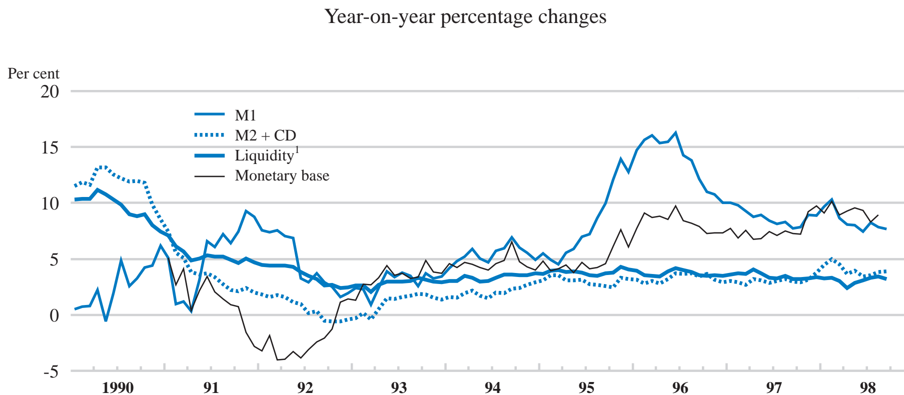
Yen trillion (project cost base)

	Infrastructure investment					Tax cuts	Other	Total
	Public works			Building and equipment	Total			
	General[a]	Disaster relief	Local government					
28 August 1992	3.4	0.5	1.8	0.6	6.3	0.0	4.5	10.7
13 April 1993	3.6	0.5	2.3	1.2	7.6	0.2	5.4	13.2
16 September 1993	1.0	0.5	0.5	0.0	2.0	0.0	4.2	6.2
8 February 1994	3.6	0.0	0.3	0.6	4.5	5.9	4.9	15.3
14 April 1995	0.2[b]	0.7[b]	0.0	0.2[b]	1.1[b]	0.0	3.5[c]	4.6[c]
20 September 1995	3.9	0.7	1.0	0.9	6.5	0.0	6.3	12.8
24 April 1998	4.5	0.2	1.5	1.5	7.7	4.6	4.4	16.7
Cumulative	20.3	3.1	7.4	4.9	35.6	10.6	33.1	79.4

a) Includes central government and joint central-local government projects.
b) Central government budget figures, rather than project cost figures.
c) OECD estimates.
Sources: Economic Planning Agency and OECD.

Figure I.3. **Money supply growth in Japan**

Year-on-year percentage changes



1. Broadly-defined liquidity; includes M2 plus certificates of deposit plus quasi-money.
Source: Bank of Japan.

Over the medium to longer term the rapid increase in public indebtedness that financing a continuing large fiscal stimulus implies will have to be reversed or at least contained. To the extent that additional fiscal stimulus must be limited by finding budget savings in other areas, and as it is withdrawn after recovery is well-established, the emphasis should be on broadening the tax base and gradually reducing expenditures on public works.

And large liquidity injections may have to continue

While there is virtually no scope for policy-determined interest rates to go lower, the Bank of Japan has been very active in providing liquidity to the system to hold money market rates down to very low levels. This liquidity has resulted in rapid increases in cash holdings and narrow monetary aggregates, but has not visibly affected broader aggregates whose growth rates remain relatively low (Figure I.3). Its main expansionary effect has been the contribution that it may have made to the weakness of the yen until mid-August and, in view of the potential deflationary effects of the recent large and rapid appreciation of the yen, continued large injections of liquidity appear to be desirable.

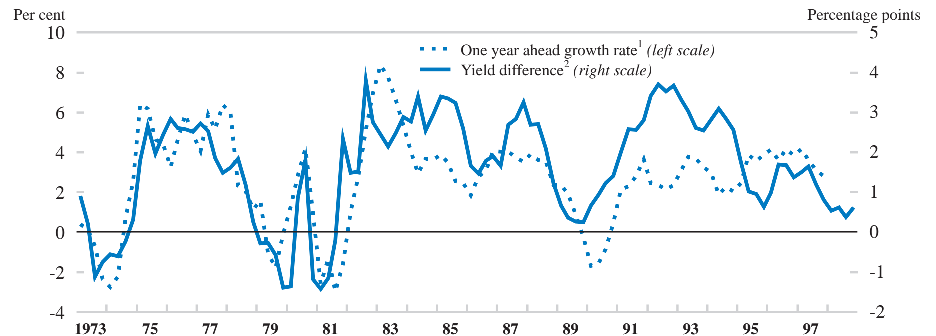
The recent strength of the yen may reflect forces of a technical nature, as a number of fund managers have moved under pressure of margin calls to close the short yen positions that low interest rates have encouraged them to build up in recent years. These forces should work themselves out and the yen's appreciation may prove to be only temporary. If the yen weakens again, however, there may be limits to how much depreciation the authorities can tolerate. A very weak yen could worsen the credit crunch by boosting banks' foreign asset levels in yen terms, thereby requiring additional capital or an offsetting cut in domestic lending, and it would not be helpful in the wider context of the Asia crisis.

The United States and the European Union

Financial market turbulence has shifted the monetary policy bias toward easing…

Until recently the monetary policy bias in the United States and the European Union was toward tightening. However, the global turbulence in financial markets has shifted this bias toward easing as the risk of inflation appears to have dissipated in the United States, to have diminished in the United Kingdom and not to exist in the euro area. At the same time, evidence that the US and UK economies are slowing has accumulated.

Figure I.4. **United States: yield curve and future growth**



1. Growth of GDP in four quarters following the yield curve observation.
2. Difference between 10-year Treasury notes and 3-month Treasury bills.

As the turbulence has increasingly affected financial markets in the United States and Europe, calls for easing have increased. Short-term interest rates in the United States and the United Kingdom have been reduced, and this appears to have been helpful to confidence in the markets. Even if the US and EU economies at this stage continue to operate at high or rising levels of capacity utilisation, further easing may well be appropriate during the coming year. Policy will need to respond flexibly in a timely way as the outlook for activity and inflation change, although care should be taken to avoid over-reactions.

… and if tighter credit conditions prevail in the United States, further rapid monetary easing may be needed

In the United States, a tension has existed since the second quarter between slowing activity and continuing robust final domestic demand. This appears likely to be resolved by a sharp slowing of final demand as the stock market correction causes consumer spending to weaken and a less buoyant outlook for corporate profits discourages business spending. To the extent that the increasing risk aversion in financial markets leads to a general tightening of the terms and conditions on which credit is available to most potential borrowers, the forces working to slow private spending will be intensified. Given that trade developments will continue to impinge negatively on activity and that slower growth in final demand is likely to slow inventory investment, the weakening could be considerably sharper than reflected in the central projections. The yield curve, which until recently has been very flat, points to some risks in this regard (Figure I.4), although it is somewhat unusual for the yield curve to flatten as a consequence of falling market rates rather than deliberate policy tightening. Should conditions which are likely to lead to such a sharper slowdown emerge, monetary policy will have to be further eased rapidly.

Easing should continue in the United Kingdom

The economic situation in the United Kingdom differs from that in most other OECD countries in that domestic cost pressures are apparent, largely reflecting labour market tightness, and inflation remains a policy concern. Monetary policy has been firm for some time and, despite the recent cuts in interest rates, remains so – the exchange rate remains reasonably firm, money market rates are relatively high in real terms and the yield curve is still quite strongly inverted. Lower commodity and import prices have helped keep inflation close to the official target, the economy has been slowing since the second half of 1997 and growth is likely to fall to slightly below 1 per cent next year. With the external environment deteriorating, the margin for manoeuvre to

relax the policy stance further appears to be increasing. Provided inflation remains under control, this margin should be used.

Monetary conditions in the euro area might also have to be eased if the favourable outlook changes for the worse

In the euro area the expansion is starting to mature but growth is projected to be strong enough to allow further progress in reducing unemployment, even if its level will remain very high (see the table contained in the Box I.7, which explains how the OECD is dealing with some data issues raised by the single currency area). So long as unemployment is declining, and its high level mainly reflects structural problems, there will be little reason for monetary policy to ease beyond *i)* what will be implied by the convergence of money market rates during the transition to monetary union, and *ii)* compensation for any decline in inflation. However, uncertainty associated with financial turbulence and the deteriorating external environment appears to be eroding business and consumer sentiment and the response of banks to these developments is uncertain. Particularly if the dollar and pound sterling should depreciate further in response to slowing activity and monetary easing in the United States and the United Kingdom, this favourable outlook could change for the worse. Should this happen, given the complete absence of area-wide inflation pressures, a timely monetary easing would be appropriate.

Euro area interest rates will converge at French and German levels

A consideration in the euro area has been the need to manage the convergence of interest rates at the end of 1998 in a way that facilitates the conversion to euros and the transfer of operational responsibility for policy to the European Central Bank. Financial turbulence has not led to intra-European exchange rate tensions and the transition to monetary union has been proceeding smoothly. Against this background, premia in some countries over the lower money market rates prevailing in Germany and France are being progressively reduced as short-term interest rates converge to these lower levels. This may be helpful in Italy, where the expansion remains hesitant, but it may also mean that monetary conditions remain easier than desirable, or will become so, in some smaller countries where expansions are quite advanced. However, once monetary union begins individual countries will have to develop ways other than monetary adjustment to adapt when cyclical conditions are out of line with the area average. In this regard, fiscal tightening may be considered, although for those countries where budget positions are already fairly good and well within Stability and Growth Pact commitments, the political case for this may prove difficult.

Fiscal policy should continue to focus on the medium term…

More generally, fiscal policy should remain geared to sustaining the consolidation that has been achieved in recent years. In the United States, the temptation to cut taxes should be resisted, as experience elsewhere suggests that surpluses that emerge around cyclical peaks are often transitory. The buoyancy of receipts from capital gains tax, for example, may prove to be temporary, while no reform of Medicare and the Social Security system to put their finances on a sound long-term basis has yet occurred. In the euro area, following the substantial consolidation effort made to meet Maastricht requirements in 1997, there has been a pause. Several countries have almost no margin for allowing the budget to deteriorate in the event of economic weakness, and only a few meet the "close to balance" criterion which the Stability and Growth Pact calls for over the medium term (see Chapter IV, "Challenges for Monetary and Fiscal Policies in the Euro Area"). EU countries should focus on continuing their progress towards medium-term consolidation objectives so that some room is created to allow more budgetary flexibility than the Pact now permits.

… but if global downside risks materialise, fiscal stimulus may have to be considered

However, if the situation deteriorates substantially, both the United States and the European Union are likely to hear calls for fiscal stimulus. Particularly if private demand falls as interest rate reductions prove to be ineffective in dealing with rising risk aversion and any balance sheet problems which emerge, this may have to be considered. Indeed,

Box I.7. **A comprehensive data set for the euro area**

The OECD regularly aggregates historical data and projections for the European Union and the OECD area and reports them in the Annex Tables of the *OECD Economic Outlook*. The introduction of the euro on the first of January 1999 will also make a complete set of macroeconomic statistics for the euro area essential for macroeconomic analyses of the area. Eurostat and the European Central Bank (ECB) already produce certain national account, inflation, financial and monetary statistics for the euro area. These are available for a relatively short time period, and so far, have only a limited coverage, with few volume series in level terms.[1] In the meantime, for the purpose of analysis, the OECD has compiled annual series, in most cases extending over the past 25 years, for demand and output (volumes, price deflators and values in current price terms), potential output and the implied output gap, the appropriation account for households, the general government appropriation account, the cyclically-adjusted general government account, the labour market, the current account, interest rates, exchange rates and competitiveness indicators.[2]

A number of aggregation methods are possible. For the years from 1999 onwards the approach is straightforward. The value and volume series of the eleven euro area countries can simply be added together after converting the national series to euros.[3] The more difficult aggregation problem lies in the years before 1999, since exchange rates *vis-à-vis* the euro do not exist and the bilateral exchange rates among euro member countries changed over time. Using the exchange rates against the ecu instead to convert is not ideal, as these were influenced by the behaviour of the exchange rates of non-euro area countries, mainly the United Kingdom, and the ecu basket does not include the Finnish markka or the Austrian schilling. To overcome this problem, growth rates for values and volumes for the euro area are calculated as weighted averages of the corresponding growth rates for the eleven member countries, with previous period values expressed in a common currency used as weights. Corresponding level series are constructed on the basis of these growth rates and corresponding 1999 values expressed in euros.[4] This approach was also adopted in order to avoid possible ruptures in series, to obtain appropriate measures of inflation,[5] as well as to avoid the distortions which can result from using fixed weights. For periods where comparisons can be made with other published estimates, the obtained growth rates do not differ significantly.

1. More information on the Eurostat series, and their method of calculation is available from the internet site: *http://europa.eu.int/en/comm/eurostat/serven/part3/euroind/eur11.htm*.
2. A document describing the methodology and providing some results is available on the OECD internet site (*http://www.oecd.org/eco/data/euroset.htm*). Half-yearly data are available for a limited number of the above variables.
3. Source data for volumes for the eleven euro countries do not have the same base year and are therefore re-based to a common 1999 base year. Export and import series are corrected for trade within the euro area.
4. The euro conversion rates are calculated as described in: "Joint communiqué on the determination of the irrevocable conversion rates for the euro", 2 May 1998 (*http://www.ecb.int/emi/pub/htm_jcom.htm*).
5. See Winder, C.C.A, "On the construction of European area-wide aggregates: a review of the issues and empirical evidence", *De Nederlandsche Bank Research Memorandum*, No. 499, 1997 (available on *http://www.dnb.nl/english/publicationsfrset.htm*).

the considerable political support in the United States for tax cuts which already exists in Congress would provide a basis for rapid implementation should a consensus in favour of fiscal stimulus emerge.

Other OECD countries

Korea must resolve balance sheet problems in corporate and banking sectors

In Korea, which has experienced a severe crisis during 1998, the critical task is to resolve balance sheet problems which have led to a high rate of bankruptcy in the corporate sector and a major deterioration of asset quality and capital positions in the banking sector. In particular, financial restructuring which would substantially reduce debt-equity ratios is urgently needed, as this would ease the cash-flow position of an important part of the corporate sector.[8] At the same time, this would facilitate the resolution of the banking sector's problems by making the sector's losses more transparent.

8. Debt-equity ratios reported at the end of 1997 reached 500 per cent for the 30 largest chaebol and averaged 400 per cent for the manufacturing sector as a whole.

Box I.7. **A comprehensive data set for the euro area** *(cont.)*

The outlook for the euro area

	1993	1994	1995	1996	1997	1998	1999	2000
				Percentage changes				
Demand and output								
Private consumption	–0.6	1.4	1.9	1.8	1.5	2.4	2.5	2.6
Government consumption	1.0	1.1	0.9	2.0	0.2	1.3	1.4	1.4
Gross fixed investment	–7.4	2.5	3.0	0.4	1.9	4.4	4.3	4.5
Private residential investment	–0.5	5.8	1.7	0.0	0.2	2.0	3.3	3.5
Private non-residential investment	–11.5	2.0	5.4	2.0	3.4	5.9	5.0	5.4
Government investment	–3.9	–2.2	–3.0	–5.6	–1.3	2.7	3.4	2.8
Final domestic demand	–1.7	1.6	1.9	1.5	1.3	2.6	2.7	2.8
Stockbuilding[a]	–0.5	0.9	0.0	–0.4	0.6	0.5	0.0	–0.1
Total domestic demand	–2.2	2.4	1.9	1.1	2.0	3.0	2.6	2.7
Exports of goods and services	11.3	9.1	6.5	7.3	11.1	6.3	4.4	5.3
Imports of goods and services	1.5	8.0	5.6	4.7	8.8	8.0	5.8	6.0
Net exports[a]	1.2	0.3	0.3	0.5	0.6	0.0	–0.1	0.1
GDP at constant prices	–1.0	2.7	2.2	1.6	2.5	2.9	2.5	2.7
Output gap (level)	–2.0	–1.5	–1.4	–1.9	–1.7	–1.3	–1.2	–1.0
				Percentage changes				
Employment, income and inflation								
Employment	–1.9	–0.6	0.4	0.0	0.4	1.1	1.0	1.0
Unemployment rate[b] (level)	11.3	12.2	11.9	12.3	12.4	11.7	11.3	10.8
Compensation per employee	5.5	3.4	4.0	2.4	2.0	1.7	2.5	2.8
Unit labour costs	4.4	0.0	2.3	1.2	0.1	0.2	1.2	1.3
Household disposable income	3.1	3.6	4.8	3.9	3.1	3.6	3.7	4.0
GDP price deflator	3.6	2.6	2.7	2.0	1.4	1.6	1.5	1.6
Private consumption deflator	3.9	3.3	2.7	2.5	1.9	1.3	1.4	1.5
Household saving ratio[c] (level)	12.9	12.1	12.3	11.8	11.5	11.3	11.1	11.0
				Percentage of GDP				
Government sector								
Total receipts	46.7	46.1	46.0	46.4	46.8	46.4	46.3	46.2
Total outlays	52.2	51.1	50.9	50.6	49.3	48.7	48.3	47.8
General government financial balance	–5.5	–5.0	–4.8	–4.1	–2.5	–2.3	–1.9	–1.6
General government structural balance	–4.4	–4.2	–4.1	–3.1	–1.6	–1.6	–1.3	–1.1
Government debt	67.2	69.5	72.8	75.4	75.2	73.9	73.1	72.1
				Per cent				
Financial indicators								
Short-term interest rate	8.7	6.3	6.5	4.7	4.2	3.9	3.0	3.1
Long-term interest rate	8.1	8.1	8.5	7.1	5.9	4.7	4.2	4.3
Euro/US dollar (percentage change)	12.9	–0.6	–8.8	2.4	14.0	1.5	–5.4	0.0
				$ billion				
External indicators								
Merchandise exports[d]	621	708	870	912	901	966	1 071	1 138
Merchandise imports[d]	532	604	727	741	724	765	854	916
Trade balance	89	105	144	172	176	201	217	222
Invisibles, net	–66	–83	–90	–87	–69	–76	–77	–75
Current-account balance	24	22	54	85	107	125	140	146
Current-account balance[e]	0.4	0.4	0.8	1.2	1.7	1.9	2.0	2.0

a) Contributions to changes in real GDP (as a percentage of real GDP in the previous period).
b) As a percentage of labour force.
c) As a percentage of disposable income.
d) Excluding intra-euro area trade.
e) As a percentage of GDP.

As this proceeds, macroeconomic policies should be as supportive as possible provided that inflation remains moderate and financial market confidence is maintained. In the longer term, there is a substantial range of structural reforms to be implemented involving the strengthening of the framework conditions – such as bankruptcy procedures, corporate governance systems and prudential arrangements in financial markets – which are essential in a market economy.

Risks elsewhere relate more to developments in the United States and European Union than to contagion

Most remaining OECD countries either have important oil and commodity producing sectors, which have been adversely affected by lower prices during the past year, or are themselves emerging market countries that have been lightly touched by contagion as financial turbulence has spread. Although most have experienced downward pressure on exchange rates during the past year, they are a heterogeneous group of countries and few generalisations can be made about policy priorities overall or in response to international developments. In most of these countries, the main risks to the outlook relate to developments in the United States and the European Union, rather than to any worsening of contagion.

In Canada and Australia where expansions remain reasonably solid, and in New Zealand, where the economy has slowed sharply, inflation is very low. Exchange rates have been allowed to fall in response to market pressure, but this should pose little risk and monetary policy can safely be accommodative, and even eased further, if the international situation worsens. Fiscal positions are good, but the need to retain financial market confidence in light of high public and/or international indebtedness calls for continued prudence in all three. Iceland and Norway, on the other hand, must resist rising inflation pressure that has emerged as a result of overheating in the recent past. In Norway, a resumption of wage moderation would be helpful but, given tight labour market conditions, continued restrictive monetary policy to resist inflation pressure seems essential regardless.

The Czech Republic, Hungary, Mexico, Poland and Turkey are somewhat more vulnerable to contagion – even if the risks differ among them. While they should continue to allow exchange rates to absorb some of any financial pressures that emerge, they cannot be indifferent to the inflationary consequences and would have to respond with monetary tightening at an early stage and to an increasing degree. A rapidly improved fiscal position is essential in Turkey and assuring the credibility of intended fiscal discipline is a priority in the other countries. In the meantime, all need to press forward with structural reform agendas which, although priorities vary considerably across countries, cover areas such as strengthening tax bases, industrial restructuring, privatisation of state-owned enterprises, and modernisation of social security regimes.

The role of financial liberalisation in the crisis in emerging markets

The role of liberalised financial markets in the crisis has become the subject of a debate

By 1997 many of the emerging market economies most affected by financial turbulence had made some progress, although generally incomplete and not well-designed, towards establishing more open and liberalised financial systems.[9] Developments during the past year have opened a debate about the role of liberalised financial markets, including the issue of reversing some aspects of the liberalisation that has already taken place. This debate has to be seen against the background of long-identified conditions achieving successful financial liberalisation,[10] in particular:

– sound and stable macroeconomic policies;
– the creation of the full range of market based systems and institutions, involving disciplines as well as rewards. Financial liberalisation must be seen in a broad economy-wide context; partially liberalised economic systems, in which serious distortions remain or some important sectors operate poorly, can develop severe and destructive imbalances;
– some combination of supervisory policies and market disciplines to ensure that financial institutions are adequately capitalised and operate in an environment conducive to prudent behaviour regarding the balance between risk and return; and
– an effective and operational framework of commercial law which, among other things, provides a basis for dealing with bankruptcy when it arises.

Most crisis countries have had important macroeconomic policy problems or weak banking systems

While virtually all emerging market countries have been subject to some financial market pressure, the extent of this pressure and the difficulties they now face, have varied considerably across countries. These variations to a considerable degree reflect differences in the extent to which the underlying conditions described above have been put into place. Generally, the countries now widely regarded as being "severely affected" or "in crisis" had:

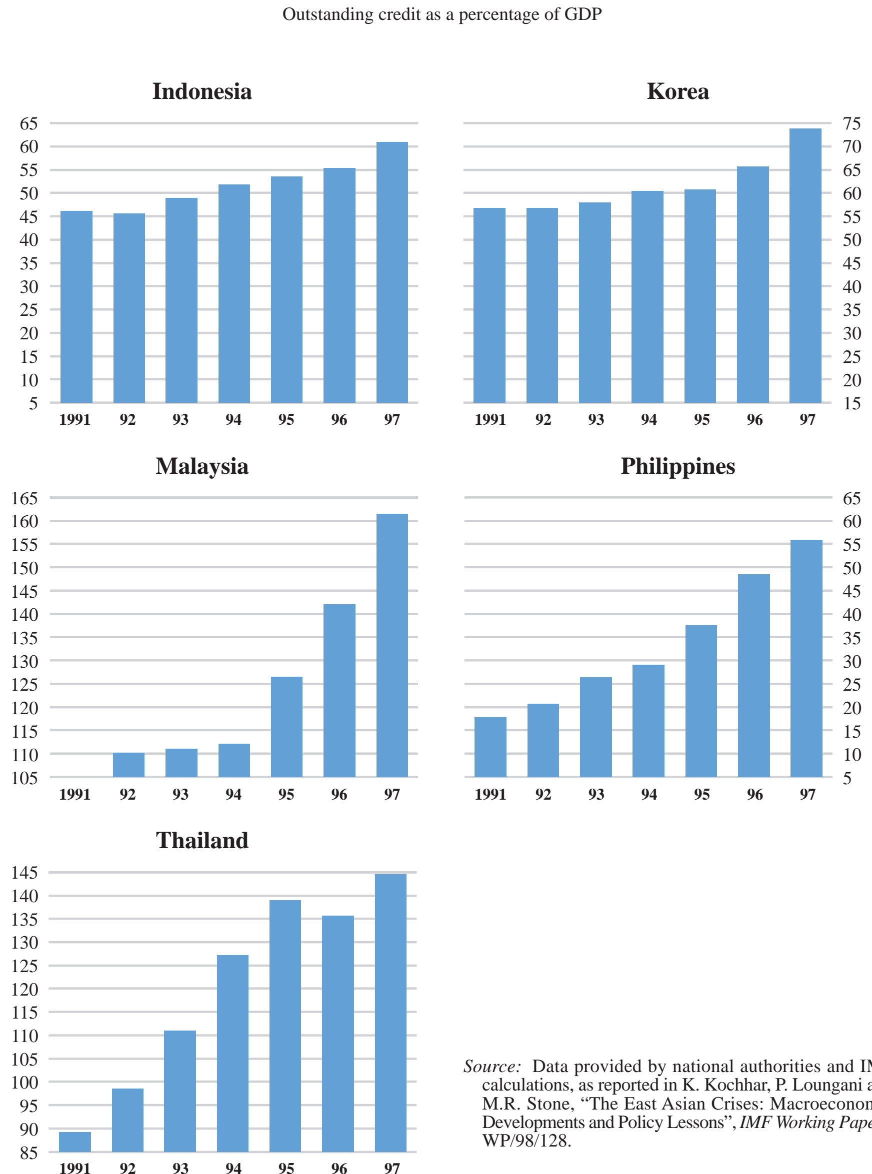
– large current account and/or underlying budget deficits that could not easily be reconciled with exchange rate policies designed to contain inflation; or
– highly leveraged corporate sectors (Figure I.5) and inadequately capitalised and poorly supervised banking systems with bad loan problems that were likely to deteriorate even before the crisis began; or
– political tensions or uncertainties that call into question the prospects for implementing the changes needed to build the necessary framework conditions of a market economy.

Emerging market countries where these problems are less severe have generally been more lightly affected by the crisis.

9. In particular, banks, whose financial condition was often fragile, were permitted in several countries to raise large amounts of short-term capital in international financial markets. At the same time, various forms of restrictions applied to many other forms of capital inflows, particularly to non-bank corporations. These probably encouraged the inflow of short-term capital through banks while limiting the breadth and depth of the foreign exchange markets once capital inflows through banks reversed. Korea, for example, maintained ceilings, prior approval requirements or other restrictive screening procedures covering foreign access to local bond and equity markets and direct borrowing abroad by non-bank corporations. Although the specific form and the scope varied across countries, similar types of restrictions existed in Indonesia, Malaysia and Thailand.
10. For more elaboration, see "Emerging Markets and the Liberalisation of Capital Markets", *OECD Economic Outlook* 58, December 1995; "Financial Sector Liberalisation in Emerging Markets", *OECD Economic Outlook* 61, June 1997; Edey, M. and K. Hviding, "An Assessment of Financial Reform in OECD Countries", *OECD Economics Department Working Paper* No. 154, 1995; and Harris, S.L. and C.A. Pigott, "Regulatory reform in the Financial Services Industry" in *The OECD Report on Regulatory Reform*, Vol. 1: Sectoral Studies, 1997.

Figure I.5. **Private sector leverage ratios in Asian crisis countries**

Outstanding credit as a percentage of GDP



Source: Data provided by national authorities and IMF calculations, as reported in K. Kochhar, P. Loungani and M.R. Stone, "The East Asian Crises: Macroeconomic Developments and Policy Lessons", *IMF Working Papers,* WP/98/128.

But moral hazard may have been a problem

The judgement of many financial market participants in lending countries has also been poor. It is clear that there has been an underappreciation of the risks involved in investing in emerging markets. Where Asia is concerned, unrealistic optimism related to the region's long history of spectacular success and the apparently sound macroeconomic fundamentals there may explain the judgements that were made. But Russia and Brazil had obvious macroeconomic policy imbalances and, in the case of Russia, far more fundamental structural problems. It seems clear from market commentary, in the case of Russia at least, that a perception that these countries were "too important to fail", and that financial support from either governments or international institutions would be forthcoming if necessary, played an important role in encouraging financial institutions to behave as they did. Such a perception, that the disciplines of a market economy will not be applied where large amounts of international lending is involved,

creates a moral hazard problem in financial markets that is inconsistent with maintaining a prudent balance between risk and return.

Especially where underlying structures are weak, restraints on financial operations are needed

If a country's financial institutions, supervisory arrangements and wider economic framework are so weak that it would be unwise to allow open financial markets to operate freely, restraints of some kind may be implicitly desirable. The questions are how these restraints should be structured, to whom they should be applied and how they should be implemented. In particular, it has been argued that proper sequencing in capital movement liberalisation is important, and that excessive short-term instability in foreign exchange markets may potentially have important effects. Restraints to limit this should be evaluated in line with the need to encourage longer-term capital flows.[11]

Priority should be given to applying restraints to financial institutions in a supervisory context

Since the main concerns about the operation of liberalised financial markets appear to relate to the behaviour of financial institutions themselves, priority should be given to ensuring that appropriate restraints are applied to these institutions. This can best be done in the context of prudential supervision since restraints can be applied to the observable financial behaviour of a manageable number of identified institutions which are, or in any case should be, obliged to provide accurate reporting of their financial activities on a regular basis. These restraints can apply generally to institutions' operations and portfolio management. Alternatively, they can involve more focused regulations, such as the Slovak Republic's requirement, designed to avoid excessive net foreign exchange exposure, that requires a 80 per cent ratio between foreign exchange claims on non-residents and total foreign exchange liabilities.

Capital controls on broad classes of cross-border transactions have also been recommended

Much of the debate about the role of liberalised financial markets has centred on capital controls, which would be applied to most business and households and would be imposed more widely on broad classes of cross-border transactions. Such controls, which are widely recognised to be undesirable as a general matter but have been recommended as a way of gaining temporary relief from exchange market pressures, were widely applied in OECD countries during the post-war period. They did not prevent the very good economic performance most countries enjoyed when the controls were most pervasive, and their general elimination was not complete until fairly recently. On the other hand, they did not ultimately succeed in insulating foreign exchange markets from pressures related to capital movements, which was their principal objective. Indeed, the post-war dollar and sterling crises that led to the collapse of the Bretton Woods system in 1971-73 occurred before capital controls were abolished in the United States in 1974 and the United Kingdom in 1979.

But most types of capital controls entail practical difficulties

At a practical level, the difficulties that capital controls entail are well known:

– International capital movements are economists' abstractions estimated and classified after the fact by statisticians, which makes it difficult to design and implement controls effectively. In practice, restrictions are usually applied at points where official channels operate to provide legal access to foreign exchange, and often include an ad hoc range of other restrictions affecting areas such as repatriation of proceeds from exports. But since international capital movements

11. It is still debatable whether the Chilean scheme, designed to sustain longer-term capital inflows while discouraging short-term movements by such devices as a one-year holding period on some flows and non-remunerated deposits on others, has been fully successful. This owes much to the difficulty of assessing the extent to which the behaviour of capital flows reflects this scheme or other measures which are in effect and more general features of the Chilean economic environment.

need not involve observable financial transactions, circumventing controls is rarely difficult, although it may involve costs.
– The costs of administering, enforcing and complying with capital controls are relatively high.
– Capital controls encourage economic inefficiency to avoid them and may invite corruption.
– To the extent that capital controls are effective in insulating foreign exchange markets from pressure they may encourage governments to avoid problems rather than attempt to solve them.
– Broad and stringent controls maintained for too long impede domestic financial market development.

Changes in the international architecture are being considered

Finally, as regards the international financial architecture, a wide range of ideas has been floated. The actions to which the G-7 Finance Ministers and Central Bank Governors committed themselves in late October, and which were endorsed by their leaders (see Box I.3), represent useful steps to increase transparency, strengthen the resiliency of domestic financial systems to shocks and facilitate crisis management – in particular by bringing private creditors into the process at an early stage.[12] More ambitious proposals which would involve new international institutions or a large role for regulation (including capital controls) will need to be reviewed cautiously before action is taken. In any event, no amount of strengthening of the international architecture can be expected to prevent difficulties from emerging in countries that do not address their domestic problems. And no institutional framework or regulatory environment is likely to insulate the world from excesses by financial markets unless major participants are obliged to face more of the negative consequences of their own decisions with greater frequency than has often been the case in the past.

Appendix: Quantifying the downside risks

Downside scenarios consider alternative monetary policy responses while allowing automatic stabilizers to operate

The alternative downside scenarios reported in the main text were quantified with the OECD's INTERLINK model on the basis of a number of separate component shocks related to specific downside risks, namely a further emerging markets shock, a demand shock in Japan, an OECD equity markets shock and an exchange rate shock. Since outcomes are likely to be quite sensitive to the response of policies, two alternative monetary policy reactions are considered: a first case with real interest rates in the United States and Europe and nominal rates in Japan unchanged compared to those in the central projections, and a second case with a more "aggressive" policy easing in which real interest rates in the United States and Europe are allowed to decline, in line with a rule giving equal weight to changes in output gaps and inflation from the central projections. In both scenarios the automatic fiscal stabilizers are allowed to work. To assess the potential impact of a more aggressive fiscal policy response, corresponding ready reckoners are discussed

12. In particular, working groups were set up by Finance Ministers and Central Bank Governors of a number of systemically significant economies in April 1998 to examine some of the issues related to the stability of the international financial system and the effective functioning of global capital markets; enhancing transparency and accountability; strengthening domestic financial systems; and managing international financial crises. The reports of these working groups, and a summary entitled, "Summary of Reports on the International Financial Architecture" were released to the public in October 1998. The declaration of the G-7 Finance Ministers and Central Bank Governors on 30 October 1998 (summarised in Box I.3) effectively endorsed many of the recommendations of these reports.

below. Table I.10 and Table I.11 summarise the effects on main macroeconomic aggregates (as differences from the central projection) for the main OECD zones, coming from each of the relevant components. The key assumptions underlying the individual shocks are described in the footnotes to these tables and in the main text.

In one, OECD growth falls close to zero in 1999

In the first scenario, with unchanged real interest rates, OECD growth falls substantially to be close to 0 and 1¾ per cent in 1999 and 2000 respectively. World trade growth falls sharply, to less than 1¼ per cent in 1999 before recovering to around 4½ per cent in 2000, while unemployment rises to almost 8¼ per cent by the end of 2000, higher than its previous peak in 1993. Nominal short-term interest rates fall to just below 2 and 1 per cent in the United States and Europe, respectively, in line with declining inflation.

In the second, monetary policy eases more aggressively and OECD growth in 1999 is ½ per cent

With a more "aggressive" monetary easing in Europe and the United States, the negative impact on demand and activity is more limited. The extent to which the slowdown is likely to be reduced depends significantly on the influence of policies on equity markets, which is difficult to assess. In the second scenario, the equity market shock is assumed to be about one-third smaller than before. In this case, substantial reductions in real interest rates imply corresponding declines in nominal short-term rates to around 1¼ per cent for the United States and ¼ per cent for Europe by 2000. The OECD area would then grow by a little over ½ per cent in 1999 and 2 per cent in 2000, while world trade would grow by about 2 per cent next year before recovering more strongly to around 6 per cent in 2000.

The emerging markets shock accounts for half the impact

In terms of underlying components, the *emerging markets shock* accounts for about one-half of the overall impact on the level of OECD area GDP by the end of 2000 and more than three-quarters of the impact on world trade. This is mainly reflected in a worsening of the OECD area's current account balance of about $130 billion over the next two years, given the role of the emerging market economies both as export markets and export competitors. The impact of this component shock on GDP is largest for Japan, which is more exposed to the emerging markets in both respects than either the United States or Europe.

The effects of declines in oil and other commodity prices, which are also included in the *emerging markets shock*, are relatively small for GDP with a terms-of-trade gain for the OECD area being largely offset by a decline in export demand by the non-OECD commodity-producing regions. Competition from emerging markets and lower commodity prices does, however, put substantial further downward pressure on OECD area inflation, which is also reflected in declining nominal interest rates in the United States and Europe and rising real interest rates in Japan.

The *equity market shock* is equally important, operating mainly through the influence of lower stock market wealth on consumption.[13] Investment would also be affected, although the direct effects are less well-defined empirically (the implications of a separate "credit crunch" channel are not included). The direct effects of the equity-market shock are most marked for the United States, given its much higher degree of market capitalisation, and contribute to further reductions in its current-account deficit and

13. The calibration of equity market effects is based on the various estimates reported in L. Boone, C. Giorno and P. Richardson, "Stock Market Fluctuations and Consumption Behaviour: Some Recent Evidence", *OECD Economics Department Working Paper*, 1998 (forthcoming), which are also summarised in Chapter V "Recent Equity Market Developments and Implications".

Table I.10. Downside scenario with unchanged real interest rates in Europe and the United States

Difference from the central projection

	Combined shock		*of which:*							
	[1]+[2]+[3]+[4]		*Emerging-markets shock*[a] [1]		*Demand-shock in Japan*[b] [2]		*Equity-market shock*[c] [3]		*Exchange-rate shock*[d] [4]	
	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000
	Percentage points									
GDP growth rate (volume)										
United States	–1.9	–0.6	–0.9	–0.2	–0.1	0.0	–1.0	–0.4	0.2	0.0
Japan	–2.6	1.2	–1.1	–0.5	–2.6	0.0	–0.3	–0.2	1.4	2.0
European Union	–1.5	–1.1	–0.6	–0.3	–0.1	0.0	–0.4	–0.4	–0.5	–0.5
OECD	–1.6	–0.5	–0.7	–0.3	–0.5	0.0	–0.6	–0.3	0.2	0.1
Inflation (private consumption deflator)										
United States	–1.4	–1.7	–1.0	–1.0	0.0	–0.1	–0.1	–0.6	–0.2	0.1
Japan	–0.4	–2.2	–1.0	–1.4	–0.4	–2.2	0.0	–0.3	1.1	1.6
European Union	–1.6	–2.4	–0.8	–1.2	0.0	–0.1	–0.1	–0.4	–0.7	–0.7
OECD[e]	–1.2	–1.8	–1.0	–1.0	–0.1	–0.4	–0.1	–0.5	–0.1	0.1
	$ billion									
Current account balance										
United States	15.8	17.2	–9.4	–28.7	–3.6	–1.0	19.2	41.0	9.7	5.9
Japan	–0.9	5.4	–4.4	–17.7	21.6	17.6	–4.2	–10.3	–13.9	15.7
European Union	–34.6	–92.0	–25.4	–51.0	–4.3	–3.2	–0.9	–0.7	–4.0	–37.1
OECD	–16.0	–59.7	–39.9	–89.6	11.3	10.0	10.6	21.0	2.0	–1.1
	Percentage points									
Unemployment rate										
United States	0.8	1.5	0.4	0.7	0.1	0.1	0.4	0.9	–0.1	–0.2
Japan	0.2	0.2	0.1	0.1	0.2	0.3	0.0	0.0	–0.1	–0.3
European Union	0.4	1.0	0.2	0.4	0.0	0.0	0.1	0.2	0.1	0.3
OECD	0.4	0.9	0.2	0.5	0.1	0.1	0.2	0.4	0.0	0.0
Short-term interest rate										
United States	–1.7	–2.1	–1.2	–1.2	0.0	–0.2	–0.2	–0.8	–0.2	0.1
Japan	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Euro area	–2.0	–2.2	–1.0	–1.0	0.0	–0.1	–0.1	–0.3	–0.9	–0.8
World trade growth rate	–4.1	–1.6	–3.1	–0.6	–0.5	0.1	–1.1	–1.2	0.6	0.0

Note: Interest rates are assumed unchanged in nominal terms for Japan and unchanged in real terms for the other OECD countries (see text).

a) Relative to the central projections, the emerging-markets shock assumes: exchange rates *vis-à-vis* the US dollar are 20 per cent lower in China; Hong Kong, China; the Asian NIEs and Korea; 30 per cent lower in Latin America; 15 per cent lower in Mexico; and, for Turkey, the real effective rate is 10 per cent lower. Import volume growth is lower by 7 per cent in China; Hong Kong, China; and the Asian NIEs in 1999; and by 3 per cent in 2000. For Latin America, corresponding reductions in import volume growth are 8 per cent and 4 per cent respectively. For Hungary, Korea, Mexico, Poland and Turkey, domestic demand is assumed to grow by an *ex ante* 2 per cent slower than in the central projections for 1999. Oil prices are assumed to be $3.50 lower (about 30 per cent) and other commodity prices 12 per cent lower.

b) Relative to the central projection, Japanese domestic demand is assumed to contract by $3\frac{1}{4}$ per cent in 1999.

c) Relative to the central projection, equity prices are assumed to fall by 30 per cent in G-7 countries (the effects of stock market contraction in Japan are, however, embodied in the demand shock in Japan, *i.e.* [2] in the table heading above).

d) Relative to the central projection, the exchange-rate shock assumes the following movements in exchange rates *vis-à-vis* the US dollar: The euro (along with the exchange rates of Denmark, Greece, Sweden and Switzerland) is assumed to appreciate by 10 per cent and the pound sterling by 5 per cent. The Japanese yen depreciates by 20 per cent, the Canadian dollar by 5 per cent and both the Australian and New Zealand's dollar by 12 per cent. All other OECD currences are assumed unchanged.

e) Excluding high-inflation countries.

Table I.11. **Downside scenario with lower real interest rates in Europe and the United States**

Difference from the central projection

	Combined shock		*of which:*							
			Emerging-markets shock[a]		*Demand-shock in Japan*[b]		*Equity-market shock*[c]		*Exchange-rate shock*[d]	
	[1]+[2]+[3]+[4]		[1]		[2]		[3]		[4]	
	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000
	Percentage points									
GDP growth rate (volume)										
United States	–1.1	–0.4	–0.7	–0.3	–0.1	0.0	–0.5	–0.2	0.2	0.0
Japan	–2.4	1.7	–1.1	–0.4	–2.6	0.0	–0.2	0.0	1.5	2.0
European Union	–1.2	–0.8	–0.5	–0.2	–0.1	0.0	–0.2	–0.2	–0.4	–0.4
OECD	–1.1	–0.2	–0.6	–0.2	–0.4	0.0	–0.3	–0.1	0.2	0.1
Inflation (private consumption deflator)										
United States	–1.3	–1.2	–1.0	–0.9	0.0	–0.1	–0.1	–0.3	–0.2	0.1
Japan	–0.4	–2.0	–1.0	–1.3	–0.4	–2.2	0.0	–0.2	1.1	1.7
European Union	–1.5	–2.2	–0.8	–1.1	0.0	–0.1	–0.1	–0.3	–0.6	–0.7
OECD[e]	–1.2	–1.5	–0.9	–0.9	–0.1	–0.4	–0.1	–0.3	–0.1	0.1
	$ billion									
Current account balance										
United States	10.8	–16.5	–11.4	–40.8	–3.3	–2.9	16.1	21.6	9.4	5.6
Japan	1.4	14.1	–3.7	–15.0	21.5	18.0	–3.4	–5.9	–13.1	17.0
European Union	–35.7	–88.9	–25.6	–49.2	–4.5	–2.6	–1.9	0.9	–3.7	–38.0
OECD	–22.4	–79.1	–41.8	–96.0	11.4	9.1	7.9	10.8	0.1	–3.1
	Percentage points									
Unemployment rate										
United States	0.4	0.9	0.3	0.6	0.0	0.1	0.2	0.4	–0.1	–0.2
Japan	0.2	0.2	0.1	0.1	0.2	0.3	0.0	0.0	–0.1	–0.3
European Union	0.4	0.8	0.2	0.4	0.0	0.0	0.1	0.1	0.1	0.3
OECD	0.3	0.6	0.2	0.4	0.0	0.1	0.1	0.2	0.0	0.0
Short-term interest rate										
United States	–2.7	–2.8	–2.0	–1.9	–0.1	–0.2	–0.4	–0.9	–0.2	0.3
Japan	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Euro area	–2.6	–2.9	–1.3	–1.4	–0.1	–0.1	–0.1	–0.4	–1.1	–1.1
World trade growth rate	–3.3	–0.1	–2.9	0.0	–0.5	0.3	–0.8	–0.3	0.9	0.0

Note: Interest rates are assumed unchanged in nominal terms for Japan and lower in real terms for the other OECD countries (see text).

a) See Table I.10.

b) See Table I.10.

c) Relative to the central projection, equity prices are assumed to fall by 20 per cent in G-7 countries (the effects of stock market contraction in Japan are, however, embodied in the demand shock in Japan, *i.e.* [2] in the table heading above).

d) See Table I.10.

e) See Table I.10.

inflation rate. There are, nonetheless, significant effects for Japan and Europe, which reflect the relative importance of international trade linkages.

The effects of the *demand shock in Japan* are mainly confined to Japan, as its imports from the rest of the OECD area are relatively small, but are nonetheless significant given its weight in the OECD aggregates. This component shock contributes to a significant increase in Japan's current account surplus and decline in its inflation rate.

And the exchange rate shock redistributes growth and current account adjustments

The main impact of the *exchange rate shock* is to redistribute the current account and growth adjustments within the OECD area: a net appreciation in Europe reduces its current account surplus and growth rate with corresponding depreciations in the

United States and Japan boosting their current accounts and growth rates. Together with the relatively large effects of the crisis on internal demand in the latter two countries, the exchange-rate adjustment fully offsets the original negative impact of the emerging-markets shock on their current accounts. With such movements in exchange rates, the burden of OECD area current-account adjustment would be largely borne by Europe.

Ready reckoners suggest fiscal stimulus could play a stabilizing role

Given the size of the various shocks envisaged, and if the risks considered here were to materialise, then the possibility of *stimulative fiscal action* would likely come onto the policy agenda as a means of stabilizing the situation. This would be particularly the case if the room for monetary-policy manoeuvre were limited by already very low interest rates. Ready reckoners of more aggressive fiscal policy action suggest that for the United States, a discretionary fiscal expansion of 1 per cent of GDP through higher public investment with unchanged interest rates and exchange rates would raise the US GDP level by about 1½ per cent relative to the downside scenario in 1999 and 1¼ per cent in 2000. If direct tax cuts were used instead, then the impact multiplier would be significantly smaller (½ per cent in 1999 and 1 per cent in 2000), as a substantial part of the consequent rise in household disposable income would likely be saved. The impact of such fiscal action would be stronger if undertaken simultaneously in all three main OECD regions. If so, and assuming that public investment in the OECD area was increased accordingly, the OECD area GDP level might be raised by up to 1¾ per cent in 1999 and 1½ per cent in 2000, relative to the downside scenarios.

II. DEVELOPMENTS IN INDIVIDUAL OECD COUNTRIES

United States

The economy appears to have reached a cyclical high point in 1998. The year-on-year growth rate peaked at 4.2 per cent in the first quarter. Following a deterioration in corporate profits linked to a strong dollar, accelerating labour costs and lower external demand in Asia and Latin America, economic growth is projected to slacken progressively to not much more than one per cent in the middle of 1999. The slowdown should ease tensions in the labour market and help stabilise wage increases. Nevertheless, with labour costs running ahead of prices, the fall in profits could accelerate, raising the risk of a drop in equity prices and a significant fall in investment.

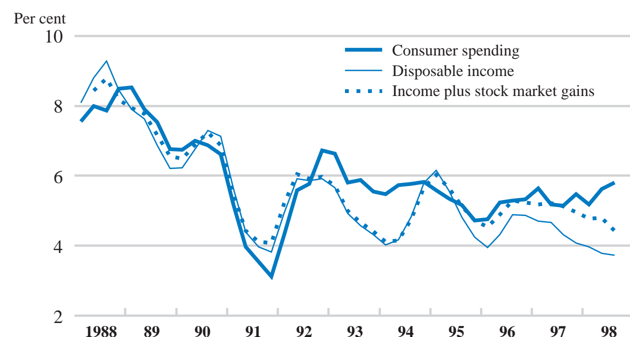
In the current situation distinguished by slowing demand growth, low inflation and financial turbulence some further reduction in interest rates seems appropriate. The projections are indeed based on the federal funds rate being lowered to 4.50 per cent during 1999 from its current level of 5 per cent. However, were the downside risks to the projections to materialise, larger cuts might be necessary, especially if the current instability in financial markets were to persist. As to fiscal policy, a continued reduction in debt over the medium-term would help prepare public finances for the ageing of the population.

Strong domestic demand kept the economy buoyant…

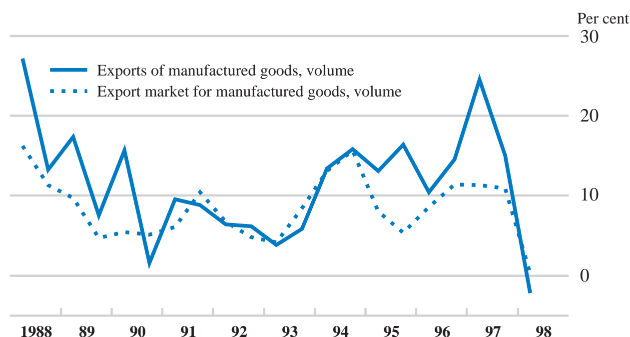
Domestic demand remained strong in the first half of 1998. Household consumption was particularly buoyant, with spending running well ahead of income, so pushing down the saving ratio. In major part, this appears to have been the result of a surge in the stock market, with the value of personal equity portfolios rising, relative to incomes, to levels not seen since the early 1960s. Business investment was also very buoyant, especially for computer equipment. Part of this strength in domestic demand was offset by the weakness of external trade, with an appreciation of the dollar and a standstill in foreign demand leading to a widening of the current account deficit. None-

United States

Consumer spending stays strong[1]



Exports stagnate[2]



1. Year-on-year percentage change.
2. Percentage change from previous period, annual rate.

Employment, income and inflation

Percentage changes

	1996	1997	1998	1999	2000
Employment[a]	1.9	2.4	2.2	1.1	1.1
Unemployment rate[b]	5.4	4.9	4.6	5.0	5.4
Employment cost index	2.8	3.1	3.6	4.0	3.9
Compensation of employees[c]	2.7	3.9	4.0	4.3	4.5
Labour productivity[c]	1.7	1.7	1.4	0.4	1.3
Unit labour cost[c]	1.0	2.2	2.6	3.9	3.2
GDP deflator	1.9	1.9	1.0	1.2	1.8
Private consumption deflator	2.0	1.9	0.8	1.2	1.9
Real household disposable income	2.5	2.4	3.1	3.2	2.4

a) Establishment basis.
b) As a percentage of labour force.
c) In the business sector.

theless, output growth continued at the same strong pace as seen in 1997, while falling oil, commodity and import prices ensured that the rate of inflation continued to fall through the first half of 1998.

… but signs of slackening emerged mid-year

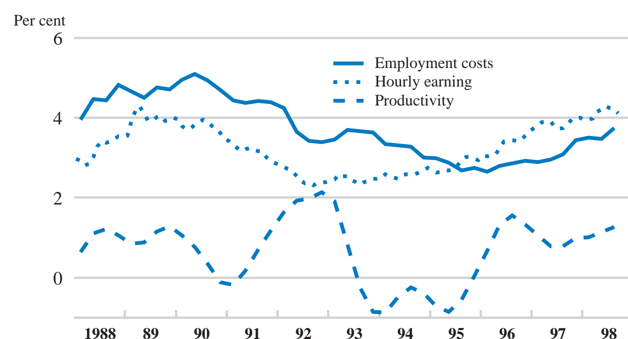
By the second quarter of 1998, some signs of slackening in activity started to emerge. Although consumer spending and housing remained strong, the fall in exports accelerated and business investment was weaker. The slackening in the growth of final demand continued in the third quarter with capital formation and foreign sales dropping. But with stockbuilding surging, output growth held up more than expected. The labour market has remained tight, even though the unemployment rate edged up after reaching a twenty-eight year low, at 4.3 per cent, in April.

As profits weakened and credit spreads widened, the stock market fell

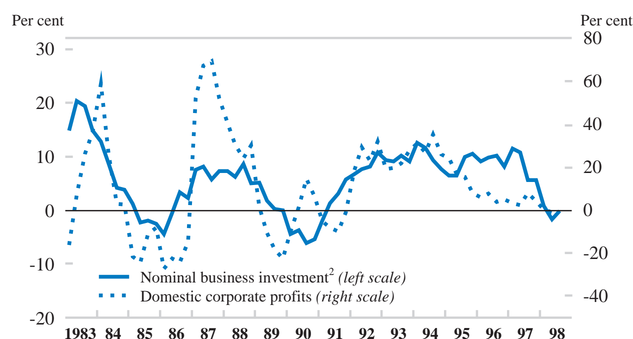
Strong demand for labour has led to a small, but significant, acceleration in both total employment costs and hourly earnings. This development was not offset by productivity gains, thus leading to an increase in the growth of unit labour costs, at a time when competitive pressures, stemming from the strong dollar, held back the increase in domestic prices. Consequently, domestic after-tax corporate profits fell in the second quarter. This development, coming after a four-year period in which the share of profits in GDP only increased slightly, was associated with a marked downward revision of earnings expectations. The valuation of these lower earnings was also affected

United States

Labour costs are accelerating[1]



Corporate profits are squeezed[1]



1. Year-on-year percentage change.
2. Lagged one year.

Financial indicators

	1996	1997	1998	1999	2000
Household saving ratio[a]	3.1	2.2	0.7	1.0	1.1
Private sector financial balance	–0.8	–2.0	–3.9	–3.5	–3.3
General government financial balance[b]	–0.9	0.4	1.6	0.8	0.6
Current account balance[b]	–1.8	–1.9	–2.7	–3.1	–3.1
Short-term interest rate[c]	5.0	5.1	4.7	3.8	4.0
Long-term interest rate[d]	6.4	6.4	5.2	4.4	4.8

a) As a percentage of disposable income.
b) As a percentage of GDP.
c) 3-month Treasury bills.
d) 10-year government bonds.

by financial turbulence that raised risk premia world wide and resulted in a substantially higher gap between the yields of high quality corporate bonds and government securities. Indeed, by early October, this spread was nearly 190 basis points, a level not seen in the previous forty years. With the medium-term outlook for corporate earnings being revised down and the risk premium up, share prices were over 20 per cent below their early summer highs.

Government bond yields dropped…

The heightened perception of risk in financial investments was accompanied by a marked rise in the price of government securities and a relatively flat yield curve for maturities over two years. At the long end of the market, most of the fall in yields appears to reflect a strong desire for liquidity and pronounced easing in inflation expectations. Bond markets have also benefited from the move of the federal budget into a surplus of one per cent of GDP, as discretionary spending caps limited the growth of outlays and revenues were boosted by high tax receipts on realised capital gains taxes.

… and official rates followed

The Federal Reserve, given the strains in the financial system and feeling that the risks of weaker output exceeded the possibility of higher inflation, lowered the federal funds rate by 50 basis points in two stages during September and October. Moreover, the second of these was not made following a scheduled meeting of Federal Open Market Committee. These cuts appear to have restored some liquidity to capital markets after the precipitous fall in new issues of equity and below-investment quality bonds in the summer, but domestic risk premia only eased slightly. Although bank lending has provided some substitute, credit standards appear to have been tightened. Market expectations of further cuts have also led to some steepening in the yield curve and weakening of the effective exchange rate of the dollar to slightly below its first half average. Moreover, the equity market staged a marked recovery eliminating a large part of its earlier losses. With the economy expected to weaken further, cuts of 50 basis points in the federal funds rate are built into the projections.

Falling asset values will slow consumption…

The slowdown in the economy is expected to become more pronounced in the first half of 1999. Overall, growth may be around 1 1/2 per cent next year, but it should pick up thereafter as the impact of lower short-term interest rates is felt and the external environment improves. The Federal budget surplus should be reduced both by slower growth and by the decision to exceed previously legislated spending caps by $20 billion (1/4 per cent of GDP). At the origin of the slowdown is the reaction of companies and households to the marked weakening of corporate profits that has occurred during 1998. Such a movement worsens domestic demand through two channels. Lower

Demand and output

Percentage changes, volume (1992 prices)

	1995 current prices billion $	1996	1997	1998	1999	2000
Private consumption	4 953.9	3.2	3.4	4.7	2.9	2.4
Government consumption	1 138.1	0.7	1.3	1.1	2.0	0.5
Gross fixed investment	1 230.8	7.9	7.3	8.9	1.0	2.2
Public	218.4	3.4	1.2	0.4	3.1	3.0
Residential	284.8	7.4	2.5	9.3	–0.6	0.7
Non-residential	727.7	9.3	10.7	10.9	1.1	2.5
Final domestic demand	7 322.9	3.6	3.8	5.0	2.4	2.1
* stockbuilding	30.7[a]	0.0	0.5	–0.1	–0.4	0.1
Total domestic demand	7 353.5	3.6	4.2	4.9	2.0	2.2
Exports of goods and services	819.5	8.5	12.8	0.5	3.1	6.6
Imports of goods and services	903.3	9.2	13.9	10.9	7.3	5.8
* net exports	–83.9[a]	–0.2	–0.4	–1.6	–0.8	–0.1
GDP at market prices	7 269.6	3.4	3.9	3.5	1.5	2.2
Industrial production	–	3.5	5.0	3.1	1.1	2.6

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.

equity values are projected to result in increased household saving. With income growth also slowing, this generates a slackening of consumers expenditure to a more sustainable growth rate. In addition, in 1999 corporations are expected to scale back investment outlays, so that investment is projected to grow only slightly and may even fall in nominal terms. Nevertheless, the corporate sector will still have a relatively high financial deficit and will have to rely more on the banking system for credit. This weakness in domestic demand is partially offset by a smaller drag on the growth of the economy from the foreign sector. The adverse impact of the past appreciation of the dollar gradually wears off and export markets are projected to recover – so boosting exports. Indeed, this movement is the principal reason why growth is projected to pick up in 2000, to 2¼ per cent, even though the current account deficit continues to widen.

… and raise unemployment, thus bringing output closer to its equilibrium level

With growth remaining below potential from the second half of 1998 onwards, some increase in the unemployment rate is projected. Such a move should relieve pressures in the labour market and help to stabilise wage increases. However, with productivity growth slackening, the expansion in unit labour costs may remain above that of prices, even though the latter may accelerate somewhat as the downward pressure from imports prices lessens. As a result, corporate profits are expected to weaken further throughout the projection period.

The reaction of financial markets to lower profits will be critical

Apart from the downside risks stemming from developments in the world economy, the main risk to these projections stems from the possible reactions of corporations and financial markets to weaker profits and from the possibility of a marked reduction in credit flows. Companies, which are relying on continued extensive borrowing to maintain the current level of investment, may indeed see their credit ratings falling in line with their declining profitability. This might further reduce their access to funds and increase their cost of borrowing, making investment less profitable. At the same time, another drop in the stock market could depress consumer sentiment further and push the economy towards recession, thereby lowering imports. While larger cuts in official interest rates could help to stabilise the situation, they might also lead to a further fall in the external value of the dollar which could put pressure on domestic inflation. On the other hand, the reaction of consumers to recent stock market falls is uncertain. In

External indicators

	1996	1997	1998	1999	2000
			$ billion		
Merchandise exports	612.0	679.3	661.5	674	721
Merchandise imports	803.3	877.3	917.2	960	1 013
Trade balance	–191.3	–198.0	–255.7	–286	–292
Invisibles, net	56.4	42.7	27.1	14	11
Current account balance	–134.9	–155.2	–228.6	–272	–281
			Percentage changes		
Merchandise export volumes[a]	9.7	15.4	0.5	2.9	6.9
Merchandise import volumes[a]	10.0	14.7	11.6	7.3	5.8
Export performance[b]	2.8	5.9	–1.6	–2.2	0.0
Terms of trade	–0.6	0.7	3.0	1.5	0.4

a) Customs basis.
b) Ratio between the total of export volumes and export market of total goods.

the near-term, households might consider their current level of wealth is still sufficient, lessening the need to increase saving. As a result, personal consumption would be better maintained than in the central projections, thereby limiting the extent of the slowdown in economic growth.

Japan

The economic situation in Japan is grave. Policy support on a number of fronts has so far not been able to prevent the recession from deepening, with renewed deflationary pressures in goods, labour and asset markets. The credit crunch is continuing, bankruptcies are rising, exports are falling and private-sector confidence is dwindling. The result is that expectations are being revised downwards and spending is being deferred. But assuming that the banking system's balance-sheet weaknesses may now finally be dealt with, that the expansionary effects of additional budgetary spending may be about to be seen and that export markets are on the verge of a turnaround, activity may begin to stabilise, even though any rebound may be limited. Output growth in 1999 might be barely positive and slack would probably continue to widen.

This critical situation calls for bolder policy action than has been adopted to date. Now that the financial legislation has been enacted, the authorities should move expeditiously to recapitalise the banking sector conditional on its wholesale restructuring. The monetary authorities should continue to ensure that ample liquidity is available, while, inevitably, fiscal policy will have to remain at least as expansionary as before, and plans being readied to provide more support should ensure that stimulus is provided in ways that are as efficient as possible. But the build-up of public debt entailed by this fiscal policy stance can be sustained only if conditions for more robust medium-term growth are quickly re-established. For this it is essential to step up the pace of structural reforms. The immediate focus should be on those that would generate increased business activity (such as further deregulation of telecommunications and easing restrictions in the construction sector) or would reduce household income uncertainty (such as temporarily raising the duration of unemployment benefit payments).

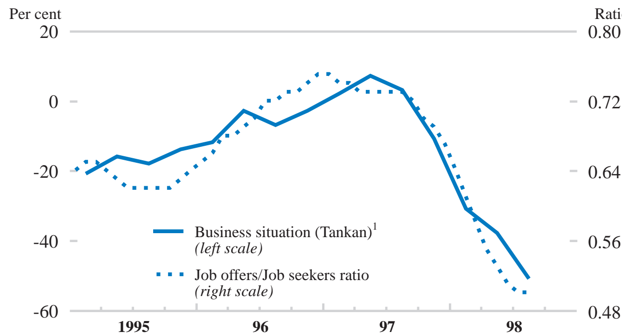
The downturn has worsened

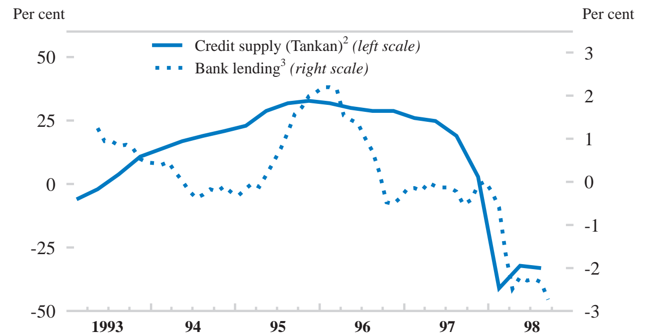
Several significant contractionary forces have combined to prolong and worsen the recession that is now well into its second year: most indicators point to the likelihood that the summer marked the fourth consecutive quarter of economic contraction. First, the balance sheet problems of the banking sector remain unresolved, and the resulting uncertainty has led to diminished confidence among consumers and investors, leading to sharp declines in private spending. Second, credit conditions deteriorated last winter and may worsen further because of renewed declines in land and equity prices. Third, the crises in emerging markets have exerted more adverse effects on export market growth, profitability and risk premia than had been foreseen, more than offsetting any positive output effects from the yen's earlier depreciation against the dollar and European currencies. Finally, these forces have triggered large-scale corporate restructuring. The resulting fall in employment and incomes has served to reinforce the loss of confidence and ratify the private sector's depressed expectations for the future. Households have raised their saving rates, and businesses have reduced both their production and investment levels. However, with industrial inventories still at very high levels in relation to shipments and profits falling sharply, pressures for production cutbacks and restructuring are likely to continue unabated. Conditions in the labour market have deteriorated, with the unemployment rate at over 4 per cent, job offers less than half the number of job seekers, and compensation levels recently falling below year-earlier levels. In addition, the number of corporate bankruptcies and the associated liabilities have increased by 25 and 28 per cent, respectively, in the first nine months of this year, thereby contributing to the difficulties in the banking sector.

Extra slack has pushed prices down

Despite the reduced levels of investment, the business-sector capital stock is still growing at around 3 per cent per year, and, with the working-age population edging down only slightly, potential supply is estimated by the OECD to be expanding by around 1¼ to 1½ per cent per year. With a cumulative decline in real GDP of 4½ per cent since the cyclical peak, it is clear that a sizeable output gap has opened up. This has generated deflationary pressures, with domestic prices falling slightly, despite higher unit labour costs. The core consumer price index (excluding perishables) is falling at a rate of around a half per cent per year. Domestic wholesale prices – goods alone – have

Japan





1. Balance of positive and negative answers (favourable minus unfavourable).
2. Opinions on financial institutions' lending attitudes (accomodative minus severe).
3. Year-on-year percentage changes.

been falling at a 2 per cent annual rate. Import prices too were falling until the spring, when the effects of the earlier depreciation began to appear, and again more recently, but in any case the terms of trade have moved favourably. This, combined with recent double-digit declines in import volumes, brought the current account surplus to around 3 per cent of GDP in the first half of 1998 for the first time in over four years.

The effects of fiscal stimulus are not yet visible

Budgetary policy, which was initially slated to be tight in the fiscal year (FY) 1998, was loosened substantially by the April fiscal package. Public investment was boosted by 7.7 trillion yen, and the special income tax cut was raised to 4 trillion yen. While most of the tax cuts have now been implemented, and the initial budget's capital spending was intended to be unusually heavily front-loaded, the effects of the stimulus have been difficult to detect thus far, in part because of local governments' inability to finance their allocated share of added public investment in view of their serious fiscal problems. It is assumed, nevertheless, that a substantial pick-up in government investment is taking place in the second half of the year.

Budgetary policy looks set to become even more expansionary

Budget guidelines for late FY 1998 and FY 1999 have been announced and, if adhered to, will entail a substantial further easing of policy, pushing the actual and cyclically-adjusted general government deficits to 7^3/4 and 5^1/2 per cent of GDP, respectively, in the calendar year (CY) 1999. Permanent tax cuts of over 6 trillion yen per year, including corporate tax cuts worth 2 to 3 trillion yen, will be implemented in

Employment, income and inflation

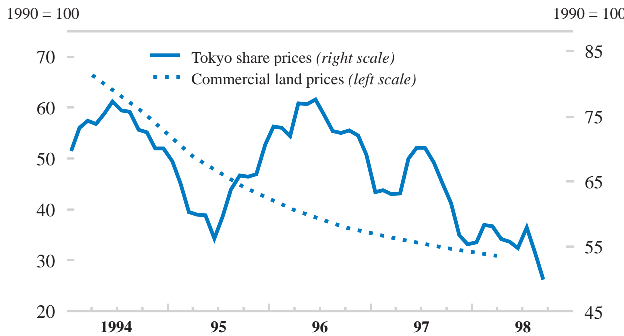
Percentage changes

	1996	1997	1998	1999	2000
Employment	0.5	1.1	–0.7	–0.6	–0.1
Unemployment rate[a]	3.4	3.4	4.2	4.6	4.9
Compensation of employees	1.9	3.0	–0.6	–1.0	–0.5
Unit labour cost	–1.9	2.1	2.0	–1.2	–1.2
Household disposable income	3.1	2.6	0.9	–0.4	0.3
GDP deflator	–0.5	0.6	0.7	–0.4	–0.5
Private consumption deflator	0.1	1.6	0.6	–0.7	–0.7

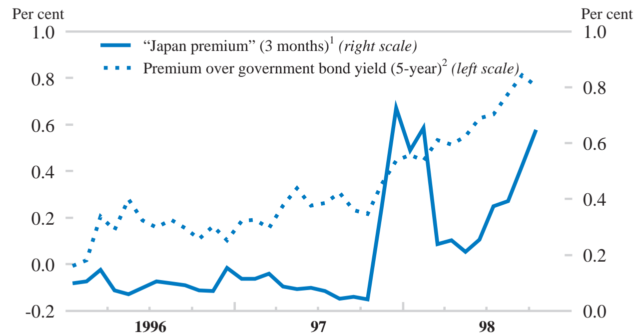
a) As a percentage of labour force.

Japan

Financial indicators are depressed



Higher credit risk in the banking system



1. Percentage point margin of the average three-month borrowing rates for US dollars of three major Japanese banks over LIBOR.
2. Percentage point margin of the average five-year bank debenture rate over the five-year government bond rate.
Sources: Bank of Japan; Japan Real Estate Institute.

1999; and, by suspending the revised Fiscal Structural Reform Law (FSRL),[1] public investment should continue to increase moderately with an additional 5 1/2 trillion yen assumed for CY 1999. The details of the proposed tax cuts and of a further supplementary budget for FY 1998 are scheduled to be released by mid-November. The projections are based on the assumption that public pension contributions will be frozen at the current rate of 17.35 per cent of standard earnings, but that benefits will be re-rated in line with wage movements in the past five years.[2] Finally, fiscal policy is assumed to remain as expansionary in the year 2000 as in 1999 on the premise that the FSRL is once again suspended. The result is that gross debt is projected to reach 118 per cent of GDP in 2000, nearly double its share in 1992.

Monetary policy has been increasingly focused on the provision of liquidity…

The monetary authorities have had to confront risks of a deflationary spiral arising in part from the unresolved problems in the banking sector, the associated breakdown in the credit creation mechanism, and the resulting widening of creditor risk premia. Their response has been to accommodate the market's needs for liquidity, to promise stability and, in September, to edge down the target overnight rate for the first time in nearly three years. As a result, there are signs of some acceleration in money supply. Year-on-year broad money growth has picked up to nearly 4 per cent, but, unlike the situation in the spring when an even higher rate was briefly recorded, it has been accompanied by faster growth in broadly-defined liquidity as well. At the same time longer-term bond yields have continued to trend lower, with 10-year government rates setting record lows of around 0.8 per cent of late.

1. This revision was passed in May. It delayed the target date for reaching the medium-term goals of eliminating the issuance of so-called deficit bonds and for reducing the deficit of central and local governments to 3 per cent of GDP from FY 2003 to FY 2005. It also allowed the social security spending ceilings stipulated in the original version to be exceeded.
2. The 1998 government net lending figures exclude the recent transfer to the general governmentís account of 26.9 trillion yen (5.4 per cent of GDP) in debt from the Japan National Railways Settlement Corporation and the National Forest Special Account. They do, however, include slightly more than 1 trillion yen (1/4 per cent of GDP) in government transfers to the Deposit Insurance Corporation to cover losses associated with bank rescues in 1998. Although this announced amount is widely expected to be just the first of many such payments, their timing and magnitude remain uncertain; accordingly, the projections exclude any further spending of this type.

Financial indicators

	1996	1997	1998	1999	2000
Household saving ratio[a]	13.8	13.6	15.4	15.6	15.5
General government financial balance[b, e]	–4.3	–3.3	–6.1	–7.8	–8.3
Current account balance[b]	1.4	2.3	3.2	3.3	3.6
Short-term interest rate[c]	0.6	0.6	0.7	0.5	0.5
Long-term interest rate[d]	3.1	2.4	1.5	1.0	1.3

a) As a percentage of disposable income.
b) As a percentage of GDP.
c) 3-month CDs.
d) Central government bonds, 10-year maturity.
e) The 1998 deficit would rise by 5.4 percentage points if account were taken of the assumption by the central government of the debt of the Japan National Railway Settlement Corporation and the National Forest Special Account.

… but banks remain in dire straits as risk premia widen

The decline in bank lending has nevertheless continued undiminished, even though firms perceive a stabilisation in lending attitudes, and many borrowers are facing higher rates despite the policy easing. Shorter-term market rates on anything other than government paper have generally edged up over the summer as they did last winter. It is the banks and credit co-operatives that have fared the worst as the "Japan premium" – the gap between what they pay and what banks based in other countries pay for three-month borrowing in global markets – has widened once again. They must now pay around 0.8 percentage point more than the government for five-year debt issues. They have also suffered from continuing increases in corporate bankruptcies, the liabilities of which have been running at around 3 to 3½ per cent of GDP per year, and from renewed declines in equities prices, with the Nikkei 225 average down about 19 per cent in the first half of the fiscal year. However, as the yen and equity prices have risen in recent weeks, banks have benefited from a reduced need for capital to cover the yen value of their foreign assets and higher values for their substantial equity holdings. Nonetheless, despite aggressive provisioning and write-offs, their balance sheets remain as encumbered as ever by their bad loans. Official figures for their problem loans as of March 1998 based on broadened criteria were 35.2 trillion yen (5.1 per cent of all loans and 7.0 per cent of GDP), but self-assessment showed loans worth 87.5 trillion yen (11.0 per cent of total credit exposure and 17.5 per cent of GDP) to be doubtful or at least in need of careful collection, and private-sector analysts believe that the amount of such loans is greater still, as much as 30 per cent of GDP.

Most of the legislation to handle the banking problems has finally been passed

The official response to the increasingly serious situation in the banking sector has been to propose a variety of financial remedies beyond the commitment of public funds for recapitalising the banks and for additional resources for the Deposit Insurance Corporation earlier in the year. The implementing legislation, just approved by the Diet, calls for the setting up of a new body to oversee the clean-up and to engage in financial planning and regulation; allows the government to temporarily nationalise failing banks[3] so as to restructure them or wind them down; and establishes clear rules governing both public intervention in banks with a high risk of failure and recapitalising the sector more generally. There is already broad support for the government's proposals to require consolidated reporting as from next March, to encourage the disposal of collateral lying behind problem loans and to ease their securitisation and to allow "servicers" (not only lawyers) to engage in the collection of such loans.

3. The Long Term Credit Bank has already been placed under temporary public administration.

Demand and output

Percentage changes, volume (1990 prices)

	1995 current prices trillion yen	1996	1997	1998	1999	2000
Private consumption	290.5	2.9	1.1	–1.8	0.2	1.0
Government consumption	47.4	1.5	–0.1	0.5	0.5	0.3
Gross fixed investment	137.6	9.5	–3.5	–7.2	–0.3	0.0
Public[a]	41.3	7.2	–11.1	1.6	8.7	0.1
Residential	24.1	13.9	–15.7	–13.5	–3.3	0.6
Non-residential	72.1	9.5	4.3	–9.6	–4.1	–0.3
Final domestic demand	475.6	4.8	–0.5	–3.2	0.1	0.7
* stockbuilding	0.5[b]	0.1	0.0	–0.1	–0.1	0.0
Total domestic demand	476.1	4.8	–0.5	–3.3	–0.1	0.6
Exports of goods and services	45.4	3.5	10.8	–2.1	3.3	4.4
Imports of goods and services	38.3	11.5	–0.2	–7.9	2.1	4.9
* net exports	7.1[b]	–0.8	1.3	0.7	0.2	0.1
GDP at market prices	483.2	3.9	0.8	–2.6	0.2	0.7
Industrial production[c]	–	2.3	3.6	–7.0	–1.0	0.9

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Including public corporations.
b) Annual amount.
c) Mining and manufacturing.

A weak recovery is in the offing…

Assuming that some recourse is made to the tools provided by this legislation, the central projection is for the recession to come to a grudging end around the turn of the year. But the recovery will be weak at best, with output still growing below modest potential rates, unemployment steadfastly rising and slight deflation continuing. It is fiscal stimulus which will prevent a further decline in the near term, but that is not likely to be enough to lift the economy onto a self-sustaining growth path in view of the private-sector weaknesses described above. Corporate restructuring is expected to be a drag, even after inventory adjustment is completed late in 1999, with firms apparently having made downward revisions to their medium-term growth expectations. Financial system fragility may persist, even if additional sudden or gradual collapses of financial institutions can be avoided. The credit crunch will only slowly be alleviated, given the time needed to deal with banks' balance-sheet weaknesses. For all these reasons, business investment is likely to be restrained. Households too may well defer their spending until their concerns about job security and future incomes – the pension system in particular – are assuaged. The only bright spot for private demand is projected to come from exports, with a rebound in market growth, especially in its Asia-Pacific neighbours, more than offsetting renewed losses in market share resulting, in part, from the recent appreciation of the yen. Even though import growth may also revive, the foreign sector would continue to make a small, positive contribution to growth. Combined with persistently favourable shifts in the terms of trade and renewed rises in net investment income, this should make for a steady increase in the current account surplus, which is projected to reach more than 3$^{1}/_{2}$ per cent of GDP by 2000.

… but downward risks predominate

The main risks to this sombre outlook are nonetheless on the downside; the realisation of any of them might be sufficient to push the economy into a more intense period of recession and deflation. Public sentiment may not be comforted by the authorities' measures to deal with the systemic problems in the financial sector. Confidence may sag if the solutions are not convincing, and market forces may cause weak banks to fail in a disruptive fashion, leading to a more severe credit crunch. On the other hand, more

External indicators

	1996	1997	1998	1999	2000
			$ billion		
Merchandise exports	400.4	409.3	377.5	414	431
Merchandise imports	316.8	307.5	251.5	264	276
Trade balance	83.6	101.7	126.0	150	155
Invisibles, net	–17.8	–7.2	–4.9	–11	–4
Current account balance	65.8	94.5	121.1	139	151
			Percentage changes		
Merchandise export volumes[a]	0.7	11.8	–0.2	3.3	4.4
Merchandise import volumes[a]	5.0	1.7	–5.8	2.4	5.2
Export performance[b]	–8.4	0.6	–2.4	–3.5	–2.3
Terms of trade	–6.8	–3.9	6.4	3.6	0.4

a) Customs basis.
b) Ratio between the total of export volumes and export market of total goods.

aggressive action to clean up banks' balance sheets might result in faster shrinkage of capacity, with possibly short-term contractionary effects. A related risk emanates from asset prices: if they resume their declines, then both direct wealth effects and indirect effects through the banking system may prevent any early end to the recession. In addition, the depression in export markets in the rest of Asia may be more prolonged or weakness may spread, removing external support for the recovery and contributing to further downward pressures on prices.

Germany

GDP accelerated strongly in the first half of the year to over 3 per cent, as the expansion broadened to include domestic demand. Employment started to increase after several years of marked decline. Business sentiment has since deteriorated markedly, as export orders weakened. While consumer sentiment has been resistant to international financial-market disturbances and domestic orders have been picking up gradually, GDP growth is projected to slow in 1999, as weakening international activity reduces the hitherto strong contribution from real net exports and investment. But monetary conditions are projected to underpin a gradual expansion of domestic demand. The labour market is projected to recover slowly with unemployment remaining high.

With inflation falling, and interest rate convergence in the Euro area expected to occur at rates prevailing in low interest countries, the authorities might not need to shift monetary stance prior to handing over responsibility for monetary policy to the European Central Bank. The slowing pace of fiscal consolidation may be viewed as appropriate from a short-term perspective in view of the current level of uncertainty, but the structural budget deficit is projected to remain high. Further consolidation measures will thus be required to achieve medium term fiscal sustainability. In the key area of labour market reform, the favourable outcomes which have been negotiated by the social partners need to be underpinned by further structural reform of the social-security and wage-bargaining systems while tax reform remains important to underpin investment and growth.

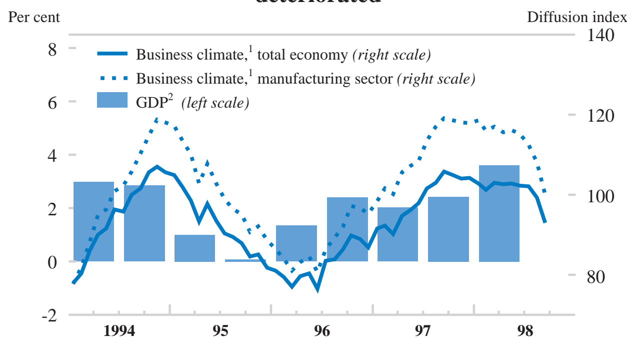
Activity was strong in the first half…

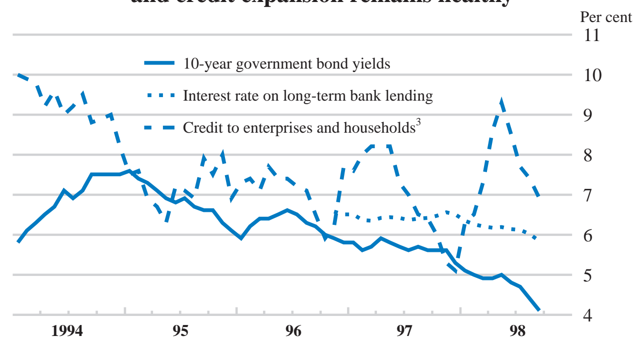
GDP expanded by 3 1/2 per cent (at an annual rate) in the first half of the year as stronger domestic demand offset a weaker pace of export growth. Public consumption surged by some 6 per cent and inventory accumulation contributed nearly 2 per cent to the growth of domestic demand. Investment in plant and machinery was particularly strong. Construction continued to be a drag on activity, but the saving ratio remained stable and private consumption increased by 1 3/4 per cent. On the external side, export growth slowed significantly and, with imports rising, the contribution to growth from the foreign balance turned negative. Merchandise exports to the Asian/Pacific region declined by 8 per cent, although export growth to Europe and to North America remained strong. Imports from south-east Asia rose by some 10 per cent.

… and the labour market stabilised

Employment stabilised and started to increase during 1998, while unemployment, seasonally adjusted, has steadily declined from the peak of 11.8 per cent in the last quarter of 1997. In western Germany the improving labour market is a consequence of

Germany

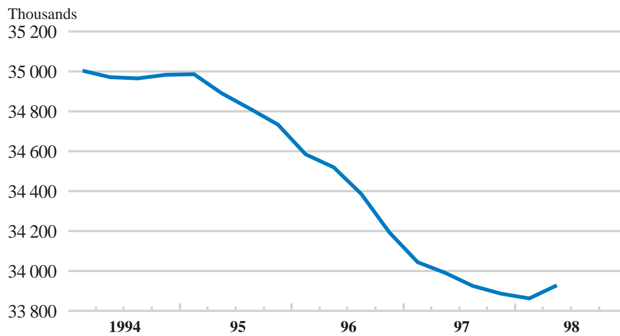




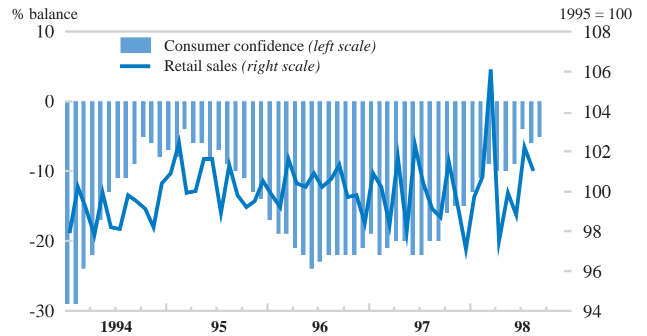
1. Western Germany. A level of 100 corresponds to a balance between positive and negative responses.
2. Percentage change over the previous period, annual rate.
3. Change over the last six months, annual rate.
Sources: IFO; Deutsche Bundesbank; OECD.

Germany

Employment has stabilised



And consumer confidence has improved



Sources: IFO; OECD.

the cyclical upturn and a redirection of demand towards more labour-intensive domestic components. In the eastern Länder improvement has been due to a sharp increase in active labour-market measures.

The business climate has deteriorated and growth should slow

Having levelled off in the first half of 1998, the business climate has deteriorated in the wake of the Russian crisis. New manufacturing orders, while remaining at high levels, have stopped increasing as firmer internal demand has been largely offset by slower growth in export orders. On balance, GDP growth is estimated to have slowed in the second half, in part because of temporary factors associated with the unwinding of the strong public consumption growth and inventory accumulation of the first half. Growth for the year could thus be around 2³/₄ per cent.

Competitiveness remains sound, while domestic conditions are strengthening

While export market growth has decelerated sharply, German competitiveness remains sound. The trade-weighted exchange rate has appreciated by around 6¹/₂ per cent compared with the 1997 average, but the real effective exchange rate has remained at about the level of mid-1997, due to increased productivity and declining unit labour costs. At the same time, conditions increasingly favour a strengthening of domestic demand. Investment in plant and machinery should continue to grow under the impulse of improved profitability and high capacity utilisation, and surveys of investment intentions have indicated a gradual shift of investment motives from rationalisation toward capacity expansion. Though investment by export-oriented industries could slow, it should strengthen in domestically-oriented sectors. Public and

Employment, income and inflation

Percentage changes

	1996	1997	1998	1999	2000
Employment	–1.3	–1.3	0.0	0.4	0.7
Unemployment rate[a]	10.3	11.4	11.2	10.8	10.3
Compensation of employees	1.0	0.2	1.6	3.1	3.8
Unit labour cost	–0.3	–1.9	–1.1	0.9	1.2
Household disposable income	3.7	1.8	2.6	3.2	3.9
GDP deflator	1.0	0.6	1.1	1.3	1.4
Private consumption deflator	2.0	1.9	1.0	1.2	1.3

a) As a percentage of labour force.

Financial indicators

	1996	1997	1998	1999	2000
Household saving ratio[a]	11.5	11.0	11.0	11.0	11.1
General government financial balance[b, c]	–3.4	–2.6	–2.4	–2.1	–1.8
Current account balance[b]	–0.6	–0.2	0.4	0.7	0.9
Short-term interest rate[d]	3.3	3.3	3.5	3.0	3.1
Long-term interest rate[e]	6.2	5.7	4.6	4.1	4.3

a) As a percentage of disposable income.
b) As a percentage of GDP.
c) Maastricht definition.
d) 3-month interbank rate.
e) 10-year bond yields.

private construction activity is recovering in the west although in the east demand is stabilising only slowly. Consumer confidence has improved markedly in line with labour market developments and indicators for the retail sector are also generally improving. Household spending power has been rising due to lower consumer price inflation, increased employment and a stabilisation of social security charges.

Financial conditions are favourable and monetary conditions remain supportive

With interest rates in the Euro area expected to converge to the lower rate now prevailing in Germany, financial conditions remain favourable and monetary policy is likely to remain supportive. Although equity prices have declined from their peak earlier in the year and volatility remains high, equity price fluctuations do not appear to have a pronounced impact on the real economy. Yields on government bonds have fallen to record low levels due not only to the low inflation environment but also to the "flight to quality" following the crisis in Russia in late August. The cost of corporate borrowing from banks has also declined, although to a lesser extent. The crisis in

Demand and output

Percentage changes, volume (1991 prices)

	1995 current prices billion DM	1996	1997	1998	1999	2000
Private consumption	1 975.3	1.6	0.5	1.6	2.1	2.5
Government consumption	686.6	2.7	–0.7	1.0	1.2	1.1
Gross fixed investment	735.6	–1.2	0.1	2.8	3.2	3.8
Public	82.5	–6.4	–8.6	1.9	3.9	2.5
Residential	251.8	–0.5	–0.7	–0.9	1.2	1.7
Non-residential	401.3	–0.5	2.1	5.0	4.1	5.2
Final domestic demand	3 397.5	1.2	0.1	1.7	2.2	2.5
* stockbuilding	18.3[a]	–0.5	1.2	0.9	0.0	0.0
Total domestic demand	3 415.7	0.7	1.4	2.6	2.1	2.4
Exports of goods and services	821.2	5.1	11.1	6.8	5.0	5.1
Imports of goods and services	794.2	2.9	8.1	6.5	4.9	4.9
* net exports	27.1[a]	0.6	0.8	0.1	0.1	0.1
GDP at market prices	3 442.8	1.3	2.2	2.7	2.2	2.5
Industrial production	–	0.5	4.0	3.9	2.9	3.7
Memorandum items						
Investment in machinery and equipment	262.3	1.9	3.9	8.8	6.1	6.3
Construction investment	473.3	–3.1	–2.5	–1.5	1.0	1.9

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.

External indicators

	1996	1997	1998	1999	2000
			$ billion		
Merchandise exports	522.7	510.9	544.7	607	645
Merchandise imports	451.4	439.2	456.4	506	537
Trade balance	71.3	71.7	88.3	102	108
Invisibles, net	–85.1	–76.4	–80.2	–84	–86
Current account balance	–13.8	–4.7	8.1	17	22
			Percentage changes		
Merchandise export volumes[a]	7.1	10.6	7.4	5.1	5.1
Merchandise import volumes[a]	5.5	6.1	7.8	5.2	5.1
Export performance[b]	–0.6	0.3	0.5	–0.1	–1.0
Terms of trade	–0.3	–1.7	3.4	0.7	0.0

a) Customs basis.
b) Ratio between the total of export volumes and export market of total goods.

Russia should not result in much strain to the banking system as a whole. In the event of a full default (unlikely at this stage) there could be a fiscal impact of around DM 20 billion spread out over a number of years. In general, the banking sector remains well capitalised, thereby supporting continued lending activity.

Fiscal consolidation has slowed and will not represent a drag on growth

Although the fiscal objectives of the new government are still to be legislated – and are therefore not taken into consideration – fiscal consolidation is set to continue on the basis of current policy. But it will be at a slower pace, with the general government deficit projected to decline marginally to around 2½ per cent of GDP this year and to 2¼ per cent in 1999. It is assumed that the existing policy to restrict current expenditures, particularly in the health sector, will continue, general government consumption being projected to expand by around 1 per cent a year. The social security surplus is expected to persist in 1999 but should be reduced in 2000 as reserves are rebuilt. In the absence of further policy initiatives, OECD projections show the structural budget deficit falling to close to 1¼ per cent of GDP in 2000 reflecting, *inter alia*, pension reform measures and the increased VAT rate in 1997. Privatisation revenues of DM42.2 billion and DM 17.3 billion in 1998 and in 1999 respectively will help to reduce gross financial liabilities as a share of GDP.

Structural reforms have served to improve performance but need to be completed

Structural reforms have served to improve the functioning of labour markets, although the full impact of the measures on employment creation will probably take some time to emerge. At the same time, further financial-market liberalisation and reforms to corporate governance have served to make goods markets more competitive and efficient. However, the tax system remains an important impediment to a stronger pick up of investment and growth and structural unemployment is likely to remain high unless recent more flexible labour-market behaviour is underpinned by further institutional change.

GDP growth is projected to slow in 1999 but this should only be temporary

Although domestic demand should slow significantly in the second half of 1998, there is sufficient momentum for it to expand by around 2 per cent in 1999. With export growth decelerating and imports picking up, the contribution to growth from net exports will be negligible, so that GDP is expected to increase by around 2 per cent, firming to 2½ per cent – a little above potential – in 2000. Germany's export markets should expand by around 5-6 per cent a year and, with competitiveness remaining rather steady, export growth should stabilise at this level. Negotiated wage rises are set

to increase but they should not affect competitiveness significantly since productivity gains should imply broadly stable unit labour costs. Employment is projected to increase by around $^{2}/_{3}$ per cent in 2000, but the unemployment rate is likely to remain high at around 10 per cent.

Financial market turmoil increases uncertainty

The projection is based on the expectation that financial turbulence will be contained, so that the banking system will not come under any pressure to curtail the supply of credit to the economy. Moreover, international uncertainty is assumed to have only a limited effect on consumer confidence. There is, however, considerable uncertainty about how instability in the international environment might be transmitted to the domestic economy, and more negative outcomes via depressed business sentiment cannot be precluded. A downside risk to investment would also arise if wage growth accelerated in the context of the changed policy environment following the introduction of the euro. Any move to reverse recent structural reforms could also impact negatively on investment activity and employment growth. With respect to upside risks, private demand could recover more quickly than projected, while past structural reforms in goods and financial markets might have increased potential growth to a greater extent than incorporated in the projections.

France

Despite weakening foreign demand, output growth remained strong in the first half of 1998, driven by a rebound in household consumption and investment. Recent indicators point to a continuation of favourable domestic demand conditions. Price stability and historically low interest rates will contribute to supporting activity, although at a slightly slower pace, in 1999 and 2000. Notwithstanding the buoyancy of domestic demand, the current account should remain in sizeable surplus. With growth still somewhat above potential, the unemployment rate should continue its slow decline.

Progress in further reducing the structural fiscal deficit is projected to be gradual and limited, reflecting selective tax cuts and significant social spending. Fulfilling the government's ambition to sustain vigorous and job-creating growth in the face of a possible additional deterioration in the external environment calls for intensifying structural reform efforts, particularly in and around the labour market. Social partners should be allowed maximum flexibility in implementing the reduction in legal working time.

Growth is now pulled entirely by domestic demand

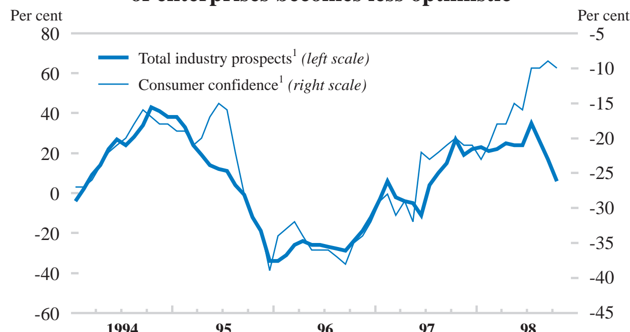
While the pace of the expansion has remained on the order of 3 per cent per annum through mid-1998, it has been increasingly driven by domestic demand. Consumption has distinctly strengthened, buoyed by rapid job creation, real wage gains and rising consumer confidence. With the capacity utilisation ratio exceeding its long-run average, the long-awaited investment rebound gathered momentum, especially as regards machinery. Stockbuilding has also contributed to domestic demand growth, albeit less markedly than during earlier cycles. Exports slowed down considerably during the first half of this year, while the tempo of imports barely slackened. The deceleration in exports mainly resulted from drops in sales to Asian countries in crisis, and translated into a slowdown of industrial output. Recent foreign trade developments also reflect the appreciation of the franc's effective exchange rate since the start of this year. Even so, the current account surplus remained large, at 2.6 per cent of GDP in the first half.

Job creation has strengthened accompanied by continuing wage moderation

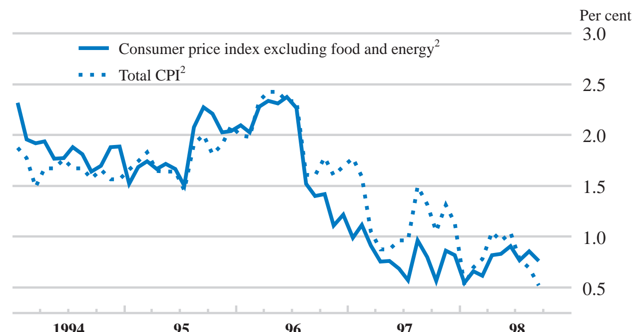
Thus far in 1998, job creation has been more dynamic than generally foreseen, with private sector employment up by 2.1 per cent in the year to June. By September, the unemployment rate had declined to 11.7 per cent of the labour force, down 0.6 percentage point from the end of 1997. Youth unemployment decreased, partly as a result of a large-scale youth-job programme which by end-September had led to 89 000 hires, mostly in or around the public sector. The law cutting legal weekly working time from 39 to 35 hours, described in *OECD Economic Outlook 63*, was promulgated in

France

Consumers remain confident while the mood of enterprises becomes less optimistic



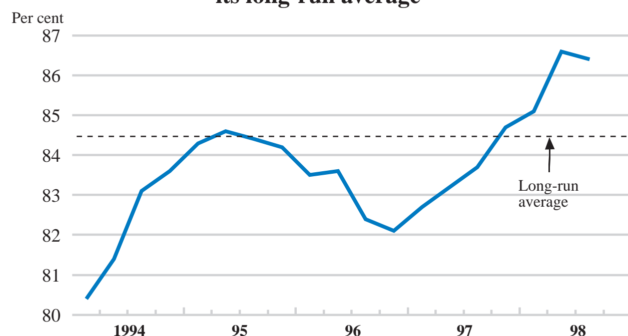
Inflationary pressures remain minimal



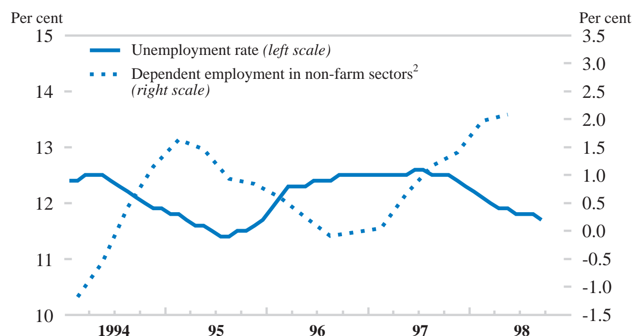
1. Balance between optimistic (+) and pessimistic (-) answers.
2. Year-on-year percentage changes.

France

Capacity utilisation is now above its long-run average[1]



Employment is rising and unemployment slowly declining



1. In manufacturing.
2. Year-on-year percentage changes.
Sources: INSEE and OECD.

June 1998. By late October, some 500 enterprise agreements had been reached covering around 60 000 persons, typically involving increased flexibility in the allocation of time over the year and a temporary freeze in nominal wages. The anticipation of the implementation of the new law, which will become compulsory at the start of 2000 for enterprises employing over 20 persons, may have helped to moderate the wage increases granted this year. Nominal wage restraint is also related to the persistence of very low inflation, with consumer prices rising at less than 1 per cent per annum and producer prices for commodities and intermediate goods falling.

Monetary conditions are fairly accommodative

Monetary conditions have remained rather accommodative, despite marginal tightening since mid-1997. The central bank's intervention rate has not changed since last fall, short-term market rates have been hovering around 3½ per cent, and long-term rates have continued to drop, approaching a historic low of 4 per cent recently, in the context of the general flight to quality. Narrow monetary aggregates have been growing rapidly this year, but to some extent this reflected substitution within broader aggregates, with M3 currently expanding at about the targeted medium-term pace of 5 per cent per annum, following a prolonged lull. Credits to enterprises and households are also on the rise.

Financial indicators

	1996	1997	1998	1999	2000
Household saving ratio[a]	13.3	14.5	14.4	14.3	14.3
General government financial balance[b, c]	–4.1	–3.0	–2.9	–2.4	–1.9
Current account balance[b]	1.3	2.7	2.6	2.4	2.4
Short-term interest rate[d]	3.9	3.5	3.5	3.0	3.1
Long-term interest rate[e]	6.5	5.7	4.7	4.1	4.3

a) As a percentage of disposable income.
b) As a percentage of GDP.
c) Maastricht definition.
d) 3-month interbank rate.
e) Public and semi-public sector bonds.

Employment, income and inflation

Percentage changes

	1996	1997	1998	1999	2000
Employment	0.1	0.4	1.2	1.3	1.3
Unemployment rate[a]	12.3	12.4	11.8	11.2	10.6
Compensation of employees	3.4	2.7	3.7	3.8	3.8
Unit labour cost	1.8	0.4	0.6	1.3	1.2
Household disposable income	2.4	3.5	3.8	3.4	3.6
GDP deflator	1.2	0.9	0.7	1.0	1.3
Private consumption deflator	1.8	1.1	0.5	0.9	1.2

a) As a percentage of labour force.

Fiscal consolidation is proceeding rather gradually

With employment and consumption overtaking the authorities' projections, the execution of the 1998 Budget is turning out to be easier than planned. Despite some slippage on health care outlays, the deficit of the general government is therefore projected to end up slightly below the 3 per cent target. However, this would not imply a significant improvement in the structural deficit, if one corrects also for a one-time accounting operation in 1997. On this measure, the draft budget for 1999 foresees limited tightening. This strategy of gradual deficit reduction reflects the authorities' concern not to dampen domestic demand in the face of a negative external contribution to growth. It translates into a significant increase in the volume of total outlays and a reduction in the revenue to GDP ratio, which by international standards is indeed very high. A number of taxes are being cut, including the real estate transaction tax (which should foster labour mobility) and, over the next five years, the wage-based component of a widely criticised local government tax (the *taxe professionnelle*). At the same time, the wealth tax is stiffened and a new green tax is being introduced. For the first time in many years, the social security accounts are projected to show a small surplus. Public debt is projected to increase somewhat in 1999, to close to 59 per cent of GDP.

Demand and output

Percentage changes, volume (1980 prices)

	1995 current prices billion FF	1996	1997	1998	1999	2000
Private consumption	4 586.6	2.0	0.9	3.4	2.6	2.4
Government consumption	1 495.6	2.6	1.2	1.5	2.0	2.2
Gross fixed investment	1 374.8	–0.5	0.0	4.6	4.6	4.2
General government	242.1	–7.5	0.2	0.9	2.3	2.6
Household	351.1	–1.0	–0.6	2.1	3.8	3.4
Other	781.6	2.0	0.3	6.8	5.6	5.0
Final domestic demand	7 457.1	1.6	0.8	3.3	2.9	2.7
* stockbuilding	23.7[a]	–0.7	0.0	0.5	0.1	0.0
Total domestic demand	7 480.9	0.9	0.8	3.9	3.0	2.7
Exports of goods and services	1 803.0	5.2	12.5	5.7	4.0	5.1
Imports of goods and services	1 621.5	3.0	7.7	8.2	5.7	5.5
* net exports	181.5[a]	0.6	1.5	–0.6	–0.5	–0.1
GDP at market prices	7 662.4	1.6	2.3	3.1	2.4	2.6
Industrial production[b]	–	0.2	3.9	4.8	3.3	3.1

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Annual amount.
b) Quarterly index.

External indicators

	1996	1997	1998	1999	2000
			$ billion		
Merchandise exports	281.8	284.1	298.8	329	349
Merchandise imports	266.9	255.9	270.8	302	322
Trade balance	15.0	28.1	27.9	27	26
Invisibles, net	5.6	9.4	9.9	11	13
Current account balance	20.5	37.6	37.9	38	40
			Percentage changes		
Merchandise export volumes[a]	5.1	12.9	6.3	3.9	5.0
Merchandise import volumes[a]	2.5	7.8	8.7	5.7	5.5
Export performance[b]	–1.2	3.6	–0.1	–1.4	–0.9
Terms of trade	–1.2	–0.3	1.0	0.5	–0.2

a) Customs basis.
b) Ratio between the total of export volumes and export market of total goods.

Growth is set to remain above potential save a further sharp deterioration in the external environment

The latest business surveys are somewhat less encouraging but still suggest that activity will remain strong in most sectors and that domestic demand will continue to drive the expansion. Output growth is projected to slow a bit in the near future but to remain above potential over the next two years. Private consumption is likely to benefit from an improving labour market situation, which should reduce precautionary saving a little. Low interest rates should bolster private residential construction as well as business investment, which may also be boosted by the advent of the euro and the millennium bug. The current weakness of export growth is projected to lessen over the projection horizon and the current account surplus should remain in the neighbourhood of 2½ per cent of GDP. With growth somewhat above potential and the continuing creation of some 100 000 new quasi-public sector youth jobs each year, the unemployment rate may fall to 10½ per cent by the end of 2000. Wage and price inflation are projected to pick up only marginally over the projection period, reflecting some rebound in world commodity prices and a gradually closing output gap.

Risks are more on the downside than on the upside

This central scenario fits into one of a largely self-sustained expansion in the euro area. However, considerable uncertainty surrounds the international environment at large. If export growth does not pick up, the still relatively upbeat mood of businesses could be affected, with an adverse impact on investment. On current policies, fiscal consolidation would then slow down, all the more so as controls on social spending remain insufficient. Another risk pertains to the complex ramifications of the move towards the 35-hour legal working week, which, if not implemented very flexibly, could affect competitiveness.

Italy

After a growth pause in the opening months of 1998, prospects for the second half of the year appear finely balanced. Helped by less restrictive economic policies and tax breaks for residential construction, business fixed investment should strengthen, while stronger real income growth should begin to support consumption. But investor uncertainty has increased with the volatility of global financial markets, and consumer confidence remains fragile following a five-year period of stagnant real disposable income. Overall, real GDP growth is projected to be around 1½ per cent in 1998. While it could pick up to 2 to 2½ per cent in the following two years, Italy's growth performance is likely to remain weaker than in many European countries. In such a context, labour market conditions, though improving, will remain weak, dampening nominal wage growth and inflation.

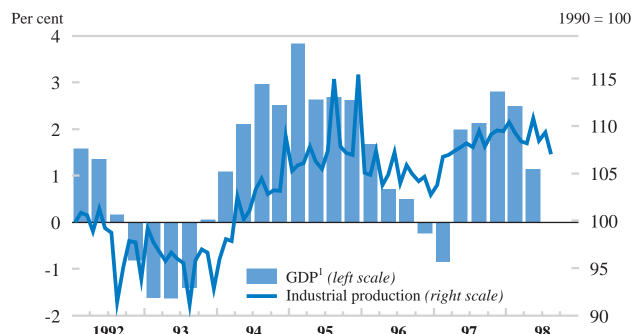
The immediate policy requirement is to keep the budget deficit and inflation low, and to reduce outstanding public debt. This will consolidate the progress towards convergence and underpin recent structural policy initiatives. These have focused on improving public-sector efficiency, exposing product markets to greater competition and reducing unemployment. The latter remains the major disequilibrium in Italy's economy, calling for more vigorous policy action to tackle problems in the labour market, which remains characterised by over-regulation, while productivity differentials across regions are not fully reflected in wage levels. Skill imbalances need to be addressed through improved training and education.

Economic growth has slowed

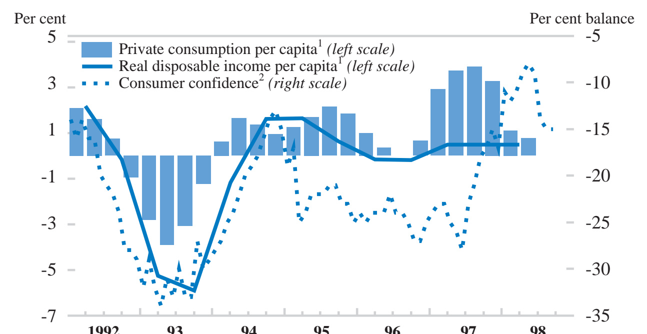
Following a pick-up in the second half of 1997, real GDP growth unexpectedly stalled in the first half of 1998. The Asian crisis contributed to a fall in exports and higher imports, while growth was also adversely affected by decelerating private consumption under the combined effects of reduced incentives for car purchases and weak disposable income growth. In addition, a fall in construction investment more than offset the influence of stronger purchases of machinery and equipment. Stockbuilding cushioned the slowdown in aggregate output growth, but even so the industrial sector underwent a significant slowdown. Industrial production estimates suggest that activity may have firmed since September, and recent business surveys have displayed signs of a pick-up in the demand for investment goods. While both domestic and foreign orders have declined recently, they remain close to levels obtained by mid-1997 and the investment plans of small firms have been resilient in the face of international uncertainty. On balance, real GDP growth is unlikely to exceed 1½ per cent for 1998 as a whole.

Italy

Output growth has slowed



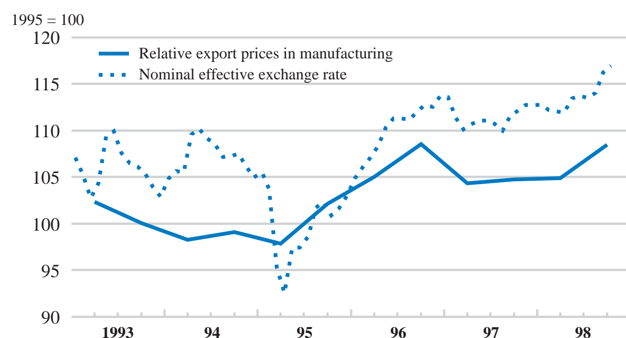
Consumption remains relatively weak



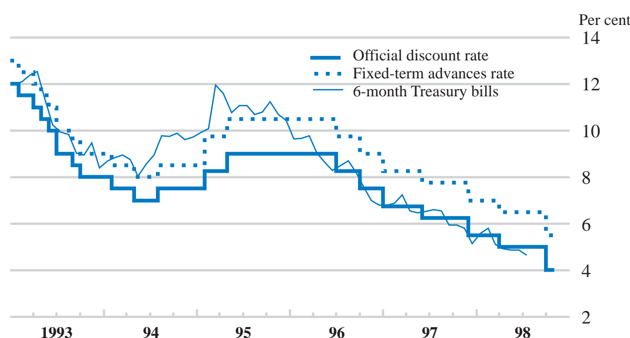
1. Year-on-year percentage changes.
2. Per cent balance of positive and negative answers.

Italy

Some erosion of competitiveness has occurred



Monetary conditions have continued to ease



Sources: Bank of Italy; OECD.

Unemployment has remained high and inflation low

With the economy operating below its potential and capacity utilisation still beneath the 1990 cyclical peak, labour market conditions have been showing only weak signs of improvement. Job creation has increased in the service sector, and there has been a rise in female and youth employment in the south. Overall, however, the seasonally-adjusted rate of unemployment has been steady at around 12½ per cent, while regional unemployment rates have continued to diverge. Recent wage settlements in the chemical, banking, insurance and civil service sectors have provided for moderate wage increases, influenced by high unemployment and a favourable inflation performance. Falling import prices and steady producer prices have stabilised the rate of consumer price increases at around 1¾ per cent, despite a rise in VAT rates.

The trade surplus has fallen

On the external side, the trade surplus has continued to shrink, notwithstanding improved terms of trade. This mainly reflects relatively weak exports to Germany and a switch from surplus to deficit in trade with Japan and the emerging Asian economies, including China. Although Asian countries account for less than 7 per cent of Italy's total imports and a little over 5 per cent of total exports, certain sectors, such as textiles and clothing, have been severely hit by the Asian crisis.

Interest rates have fallen

Falling nominal and real interest rates, together with high and rising rates of return on capital and tax incentives for construction, should continue to make gross fixed investment the most dynamic component of domestic demand. Benchmark long-term Treasury bond rates have already declined to historical lows. After a temporary rise, by

Employment, income and inflation

Percentage changes

	1996	1997	1998	1999	2000
Employment	0.4	0.0	0.2	0.4	0.4
Unemployment rate[a]	12.1	12.3	12.2	12.1	11.9
Compensation of employees	6.0	4.7	1.2	2.2	2.7
Unit labour cost[b]	5.3	3.2	–0.3	0.1	0.2
Household disposable income	4.6	3.2	3.0	3.2	3.5
GDP deflator	5.0	2.6	2.7	1.9	1.5
Private consumption deflator	4.4	2.4	2.3	1.8	1.3

a) As a percentage of labour force.
b) The estimate for 1998 takes into account the introduction of the regional tax (IRAP) which was accompanied by the partial abolition of the employers' compulsory contributions to the health care system.

External indicators

	1996	1997	1998	1999	2000
			$ billion		
Merchandise exports	250.8	238.4	249.1	273	291
Merchandise imports	190.1	191.3	198.1	218	233
Trade balance	60.7	47.1	51.0	56	57
Invisibles, net	–20.2	–13.5	–12.8	–13	–11
Current account balance	40.5	33.5	38.2	43	47
			Percentage changes		
Merchandise export volumes[a]	4.5	5.0	3.6	3.5	5.3
Merchandise import volumes[a]	0.0	10.1	7.9	4.1	5.5
Export performance[b]	–2.7	–3.9	–2.4	–1.6	–0.7
Terms of trade	2.5	–1.2	4.1	0.5	–0.5

a) Customs basis.
b) Ratio between the total of export volumes and export market of total goods.

early November the differential *vis-à-vis* the German equivalent had fallen back to around 30 basis points, close to the level prevailing prior to the weakening of global financial-market conditions. With inflation remaining in line with targets, and money supply having decelerated since the summer, key official rates were cut by 1/2 per cent in April and a further 1 per cent in October, bringing the discount rate down to 4 per cent and the rate on fixed-term advances to 5.5 per cent. Consequently, the short-term interest-rate differential *vis-à-vis* Germany has fallen to 75 basis points.

Fiscal consolidation is set to continue, albeit at a slower pace

According to the 1999 budget, the general government deficit is expected to decline to 2.6 per cent of GDP this year (so far, roughly on target) and 2 per cent in 1999. This represents a slowing in the pace of fiscal consolidation, reflecting the commitments by the government to increase capital spending in the south, to raise welfare spending for families in need, and to introduce a once-and-for-all tax bonus (the partial reimbursement of the 1997 Eurotax). The greater part of the deficit reduction is to come from both falling interest payments and lower transfers to the health system and public corporations (railways and postal services). Revenue gains are expected to accrue from reduced tax evasion. Given somewhat weaker projections for real GDP growth, OECD estimates suggest that the 1999 deficit may not fall below 2.2 per cent of GDP. A further decline in interest payments, brought about by falling public debt and privatisation proceeds should reduce the budget deficit to 1.8 per cent of GDP in 2000, moderately above the official target of 1.5 per cent set out in the three-year plan of April 1998.

Overall, the economic policy stance is expected to ease…

OECD projections take into account the establishment of European Economic and Monetary Union at the beginning of 1999. Short-term interest rates are thus expected to ease further in the final quarter of this year, converging by January 1999 towards the lower rates prevailing in Germany and France. At the same time, the contractionary demand impact of fiscal policy is projected to abate, giving way to a small expansionary impulse in cyclically-adjusted terms. On the other hand, export markets will expand less rapidly, and the real exchange rate has appreciated, so that export growth is expected to weaken. But the growth of imports of goods and services should also decelerate under the influence of reduced stockbuilding – after the strong build-up in both 1997 and the first half of 1998 – and reduced car incentives. Overall, the net foreign balance should have little impact upon real GDP growth over the projection period.

Financial indicators

	1996	1997	1998	1999	2000
Household saving ratio[a]	13.8	12.4	11.8	11.0	10.5
General government financial balance[b]	–6.7	–2.7	–2.6	–2.2	–1.8
Current account balance[b]	3.3	2.9	3.2	3.3	3.5
Short-term interest rate[c]	8.8	6.9	4.8	3.0	3.1
Long-term interest rate[d]	9.4	6.9	4.9	4.3	4.4

a) As a percentage of disposable income.
b) As a percentage of GDP.
c) Interbank deposit rate.
d) Treasury bonds with residual maturity above 1 year.

… setting the stage for a mild output acceleration and easing unemployment

The projected pick-up in real GDP growth to just over 2 per cent in 1999 and further to around 2 1/2 per cent in 2000 partly derives from private consumption, which should be stimulated by a recovery in real disposable income as fiscal policy becomes less restrictive. In addition, gross fixed investment is expected to strengthen in 1999 with a further rise in profitability, lower real interest rates and improving consumption prospects. The projected expansion of economic activity being mild and employment gains small, the rate of unemployment may ease only slightly, to below 12 per cent in 2000. Remaining well above its estimated structural rate, unemployment should continue to restrain nominal wage growth as in 1997 and 1998. Assisted by moderate import prices, the rise in the private consumption deflator should fall to below 2 per cent in 1999. On the external side, positive terms of trade are projected to widen the trade surplus, outweighing the adverse effects of currency depreciation in Asian and East European countries. Together with a sharp contraction of the deficit on the invisible account as the deficit in net investment income disappears, this may raise the current account surplus to around 3 1/2 per cent of GDP at the end of the projection period.

Demand and output

Percentage changes, volume (1990 prices)

	1995 current prices trillion L	1996	1997	1998	1999	2000
Private consumption[a]	1 108.2	0.8	2.4	1.3	2.4	2.6
Government consumption	288.9	0.2	–0.7	0.9	0.4	0.4
Gross fixed investment	306.9	0.4	0.6	3.3	4.0	4.1
Machinery and equipment	157.6	–0.3	2.6	5.7	4.3	4.1
Construction	149.3	1.1	–1.6	0.5	3.6	4.0
Residential	84.6	–3.4	–4.4	4.5	6.0	5.6
Non-residential	64.7	7.0	1.8	–3.9	0.7	2.0
Final domestic demand	1 704.0	0.6	1.5	1.6	2.3	2.5
* stockbuilding	16.3[b]	–0.3	1.0	0.5	0.0	0.0
Total domestic demand	1 720.3	0.3	2.5	2.1	2.3	2.5
Exports of goods and services	444.8	–0.2	6.3	5.2	3.5	5.4
Imports of goods and services	392.8	–2.0	11.8	8.5	4.1	5.6
* net exports	52.0[b]	0.4	–0.9	–0.6	–0.1	0.1
GDP at market prices	1 772.3	0.7	1.5	1.5	2.1	2.6
Industrial production	–	–2.9	2.7	1.7	2.5	3.1

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Final consumption in the domestic market by households.
b) Actual amount.

Some uncertainty exists as to the effects of weak consumer confidence and volatile global financial markets

Significant uncertainties attach to the projections. From the supply side, recent years have seen substantial progress in structural reform, particularly in exposing product markets to greater competition, and this could have improved the supply-side potential of the economy. Labour market reform could also have lowered the structural rate of unemployment, though the sector is still over-regulated, calling for more policy action. From the demand side uncertainties exist, arising both from consumer behaviour and international events. Consumer confidence remains weak, while major categories of exports are exposed to much keener competition from Asia and Latin America. On the other hand, real incomes, while below 1993 levels, are picking up and employment has stopped falling; confidence could therefore recover. On the external side, overall Italian banking exposure is low. But the balance sheets of certain major Italian corporations which made large investments in some of these crisis countries, including Russia, may have deteriorated, with potentially adverse effects on their propensity to invest domestically. This would add to the risk of demand being weaker than projected.

United Kingdom

The UK economy has recently reached a turning point, following six years of expansion. Output growth has slowed from the unsustainable peak rate recorded in the second half of 1997, and the weaker pace has started to spread to the services sector. Domestic cost pressures, largely reflecting labour market tightness, have been intensifying, but lower commodity and import prices have helped keep inflation close to the official target. Tighter macroeconomic policies commenced in mid-1996 and were considerably strengthened through the second half of 1997. Given the usual lags, this firm policy stance should continue to dampen economic activity and is likely to lead to growth considerably below potential over the next two years. With activity weak, inflation should remain low, but labour market conditions will weaken and lead to higher unemployment.

The challenge facing policy has shifted from orchestrating a needed slowdown in growth, towards avoiding unnecessarily low growth. The policy context is complicated by mixed signals from economic indicators and the intense uncertainty concerning the full impact of recession in many emerging economies and Japan, which makes it difficult to assess the speed and eventual depth of a slowdown. At the same time, wage pressures have barely eased. Nevertheless, given weakening economic prospects, the margin for manoeuvre to soften the overall policy stance should increase.

Economic growth is slowing

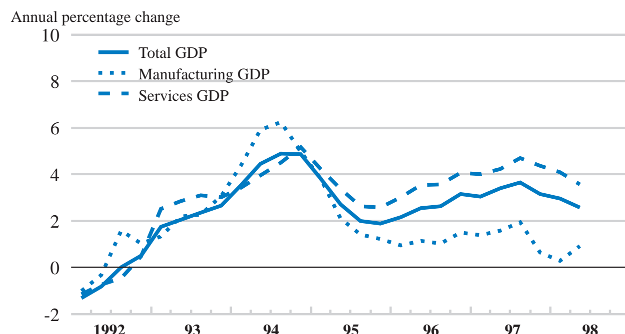
GDP rose by 2.7 per cent in the first half of 1998, considerably lower than the peak of 4 per cent in the second half of 1997 and growth continued to ease in the third quarter. So far, the slowdown has been most visible in the external sector, as the high level of the exchange rate and resulting loss in competitiveness has increased imports and eroded the ability of UK firms to compete in export markets. Recession in many emerging economies has further weakened export market growth. As a result, exports slowed sharply in volume terms in the first half of 1998 and the trade deficit has almost doubled to 2 per cent of GDP over the last year.

The slowdown is now more broadly based

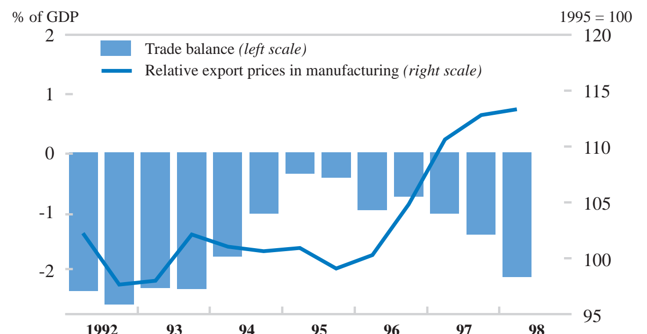
But signs of weakness in the domestic economy are also mounting. Growth in services output has started to slow, while manufacturing output growth remains sluggish. Most indicators portend a period of below trend economic growth. Retail sales volume growth has moderated, albeit slowly and erratically, in line with lower consumer confidence, tighter monetary conditions, slower housing investment and level effects from building society windfalls, which temporarily boosted consumer spending last year. Lower corporate profits and business confidence have dented investment spending intentions, especially in the manufacturing sector.

United Kingdom

Output growth slows



The trade balance deficit has widened



Employment, income and inflation

Percentage changes

	1996	1997	1998	1999	2000
Employment	1.1	1.7	0.5	–0.6	–0.2
Unemployment rate[a]	8.0	6.9	6.5	7.4	8.0
Compensation of employees	5.1	6.9	6.3	4.3	4.4
Unit labour cost	2.4	3.3	3.5	3.5	2.8
Household disposable income	5.4	6.1	5.4	4.2	4.8
GDP deflator	3.3	2.7	2.2	3.1	2.6
Private consumption deflator	3.1	2.6	2.0	2.8	2.5

a) As a percentage of labour force.

Labour market conditions are tight, although some signs of easing are emerging

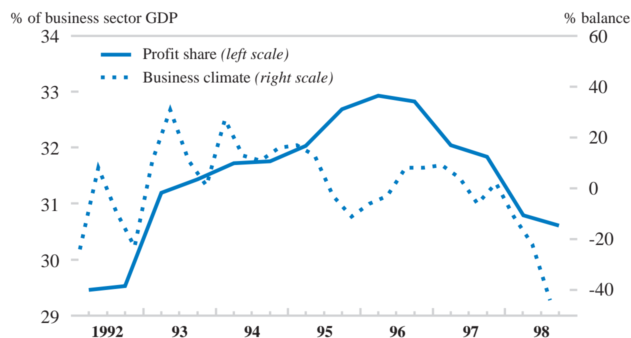
Labour market conditions are tight, although some signs of easing are emerging. Employment growth has slowed, hiring intentions are falling and the level of vacancies has slipped marginally from its high level. On the other hand, the unemployment rate has continued to decline to 6¹/₄ per cent, its lowest level in 18 years; and recruitment difficulties persist, particularly for skilled workers in the service sector. The recently revised headline measure of average earnings growth fell back in July closer to the 4¹/₂ per cent rate that the Bank of England considers consistent with the Government's inflation target, though the reliability of the new index is under review. The New Deal, more generous in-work benefits and reforms to national insurance contributions to reduce high marginal effective tax rates paid by low income earners are likely to increase labour supply, and should help to moderate wage pressures. So far more than 100 000 young people have joined the New Deal, but since the scheme is recent, most participants are still being counselled. The proportion of participants finding work is expected to rise significantly in the months ahead, as more young people complete the counselling phase.

Inflation is on target, but pressures are evident

Import prices have been subdued due to sterling's appreciation and the decline in world commodity prices, which have helped keep inflation close to the government's 2¹/₂ per cent target. However, in most service sectors, prices are rising at a rate well above the overall inflation target. Following the government's decision to introduce a

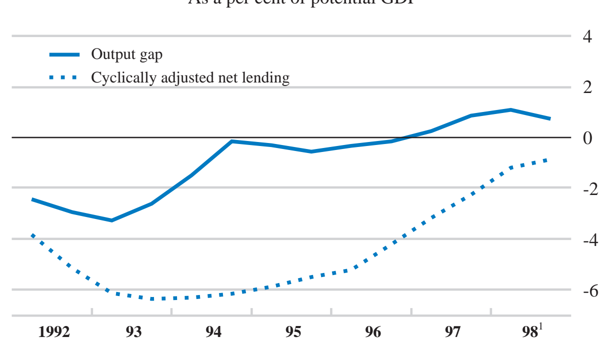
United Kingdom

Business profits and confidence are falling



The fiscal stance has tightened

As a per cent of potential GDP



1. Estimate.

Financial indicators

	1996	1997	1998	1999	2000
Household saving ratio[a]	9.7	9.9	10.0	9.6	10.5
General government financial balance[b]	–4.4	–2.0	–0.4	–0.7	–1.0
Current account balance[b]	–0.3	0.6	–0.6	–1.2	–1.5
Short-term interest rate[c]	6.0	6.8	7.3	6.1	5.1
Long-term interest rate[d]	7.8	7.0	5.5	5.0	5.0

a) As a percentage of disposable income.
b) As a percentage of GDP.
c) 3-month interbank rate.
d) 10-year government bonds.

national minimum wage in April 1999, a temporary inflation fillip is likely. The Bank of England estimates that the direct effect would be to raise the wage bill by about 0.6 per cent and that it would add, over time, about 0.4 per cent to the price level.

Monetary conditions are firm…

The stance of macroeconomic policy has tightened significantly since mid-1997, and the impact on domestic demand now seems apparent. The tight policy stance is expected to continue to exert a sizeable restraining force on domestic demand growth over the next year. Monetary conditions are particularly firm, but the tightening phase now appears to have ended. The Bank of England reduced the base lending rate by 25 basis points in early October – the first cut in 2 years – and again on November 5 by a further 50 basis points to 6.75 per cent. The effective exchange rate has also moved down from its high level. The impact on activity from the policy stance is likely to be partly counterbalanced by the further substantial declines in long-term interest rates – initially associated with credibility gains following the decision to grant the Bank of England operational independence over monetary policy and more recently induced by the OECD-wide decline in bond yields.

Demand and output

Percentage changes, volume (1995 prices)

	1995 current prices billion £	1996	1997	1998	1999	2000
Private consumption	454.2	3.6	4.2	3.0	1.3	1.5
Government consumption	140.4	1.7	0.0	2.1	1.5	2.2
Gross fixed investment	108.7	4.9	6.1	7.0	2.0	1.7
Public[a]	15.9	–21.4	–7.9	1.1	4.6	6.8
Private residential	24.0	9.7	4.3	1.8	2.2	2.5
Private non-residential	68.8	8.8	8.8	9.3	1.6	0.9
Final domestic demand	703.3	3.5	3.7	3.5	1.4	1.7
* stockbuilding	4.4[b]	–0.4	0.2	0.4	–0.2	–0.1
Total domestic demand	707.7	3.0	3.9	3.9	1.2	1.6
Exports of goods and services	202.4	7.5	8.4	2.7	2.9	4.8
Imports of goods and services	205.2	9.1	9.5	6.7	4.1	4.6
* net exports	–2.8[b]	–0.5	–0.4	–1.3	–0.5	–0.1
GDP at market prices[c]	704.9	2.6	3.5	2.7	0.8	1.5
Manufacturing production	–	0.3	1.5	0.1	0.5	1.4

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Including nationalised industries and public corporations.
b) Actual amount.
c) Data for GDP in the past are based on a compromise estimate which is the average of the expenditure, output and income estimates of GDP. The compromise adjustment is the difference between compromise GDP and the expenditure estimate of GDP.

External indicators

	1996	1997	1998	1999	2000
			$ billion		
Merchandise exports	261.5	279.4	273.2	285	303
Merchandise imports	281.3	299.9	302.4	317	336
Trade balance	–19.8	–20.6	–29.2	–32	–33
Invisibles, net	16.3	28.5	21.1	14	10
Current account balance	–3.6	7.9	–8.1	–18	–23
			Percentage changes		
Merchandise export volumes[a]	7.5	7.0	–1.7	3.0	4.8
Merchandise import volumes[a]	9.6	7.5	3.1	3.8	4.5
Export performance[b]	0.8	–2.6	–8.3	–2.8	–1.3
Terms of trade	1.7	0.8	2.4	0.4	–0.1

a) Customs basis.
b) Ratio between the total of export volumes and export market of total goods.

… and the fiscal stance is broadly neutral

Over the last five years above potential growth has led to a positive output gap and the budget has been reduced considerably. A large part of the reduction in the deficit is structural as a result of higher taxation and tight spending controls, although a small cyclically adjusted deficit remains. Fiscal policy assumptions underlying the projections lock in the progress achieved. The June 1998 Economic and Fiscal Strategy Report (ESFR), outlines a new medium-term public expenditure plan with multi-year limits for the control of around half of public expenditure, with the remainder subject to annual review and extends the fiscal policy framework put in place since 1997. Real current expenditure growth is limited to an average of 2$^1/_4$ per cent per annum for the remainder of the Parliamentary term and public capital spending is planned to rise rapidly, and ultimately double the share of public investment in GDP to 1.5 per cent. The November Pre-Budget Report updated the government's economic and public finance forecasts and also indicated a number of initiatives being considered in the lead-up to the 1999 budget and which aim to raise the UK's relatively low productivity level. The Secretariat's projections, which are on a national accounts and calendar year basis, show lower revenues and higher outlays than official and updated plans in the Pre-Budget Report, reflecting a weaker economic outlook. The cyclically-adjusted deficit is virtually unchanged between 1998 and the year 2000, at around $^3/_4$ per cent of GDP, but the actual deficit doubles over the projection period. Nonetheless, observance of the "Golden Rule" over the cycle – a deficit no larger than net government investment – is comfortably adhered to and net debt as a share of GDP should decline slightly.

A sharp slowdown in growth is expected…

Output growth is projected to fall considerably below trend over the next two years. GDP could rise by just under 1 per cent in 1999 and by 1$^1/_2$ per cent the following year. Initially, the further slowdown is due to continued weak external demand, following the significant deterioration in UK competitiveness since 1996 and falling import demand in emerging economies. A weaker current account position and lower interest rates might lead to a depreciation, but as usual these projections are based on the technical assumption of unchanged exchange rates. The full impact of lower profits, consumer and business confidence, and the tight overall stance of policy are expected to slow consumer and private investment spending in 1999, before a slight recovery in 2000.

… as well as rising unemployment

With the slowdown in activity, labour market conditions are expected to slacken. Employment is likely to fall slightly and unemployment could reach 8 per cent of the labour force by the year 2000. In the near term, however, the still tight labour market conditions and a positive output gap could lead to a rise in inflation, despite lower commodity and import prices. As slack in the labour market progressively re-emerges, wage pressures, especially in the private sector, should ease and inflation should stay in line with the government's target.

The risks are unusually large

The main downside risk to the outlook concerns larger spillover effects from the economic contraction in Japan and emerging markets. If conditions do not improve in Japan, and economic contagion spreads to other emerging economies, it could trigger a negative impact on financial and equity markets, hit confidence and result in weaker consumer and business investment spending than projected. The main domestic risk is a potential overestimation of near-term labour market tightness and corresponding wage pressures, which could delay further reductions in the repo rate, with a higher likelihood of recession later on. On the other hand, the introduction of a national minimum wage in early 1999 could exert some upward pressure on inflation if demands for restoration of wage differentials emerge. A related risk is stronger wage demands in the public sector, linked to the prolonged period of subdued earnings growth and the consequent widening wage gap with private-sector employees.

Canada

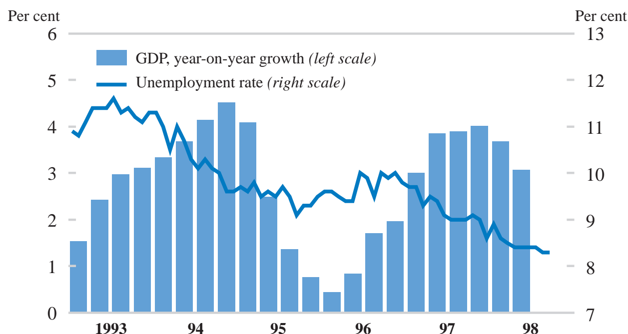
Following a period of strong economic expansion, the pace of activity has slowed in response to a weakening external environment. Despite the resilience of the US economy, Canada's export market growth has softened in the wake of the Asia crisis and resource-based industries have been hit hard by global falls in commodity prices. Associated downward pressure on the Canadian dollar has led to higher short-term interest rates which have begun to dampen domestic demand. These influences will continue to act as a drag on the economy in the near term, preventing a further narrowing in the output gap. In the absence of a further deterioration of the external environment, economic growth is expected to gradually recover later in the projection period, as interest rates ease in line with those in the United States and the low exchange rate allows some gain in export market share.

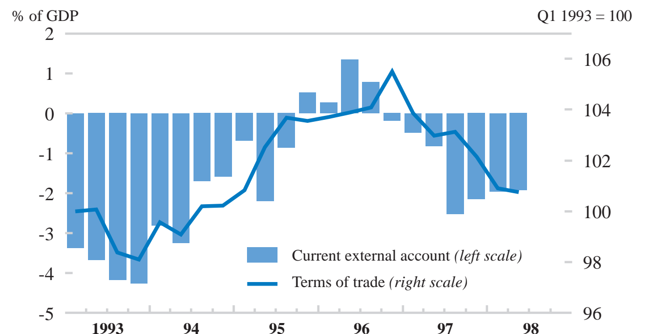
Despite the rise in short-term interest rates over the past year or so, overall monetary conditions have eased somewhat as a result of the marked fall in the effective exchange rate. Given the weaker and more uncertain outlook for the world economy and the apparent absence of inflationary pressure, an accommodating monetary stance would seem warranted until the closing of the output gap resumes. At the same time, in view of the high level of public debt, it will be important to continue with fiscal consolidation to make the economy less vulnerable to external shocks.

Growth has slowed…

Real GDP growth fell from an annual rate of 4 per cent in both semesters of 1997 to 3 per cent in the first half of 1998, reflecting a softening in all major demand components. Despite continued strong activity in the United States, Canada's main customer, export volumes expanded at a slower pace as rising sales to Europe did not make up for sharply lower shipments to Asia. On the domestic side, consumer demand lost momentum even though real disposable income finally picked up, since households appear to have hesitated to reduce their – historically low – saving ratio further. Growth in housing investment virtually came to a halt even though it has still not regained the levels recorded in the late 1980s and continues to fall short of estimates of potential demographic requirements. Business investment kept growing, albeit at lower rates than in 1997, given falling profits and capacity utilisation in resource-based industries. Business inventory accumulation also eased and started to act as a drag on economic growth. While the slowing in the underlying trend of demand and output is unambiguous, the weakening in activity has been accentuated by temporary factors, in particular a number of protracted labour conflicts in mid-1998. Strikes in the auto and forest product industries led to temporary plant closures and depressed production and exports, and strikes in the construction sector explain in part sluggish residential investment.

Canada





Employment, income and inflation

Percentage changes

	1996	1997	1998	1999	2000
Employment	1.3	1.9	2.5	1.8	1.7
Unemployment rate[a]	9.7	9.2	8.4	8.1	8.0
Compensation of employees	2.5	3.8	4.0	4.9	4.9
Unit labour cost	1.3	0.1	1.0	2.4	2.0
Household disposable income	1.6	1.3	2.6	4.6	4.9
GDP deflator	1.4	0.5	–0.1	1.6	2.2
Private consumption deflator	1.5	1.7	1.0	1.7	2.1

a) As a percentage of labour force.

… arresting the decline in unemployment

The labour conflicts have also affected employment which dropped in the middle of 1998 and has risen beyond previous peak levels only recently as laid-off workers returned to work. As a result, little further inroad has so far been made into unemployment since April, when it had fallen below 8 1/2 per cent of the labour force. This has contributed to wage moderation and limited cost pressures. Indeed, although productivity gains have slowed in parallel with output growth, unit labour costs have risen only slightly. Import price increases have also been modest so far, despite significant exchange rate depreciation, as world market prices for primary products have fallen sharply. With persistent economic slack, this has meant that inflation has remained subdued: the annual increase in consumer prices has kept running near the lower end of the official 1 to 3 per cent target range and the GDP deflator has been broadly stable in recent quarters, reflecting the deterioration in Canada's terms of trade.

Despite worsening terms of trade, the external deficit has narrowed

While commodities are less important to Canada than they used to be, they still make up about one-third of merchandise exports. Thus, the decline in world market prices associated with developments in Asia has had a significant effect on the country's export earnings. Although the impact on Canada's terms of trade is mitigated by the fact that commodities also account for one-quarter of imports, it is still substantial. Worsening terms of trade were a factor behind the re-emergence of an external deficit following a temporary surplus in 1996. In recent quarters, however, the current account deficit has tended to narrow as domestic demand has weakened and become less heavily weighted toward import-intensive components.

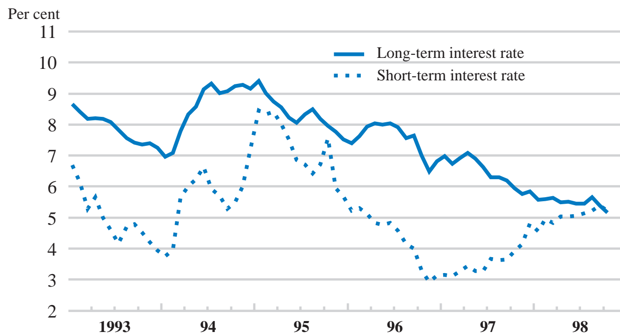
External indicators

	1996	1997	1998	1999	2000
			$ billion		
Merchandise exports	205.1	217.4	213.9	223	242
Merchandise imports	174.4	199.9	203.6	213	231
Trade balance	30.7	17.5	10.4	10	11
Invisibles, net	–27.4	–26.8	–23.0	–22	–23
Current account balance	3.3	–9.2	–12.6	–12	–12
			Percentage changes		
Merchandise export volumes[a]	5.7	9.0	7.4	6.4	7.1
Merchandise import volumes[a]	5.6	16.1	7.9	6.0	6.9
Export performance[b]	–3.5	–4.3	–1.7	–0.3	1.2
Terms of trade	2.1	–1.5	–2.9	–0.8	0.0

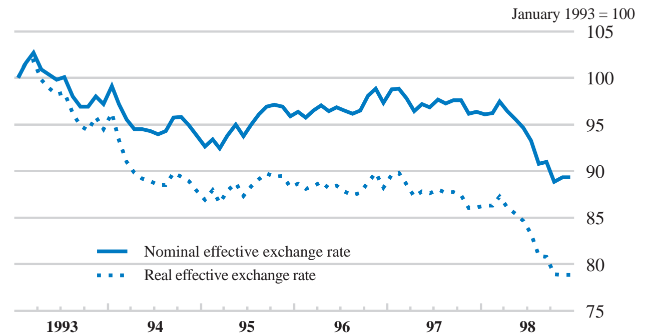
a) Customs basis.
b) Ratio between the total of export volumes and export market of total goods.

Canada

Interest rates have increased



But competitiveness has improved significantly



With downward pressure on the exchange rate, interest rates have increased

The task of monetary authorities has been complicated by the fact that financial markets have tended to exaggerate the importance of declining prices of natural resources for the Canadian economy. This has reinforced the downward pressure on the currency and hence the Bank of Canada's Monetary Conditions Index (MCI), which captures the combined effect of movements in short-term interest rates and the effective exchange rate. As a result, in late 1997 and early 1998, the authorities moved to raise interest rates, given the strong underlying momentum of the economy at that time. Subsequently, the ongoing deterioration in the Asian situation and fall in commodity prices led the Bank of Canada to refrain from further interest-rate increases despite continued currency weakness. However, during the financial market turmoil following the Russian crisis in August, the currency decline developed a momentum that, together with the re-emergence of positive long-term interest-rate differentials against the United States, convinced the Bank that it had to act to bolster confidence in Canadian dollar investments. The Bank rate was raised by 1 percentage point to 6 per cent. This has arrested the slide in the exchange rate and led to a reduction in risk premia built into long-term interest rates, allowing the Bank to follow recent cuts in US short-term rates. Presently, the MCI is still lower than in early 1998 and also below its level recorded before the Bank started raising interest rates in 1997, suggesting that overall monetary conditions remain stimulative. The projections assume that the recent stabilisation of the exchange rate will allow a further decline in Canadian short-term interest rates in line with their US counterparts. Long-term interest rates are

Financial indicators

	1996	1997	1998	1999	2000
Household saving ratio[a]	5.9	1.7	0.4	0.9	1.0
General government financial balance[b]	–2.0	0.9	2.0	2.2	2.4
Current account balance[b]	0.6	–1.5	–2.1	–2.0	–2.0
Short-term interest rate[c]	4.4	3.5	5.0	4.7	4.3
Long-term interest rate[d]	7.5	6.5	5.4	5.1	5.2

a) As a percentage of disposable income.
b) As a percentage of GDP.
c) 3-month prime corporate paper.
d) Long-term federal government bonds.

Demand and output

Percentage changes, volume (1992 prices)

	1995 current prices billion C$	1996	1997	1998	1999	2000
Private consumption	460.0	2.4	4.1	2.9	2.4	2.6
Government consumption	171.1	–1.3	–0.1	0.5	1.0	1.1
Gross fixed investment	135.3	4.8	11.4	4.9	5.3	5.8
Public[a]	20.1	–3.7	–5.4	3.2	3.6	3.5
Private residential	36.3	10.9	13.1	2.2	3.8	4.5
Private non-residential	79.0	4.2	14.5	6.5	6.4	6.8
Final domestic demand	766.4	2.0	4.5	2.8	2.7	2.9
* stockbuilding	8.2[b]	–0.9	0.8	0.2	–0.2	0.0
Total domestic demand	774.6	1.1	5.3	2.9	2.4	2.9
Exports of goods and services	302.2	5.7	8.0	6.8	6.2	6.8
Imports of goods and services	278.3	5.2	13.3	7.0	6.2	6.9
* net exports	23.9[b]	0.3	–1.6	0.0	0.0	0.0
* error of estimate	0.6[b]	–0.1	0.1	0.2	0.0	0.0
GDP at market prices	799.1	1.2	3.7	3.0	2.4	2.9
Industrial production	–	1.5	5.0	2.6	3.2	3.7

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Excluding nationalised industries and public corporations.
b) Actual amount.

projected to edge up somewhat in response to developments abroad, but their rise is expected to be limited as sound fiscal policies underpin financial market confidence.

Fiscal policy is moving toward a neutral stance

Reflecting consolidation efforts at all levels of government, the improvement in public finances has continued. In the first half of 1998, the general government financial surplus reached 2 per cent of GDP (on a national accounts basis), with the federal level contributing $1^1/_2$ percentage points. The federal authorities have indicated that, given the uncertainties surrounding the economic outlook, debt reduction will remain a key focus of fiscal policy. Indeed, despite some progress in this respect since 1997, Canada's gross and net public debt-to-GDP ratios, at 90 and over 60 per cent, respectively, are still high by international comparison. The projections assume that, after withdrawing $^3/_4$ per cent of GDP from domestic demand in 1998, fiscal policy will move toward a broadly neutral stance. This would still ensure that public debt keeps falling rapidly relative to GDP.

Following a further decline, growth is projected to recover gradually…

Given the adverse effects of the spreading Asia crisis and higher short-term interest rates, economic growth is projected to moderate further in the near term, although the ending of various labour conflicts will give a temporary boost to activity. With potential output currently expanding at a rate of about $2^1/_2$ per cent, according to OECD estimates, this means that no further progress is likely to be made in closing the economy's output gap through 1999. Later in the projection period, growth is expected to edge up gradually as the external environment and fiscal tightening cease to act as a drag on economic expansion while easier monetary conditions begin to support activity. Although households are likely to step up their saving ratio, domestic demand should be underpinned by falling short-term interest rates and the persistence of relatively low long-term rates. Exporters should gain market share following the pronounced improvement in international competitiveness stemming from both exchange-rate depreciation and subdued domestic inflation due to the persistent output gap. With the deterioration in Canada's terms of trade expected to come to a halt, this is projected to make for a broadly stable deficit on the external current account.

… although there are considerable downside risks to the outlook

Given the current turbulence in the world economy, uncertainties surrounding the outlook are greater than usual. Despite Canada's limited trade with emerging markets, a further fall in commodity prices could adversely affect business confidence and investment. Moreover, associated downward pressure on the Canadian dollar could complicate macroeconomic management, limiting the scope for lowering short-term interest rates. Indirect effects of the crisis through the US economy – Canada's major trading partner – could prove to be more consequential. This could have significant adverse implications for both exports and private sector confidence – the more so in the context of increased financial market volatility in Canada and elsewhere. Weaker equity markets also reinforce the risk of consumer retrenchment associated with the present low level of the household saving ratio.

Australia

Strong economic growth continued in the first half of 1998, driven by buoyant domestic demand, with a redirection of exports moderating the impact of the downturn in Asia. Employment growth has, however, slowed from earlier high rates, leaving the unemployment rate at just over 8 per cent. Current economic indicators suggest that growth has remained solid in the second half, but growth in domestic demand is likely to slow, reducing GDP growth from 3½ per cent in 1998 to around 2½ per cent in 1999 and 2000. This should contribute to a modest reduction in the current account deficit from 5½ per cent of GDP this year to around 5 per cent by 2000.

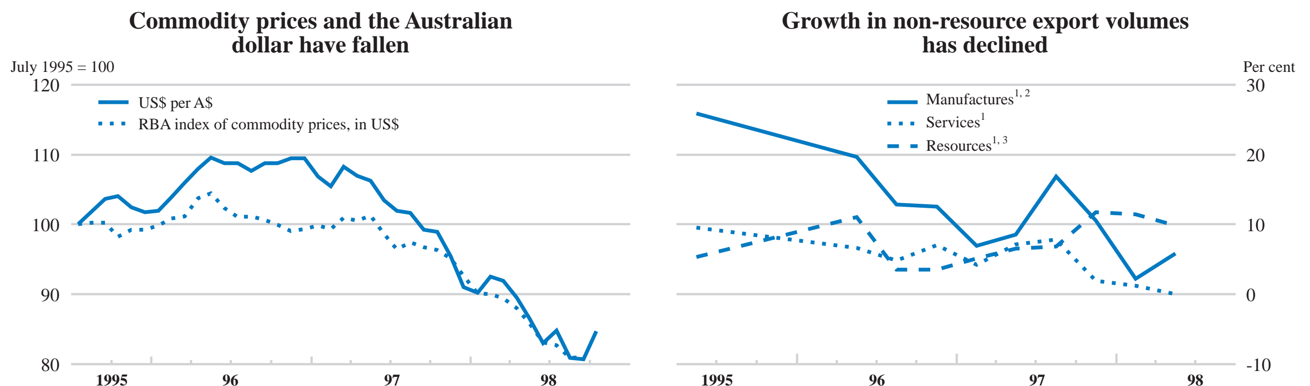
Fiscal policy needs to continue to be aimed at preserving the gains in budget consolidation so as to ensure that financial market confidence is retained in the face of global financial turbulence and the uncomfortably large current account deficit. The weakening economic outlook suggests that monetary policy should remain accommodative. Although inflation is projected to increase moderately from recent low levels, it will remain compatible with the central bank's medium-term target as the increase largely reflects one-off factors.

The domestic economy is buoyant

The pick up in growth since early 1997 was sustained in the first half of this year, with GDP growing at annual rate of almost 4 per cent. Available economic indicators generally point to steady growth having continued in the second half of the year. First half growth was domestically driven, with particularly large increases in private consumption expenditure, residential construction and inventories. Exports also rose, but this was more than offset by the increase in imports. While employment growth has remained solid in recent months, increased labour force participation has resulted in the unemployment rate remaining at just over 8 per cent since the beginning of the year, somewhat above its estimated structural rate. Wage increases remain steady at an annual rate of about 4 per cent. The underlying inflation rate (net of mortgage and consumer debt charges and some volatile items in the consumer price index) remains low, at an annual rate of around 1½ per cent. Increases in import prices in the past year have not yet flowed through to retail prices.

Depreciation is facilitating adjustment to the Asian crisis

The financial crisis which began in Asia has cut growth in the world economy, driving down commodity prices sharply in world currency terms. However, the Australian dollar has fallen by a similar percentage so that, in Australian dollar terms, overall commodity prices have been relatively stable. Growth in commodity export



1. Annual percentage change.
2. Excludes the sale of a frigate (A$ 0.5 billion) in the June quarter 1997.
3. Excludes sales of gold by the Reserve Bank of Australia: A$ 1.7 billion in the June quarter 1997 and A$ 0.7 billion in the September quarter 1997.
Source: Reserve Bank of Australia (RBA).

Demand, output and prices

Percentage changes, volume (1989/90 prices)

	1995 current prices billion A$	1996	1997	1998	1999	2000
Private consumption	297.2	3.1	3.4	4.1	3.0	3.3
Government consumption	81.3	3.1	2.3	2.5	4.6	2.3
Gross fixed capital formation	99.6	6.2	11.1	3.8	2.5	2.3
Final domestic demand	478.0	3.8	5.0	3.8	3.1	2.9
* stockbuilding	3.9[a]	–0.2	–1.7	1.6	–0.4	0.3
Total domestic demand	481.9	3.6	3.2	5.5	2.7	3.2
Exports of goods and services	93.1	11.1	11.4	–0.9	5.5	5.6
Imports of goods and services	98.6	9.8	14.0	7.5	5.5	7.2
* net exports	–5.6[a]	0.3	–0.5	–2.1	–0.1	–0.5
* Statistical discrepancy	0.6[a]	–0.2	0.1	0.3	–0.2	0.0
GDP at market prices[b]	476.9	3.7	2.8	3.6	2.4	2.7
GDP deflator[b]	–	2.1	2.0	1.9	2.4	2.9
Memorandum items						
GDP average measure[c]	–	3.7	3.3	3.5	2.5	2.7
Private consumption deflator	–	2.0	1.3	1.9	2.6	3.3
Industrial production	–	2.7	1.5	3.1	1.9	2.5
Unemployment rate	–	8.5	8.6	8.2	8.1	8.0
Household saving ratio[d]	–	4.7	3.7	2.7	2.9	2.9
General government financial balance[e]	–	–0.9	0.2	0.5	0.8	0.5
Current account balance[e]	–	–4.0	–3.2	–5.5	–5.3	–5.1

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.
b) The income measure of GDP.
c) Average measure of the expenditure, production, and income measures of GDP.
d) As a percentage of disposable income.
e) As a percentage of GDP.

volumes has remained around trend levels, reflecting substantial redirection of exports to more buoyant markets in North America and Europe. There has also been some redirection of manufactured and service exports to these markets, where Australian competitiveness has increased markedly, although not enough to prevent a significant slow down in volume growth.

Monetary conditions are accommodating and fiscal consolidation is slowing

There have been no changes in the officially targeted interest rate (the cash rate) since it was lowered by 0.5 percentage point to 5 per cent in July 1997. Together with previous cuts, this should help to sustain the economy over the next year. The ten-year government bond rate has fallen to a little over 5 per cent. Substantial fiscal consolidation, by some 2 per cent of GDP, has been achieved in the past two years. On current policy settings, the pace of consolidation will slow, with the structural budget surplus rising by $^1/_2$ per cent of GDP between fiscal year (FY) 1997/98 and FY 2000/01, despite the introduction of a tax reform package in the latter year. The states' small underlying surplus is officially projected to grow slightly over the next few years.

Economic growth is projected to slow…

Economic growth is projected to slow to around $2^1/_2$ per cent in 1999 and 2000 reflecting both the maturing of the housing cycle and some slowing of consumer demand. Building approvals for private sector houses have been falling since May, suggesting that the housing cycle has passed its peak. Growth in consumer spending is likely to moderate once the one-off boost from the demutualisation of the Australian Mutual Provident Fund (AMP) passes. Looking further ahead, the completion of projects related to the 2000 Olympics will also lower non-residential construction. Slower GDP

growth should lower employment growth from an estimated $1^3/_4$ per cent this year to about $1^1/_2$ per cent over the next two years, leaving the unemployment rate at around current levels. Inflation is projected to pick up, from less than 2 per cent this year to a little over 3 per cent in 2000, reflecting the pass-through of higher import prices, slowing productivity growth and the introduction of a Goods and Services Tax (GST) in July 2000. On the basis of these developments, the general government budget surplus should rise slightly this year and next, but fall back to $^1/_2$ per cent of GDP in 2000. The current account deficit is projected to decline from $5^1/_2$ per cent of GDP this year to 5 per cent in 2000.

… and there are downside risks

The major risks to these projections concern the external situation, in particular that recovery in Asia could be delayed by more than currently assumed and that the spreading financial market crisis could slow OECD economies. There is also a risk of domestic spending plans being revised down if external developments were to lead to a loss of business and consumer confidence.

Austria

GDP expanded rapidly in the first half of the year, driven by exports and investment. The business climate has since become less optimistic, especially with respect to exports, so that growth is projected to slow. However, employment and household incomes have increased and consumer sentiment has improved, thus domestic demand is projected to hold up and the deceleration should remain limited. GDP is expected to expand by about 3 per cent in 1998, easing to 2¹/₂ per cent over the projection period.

Having reduced the budget deficit to just under 2 per cent in 1997, little headway on fiscal consolidation is expected between 1998 and 2000. To create greater room for manoeuvre within the constraints imposed by the Stability and Growth Pact, the structural budget deficit needs to be further reduced. With monetary policy to be set in line with euro area conditions from 1999, achieving growth, employment and inflation objectives will require additional measures to promote contestable markets in the more sheltered sectors of the economy, while building on recent advances in labour market flexibility.

Growth has been led by exports and investment and is reflected in higher employment

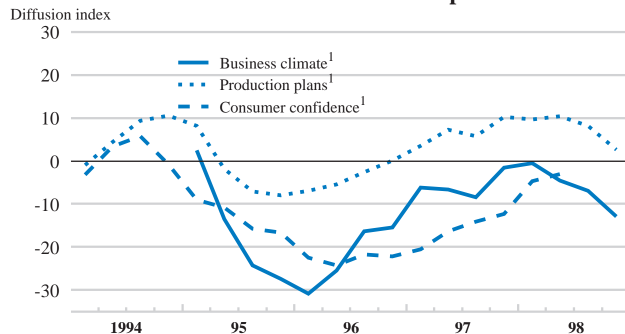
GDP expanded rapidly in the first half of the year, driven by surging exports and strong investment activity. With import growth lagging and the tourism balance improving, real net exports have contributed significantly to the growth of aggregate demand and the current account has improved. Stronger activity, rising productivity and moderate wage growth have led to increased labour demand, even in the export-oriented industries. Employment growth has been particularly strong in services and in retailing, where it has mainly been in the form of part-time jobs. This development has encouraged re-entry into the labour force, so that even though employment has grown, the rate of unemployment has not yet started to decline. With consumer price inflation under 1 per cent, household real disposable income is growing at a rate of around 3¹/₂ per cent and consumer sentiment has continued to improve.

Monetary and fiscal policies are providing a favourable framework for growth

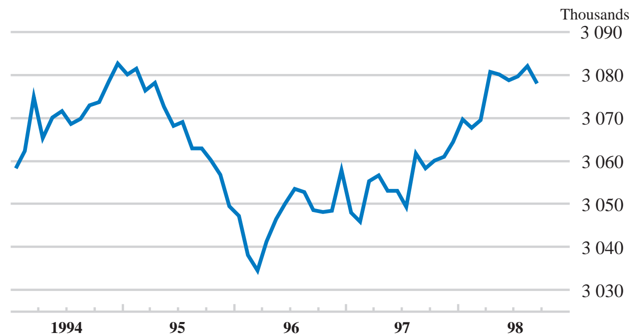
With actual and expected inflation low, monetary conditions in the euro area are expected to remain expansionary until well into 2000. The nominal effective exchange rate has appreciated since the onset of the Asian crisis, but the real effective exchange rate has remained broadly constant. Financial conditions should also remain favourable, since bank capital is adequate to support continued lending activity despite the large exposure of the banking system to Russia and other emerging markets. The budget deficit for 1997 was, at 1.9 per cent of GDP, substantially lower than at first projected. With social expenditures set to rise in line with new programmes, and public invest-

Austria

The business climate is less optimistic but consumer confidence has improved



Employment has expanded[2]



1. Seasonally adjusted. Balance of positive – negative replies.
2. Dependent employment, seasonally adjusted.
Sources: WIFO; OECD.

Demand, output and prices

Percentage changes, volume (1983 prices)

	1995 current prices billion Sch	1996	1997	1998	1999	2000
Private consumption	1 310.2	2.4	0.7	1.8	2.0	2.3
Government consumption	469.3	0.1	0.9	1.5	1.5	1.5
Gross fixed capital formation	554.1	2.4	3.6	5.5	3.8	4.3
Final domestic demand	2 333.6	2.0	1.5	2.7	2.4	2.7
* stockbuilding	10.3[a]	–0.6	0.9	0.2	0.0	0.0
Total domestic demand	2 344.0	1.4	2.4	2.9	2.4	2.7
Exports of goods and services	900.9	9.3	6.8	7.5	4.8	5.6
Imports of goods and services	910.5	8.7	6.4	7.1	4.7	5.8
* net exports	–9.6[a]	0.2	0.2	0.2	0.0	–0.1
GDP at market prices	2 334.4	1.6	2.5	3.1	2.4	2.6
GDP deflator	–	2.1	1.4	1.0	1.2	1.4
Memorandum items						
Private consumption deflator	–	2.5	2.0	1.0	1.0	1.2
Industrial production	–	1.7	5.9	6.5	4.0	4.5
Unemployment rate[b]	–	6.3	6.4	6.1	6.0	5.6
Household saving ratio[c]	–	8.6	7.8	9.2	9.8	10.5
General government financial balance[d]	–	–3.7	–1.9	–2.2	–2.2	–2.1
Current account balance[d]	–	–2.2	–2.2	–2.3	–2.1	–2.2

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.
b) See data annex for details.
c) As a percentage of disposable income.
d) As a percentage of GDP.

ment projected to increase, no further fiscal consolidation is expected during the projection period and the structural budget deficit is likely to remain at around 1¾ per cent of GDP.

The growth deceleration should be limited

Business sentiment peaked in the first quarter of the year and, with export orders declining, activity has since slowed. However, with consumer sentiment positive and investment intentions favourable, domestic demand is projected to hold up so that the deceleration should remain limited. GDP may have increased by 3 per cent this year and is projected to grow by some 2½ per cent in 1999, as export growth slows from 7½ per cent to around 5 per cent and the contribution of net exports becomes more balanced. Although the output gap should narrow during the projection period, inflation is projected to remain low at around 1 per cent: excess demand is more likely to be reflected in the current account rather than in prices.

Financial-market risks have increased and there is some uncertainty about the supply side

The projections assume that turbulence in world financial markets will not develop to such an extent that the banking system would come under pressure to curtail the supply of credit. Moreover, international uncertainty is assumed to have little adverse effect on consumer sentiment and on corporate investment plans. Downside risks to the projection would arise if activity in surrounding countries, including Germany, were to be weaker than projected. From a domestic perspective, some uncertainty attaches to potential output and the degree of slack, and hence the sustainable growth rate. Labour flexibility has improved, but re-integration of some groups into the labour market is probably frustrated by inadequate wage differentiation. Competition has also been enhanced, but market opening in several important service sectors remains limited, thereby holding back total factor productivity.

Belgium

Real GDP growth may have been close to 3 per cent in 1998, but is expected to slow to less than 2½ per cent both in 1999 and 2000, because of less buoyant domestic demand and weaker exports. Unemployment is projected to edge down to around 11 per cent but inflationary pressures should remain low, due to wage moderation and subdued import prices. The general government deficit is expected to decline to close to 1 per cent of GDP in 2000, and the debt-to-GDP ratio to just under 112 per cent.

With the economy approaching potential and public finances in better shape, the focus of attention of policy should be on stepping up structural reform with a view to increasing the low employment rate. It would seem especially important to return low-skilled workers to the active labour force through better skills and qualifications, stronger incentives to work, and a more flexible wage formation process to price them back into the market.

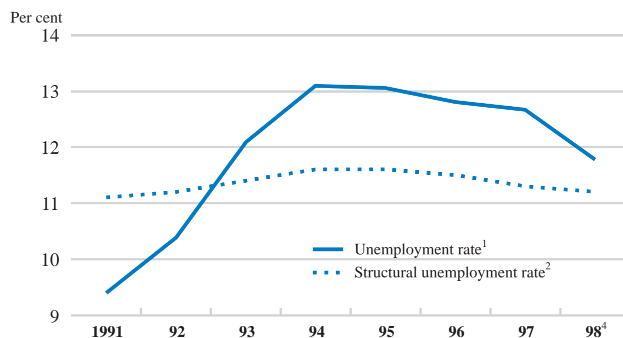
Economic growth is robust with no inflationary pressures but high unemployment

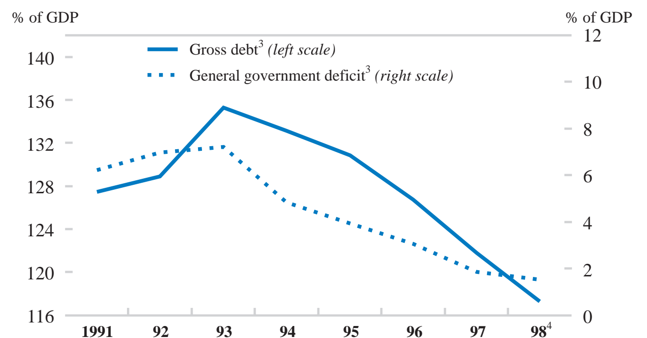
Economic activity was strong in the first half of 1998, but the conjunctural indicators of the National Bank of Belgium and other provisional data point to significantly slower growth in the second half of the year. For 1998 as a whole, GDP growth may be close to 3 per cent, virtually the same as in 1997 and well above the potential growth rate. Although the unemployment rate (national definition) has been declining, to an estimated 11¾ per cent in 1998, it remains historically high. The wage-cost performance has remained relatively good reflecting, among other factors, the law on employment and competitiveness[1] and very subdued import prices. Consumer price inflation has been somewhat volatile recently, mainly due to methodological changes: for 1998 as a whole it may have been close to 1 per cent.

Macroeconomic policy and external conditions, on balance, remain supportive to growth…

Macroeconomic policy and the external environment would seem, on balance, to remain supportive to growth. Given the limited importance of trade and financial links with emerging markets, the direct impact of problems in those areas on Belgium's exports may remain relatively small and the indirect impact may be partly cushioned by continuing vigour in the euro area. Also, the appreciation of the Belgian franc in effective terms embodied in the projection does not fully erase the depreciation of 1996-97. Combined with a cost-price performance broadly in line with that of foreign

Belgium





1. National definition (registered unemployment as a percentage of the labour force).
2. OECD Secretariat estimates (NAWRU).
3. Maastricht definition.
4. Partly estimated.

1. The law aims to limit, on an *ex ante* basis, the maximum increase in compensation per employee in the private sector to the expected weighted average increase in the three reference countries, *i.e.* Germany, France and the Netherlands.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion BF	1996	1997	1998	1999	2000
Private consumption	5 071.2	1.8	2.1	2.8	2.1	2.2
Government consumption	1 181.9	1.4	0.8	1.1	1.6	1.6
Gross fixed capital formation	1 430.2	0.5	5.4	4.9	3.8	3.4
Final domestic demand	7 683.4	1.5	2.5	2.9	2.4	2.4
* stockbuilding	32.6[a]	–0.2	–0.3	0.2	0.1	0.0
Total domestic demand	7 715.9	1.3	2.2	3.2	2.5	2.4
Exports of goods and services	5 394.6	2.2	7.1	6.1	5.3	5.4
Imports of goods and services	5 042.4	2.2	6.3	6.6	5.8	5.7
* net exports	352.2[a]	0.1	0.9	–0.1	–0.2	–0.1
GDP at market prices	8 068.1	1.3	3.0	2.9	2.3	2.3
GDP deflator	–	1.6	1.4	1.3	1.4	1.4
Memorandum items						
Private consumption deflator	–	2.3	1.8	1.0	1.2	1.4
Industrial production	–	1.0	4.5	3.8	2.0	2.1
Unemployment rate	–	12.8	12.7	11.8	11.5	11.3
Household saving ratio[b]	–	16.1	15.2	14.9	14.6	14.3
General government financial balance[c]	–	–3.1	–1.9	–1.5	–1.3	–1.1
Current account balance[d]	–	5.3	5.6	5.7	5.6	5.6

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.
b) As a percentage of disposable income.
c) As a percentage of GDP.
d) As a percentage of GDP. Balance for BLEU.

competitors, this should allow Belgian firms to remain internationally competitive. As regards macroeconomic policy, no major changes in monetary policy are expected in the euro area over the projection period; and, after being contractionary for several years, fiscal policy is now broadly neutral. The 1999 budget does not include major new initiatives. Despite the economic slow down, lower interest rates allow the general government deficit projected by the OECD to decline from 1½ in 1998 to only a little over 1 per cent of GDP in 2000, and the debt-to-GDP deficit to fall to just under 112 per cent. On a cyclically-adjusted basis, the budget deficit may remain at around ¾ per cent of GDP.

… pointing to only a modest slowdown in GDP growth, and a further decline in unemployment

Real GDP growth is projected to slow moderately – to around 2¼ per cent in both 1999 and 2000. Private consumption may lose some of its recent buoyancy but will remain underpinned by a robust increase in disposable personal income and still strong consumer confidence which may result in the saving ratio edging down further. Business investment is expected to remain dynamic as a result of the high rate of capacity utilisation, good profits and low interest rates. Weaker exports may slow economic activity somewhat although, given the openness of the economy and the consequent dampening effect on imports, the contribution of the foreing balance to growth may not change greatly. The unemployment rate is projected to fall further – to a rate close to what the OECD estimates to be the structural rate – but, due to the restraining effect of the law on employment and competitiveness and subdued import prices, serious inflationary pressures are unlikely to arise. Owing to the unsettled international environment, the risks and uncertainties in the projection are considerable and, at this stage, would seem to be mostly on the downside.

Czech Republic

Output in the first half of 1998 was 1.7 per cent lower than during the same period of 1997, principally because of a large policy-induced fall in domestic demand that was only partially offset by strong net export growth. These developments served to largely eliminate last year's external imbalance, lowering the January to June current account deficit to $459 million in 1998, less than one-quarter of its 1997 level. Aggregate demand should revive in 1999 and 2000 as monetary and fiscal policy relax somewhat. Restructuring will cause employment to fall and unemployment to rise, while further administered price hikes will probably limit the progress of disinflation.

The weakness of demand and the low level of underlying inflation suggest that there is room for a further relaxation of monetary policy – assuming fiscal policy remains prudent. Although automatic stabilisers may cause the fiscal deficit to widen, a discretionary fiscal expansion should be avoided. The stalled privatisation process should be restarted as soon as possible.

Output fell sharply in the first half of 1998…

By the first half of 1998, GDP had declined 1.7 per cent below its year-earlier level, with all components of domestic demand contributing to the fall. A surge in net exports, following the sharp depreciation of the koruna in May 1997, an increase in capacity and a redirection of output from domestic to foreign markets, partially offset the drop in domestic demand. This allowed the current account deficit for the first six months of 1998 to fall to $459 million from $1.9 billion the year before. So far, the impact of financial market turmoil on the Czech Republic has been limited to a 25 per cent fall in the stock market, while the exchange rate, despite some volatility, has actually regained its pre-depreciation level *vis-à-vis* the Deutschemark.

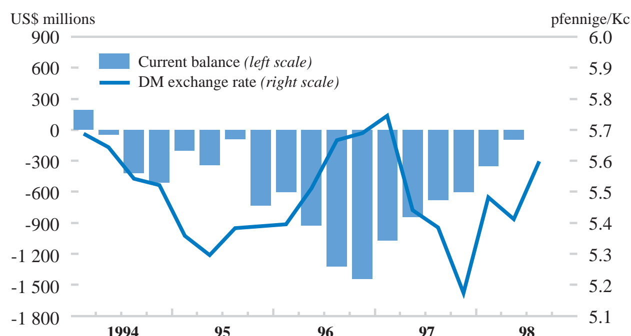
… leading to a rise in unemployment and falling inflation

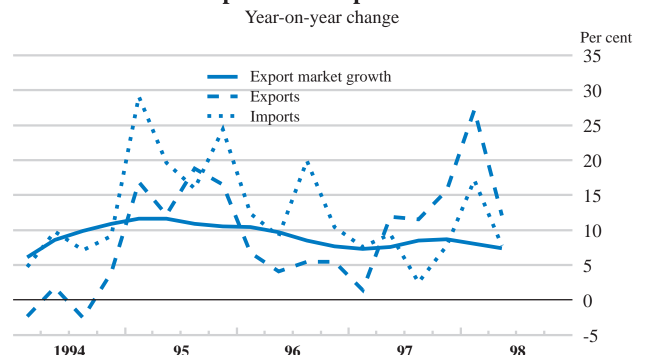
The drop in aggregate demand contributed to a fall in employment and a rise in the unemployment rate to 5.9 per cent by mid-year. Inflation, following a sharp rise in January and February related to administered price increases, has been declining. By the end of September, the twelve-month rate was below 9 per cent, while net inflation (increases in non-administered prices net of indirect tax hikes) stood at 4.3 per cent.

Cyclical factors contributed to an increase in the government deficit…

Fiscal policy remained tight in 1998 due, in particular, to a public-sector nominal-wage freeze. Nevertheless, the weaker-than-expected outturn for demand meant that government revenues were significantly lower than initially projected, while rising unemployment contributed to increased social security costs. These developments, plus an additional Kc 11 billion to cover the losses of the bad-loan bank *Konsolidacni banka*, seem likely to lead to a general government deficit in 1998 of about 1 1/2 per cent of GDP. High domestic interest rates contributed strongly to the slowdown in

Czech Republic





Demand, output and prices

Percentage changes, volume (1994 prices)

	1995 current prices billion Kc	1996	1997	1998	1999	2000
Private consumption	658.0	7.0	1.6	–2.3	1.4	2.3
Government consumption	281.5	4.3	–1.8	–0.5	1.0	1.0
Gross fixed capital formation	442.4	8.7	–4.9	–3.0	2.2	3.5
Final domestic demand	1 381.9	7.0	–1.2	–2.2	1.6	2.4
* stockbuilding	26.5[a]	1.6	0.9	0.2	0.0	0.0
Total domestic demand	1 408.4	8.5	–0.4	–1.9	1.5	2.3
Exports of goods and services	755.8	5.4	10.2	14.0	6.0	6.1
Imports of goods and services	815.5	12.9	6.7	10.5	5.9	6.0
* net exports	–59.7[a]	–5.0	1.4	1.3	–0.4	–0.4
GDP at market prices	1 348.7	3.9	1.0	–0.7	1.3	2.1
GDP deflator	–	9.4	6.6	8.4	7.4	6.5
Memorandum items						
Private consumption deflator	–	8.0	7.9	10.9	7.0	6.0
Industrial production	–	1.6	4.8	5.6	4.6	4.4
Unemployment rate	–	3.4	4.6	6.4	6.7	7.1
General government financial balance[b]	–	–1.1	–2.2	–1.6	–2.5	–2.8
Current account balance[b]	–	–7.6	–6.0	–1.8	–2.0	–2.2

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.
b) As a percentage of GDP.

activity and the re-appreciation of the currency in 1998. Reflecting these developments, the Central Bank's end of year net inflation target of 6 ± 0.5 per cent now appears within easy reach.

… while the process of structural reform paused

The government has announced a temporary halt to the privatisation process while it examines past and current deals. Although the sale of the state's stake in three of the largest banks will proceed, it remains unclear when. Provisioning requirements have been tightened, but the banking sector remains burdened by bad loans, while firms' corporate governance and the protection of minority shareholders' rights continue to be areas of concern.

Demand should pick up slowly…

An eventual stabilisation of domestic demand and deceleration in exports are expected in the second half of 1998, with output projected to decline by 0.7 per cent for the year as a whole. A 7 per cent real increase in public-sector wages and some catch-up effect in the private sector could lead to a rising general government deficit and a moderate expansion of consumer demand in 1999. Coupled with small increases in both public and private investment, a slow recovery is projected for 1999, with a further pick-up continuing on into 2000. The moderate nature of the overall expansion should allow the current account deficit to remain well below 3 per cent of GDP in the next two years.

… but financial market turmoil could threaten the recovery

World financial turmoil could provoke downward pressure on the currency, poorer growth in export markets and a decline in foreign direct investment, all of which represent significant downside risks to this projection. The impact of renewed exchange rate depreciation might be amplified because of the weak balance sheets of a number of banks and large corporations. Poorer growth in the markets for Czech exports or a decline in foreign direct investment would halt the projected recovery and reverse some of the recent current-account gains. An excessive fiscal expansion not accompanied by additional productivity improvements could, once again, provoke problems with the external balance.

Denmark

The economic upswing has begun to slow as buoyant private spending is curtailed by a series of fiscal packages and a tax reform to strengthen private saving. Inflation is under control, but a tight labour market and slowing productivity growth are making for a more marked rise in unit labour costs than in competitor countries. Combined with weaker export-market growth, this is holding back export growth. Based on continuing high real wage income growth and low interest rates, overall activity is projected to develop in line with the economy's potential growth, at around 2 per cent.

To achieve balanced growth over the longer run, further measures are being taken to reform the tax system, the labour market, the education system and the competition-policy framework. Attention has also focused on the need to confront the distortions caused by housing-market policies, which have been a source of economic instability. Together with the growing general government surplus, and continued structural reform, this should provide a basis for sustained growth.

Signs of slowing growth are emerging

After four years of substantially above-potential growth, the Danish economy has begun to slow. Following a series of fiscal packages and a tax reform aimed at curbing asset-price inflation in the housing sector and strengthening private saving incentives, confidence indicators have fallen and private consumption and housing investment growth are moderating. Business fixed investment is buoyant, but Denmark is losing export market share and a major labour conflict in the spring of 1998 lowered exports even further. New orders have weakened. While domestic demand is increasing at a $3^1/_4$ per cent pace in 1998, real GDP growth has slowed to $2^1/_2$ per cent.

Unemployment is falling, and inflation is lowered by external factors

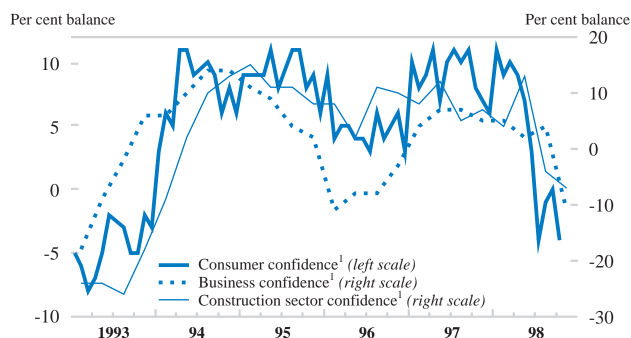
Unemployment has fallen to below $6^1/_2$ per cent, reflecting employment growth of almost 2 per cent and a $^1/_2$ per cent expansion of the labour supply. Wage growth, including costs related to a reduction in working time, has increased marginally, to $4^1/_4$ per cent, but unit labour cost inflation is somewhat higher due to higher indirect labour costs and a cyclical decline in productivity growth. Price inflation has nevertheless fallen towards the $1^1/_2$ per cent mark, due to lower raw material and import prices.

Monetary and fiscal conditions remain overall favourable

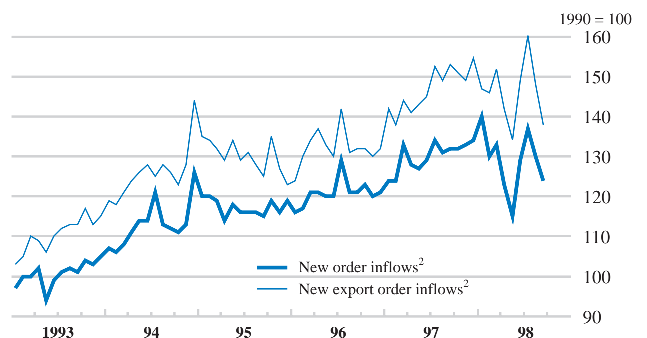
The effective exchange rate has strengthened by 7 per cent since mid-1997, the krone's parity with the Deutschemark being maintained by recent increases in the key signal rates of the Central Bank and substantial currency interventions. The interest-rate spread between Danish and German securities rose markedly during the recent

Denmark

Weaker household confidence



Moderation of demand



1. Seasonally adjusted. Balance between positive and negative answers.
2. Volume indices, s.a.
Sources: Danmarks Statistik; OECD.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion Dkr	1996	1997	1998	1999	2000
Private consumption	514.5	2.7	3.6	3.2	2.1	1.5
Government consumption	259.7	2.4	2.2	2.1	1.5	1.0
Gross fixed capital formation	189.2	4.8	10.4	4.4	3.9	3.5
Final domestic demand	963.4	3.1	4.7	3.2	2.4	1.8
* stockbuilding	9.7[a]	0.1	–0.2	0.1	0.0	0.0
Total domestic demand	973.2	3.1	4.5	3.3	2.4	1.8
Exports of goods and services	358.4	4.2	4.3	1.7	2.0	3.4
Imports of goods and services	317.9	4.2	7.6	3.9	3.0	3.3
* net exports	40.5[a]	0.2	–1.0	–0.8	–0.3	0.1
GDP at market prices	1 013.6	3.2	3.3	2.4	2.0	1.9
GDP deflator	–	2.0	1.9	1.6	2.7	3.3
Memorandum items						
Private consumption deflator	–	1.7	2.2	1.9	2.5	3.0
Industrial production	–	1.0	4.8	3.0	2.7	2.6
Unemployment rate	–	8.7	7.7	6.5	6.0	5.9
Household saving ratio	–	5.2	4.4	6.0	5.1	5.1
General government financial balance[b]	–	–0.9	0.2	1.0	2.2	2.6
Current account balance[b]	–	1.7	0.5	–1.0	–1.0	–0.9

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.
b) As a percentage of GDP.

international turmoil, but with the differentials assumed to return towards previous levels, overall monetary conditions will remain expansionary. The fiscal stance is moderately restrictive (aimed at reducing GDP growth by about $^1/_2$ percentage point in 1998 and 1999), as the combined result of a tax reform, a series of smaller fiscal packages and the recently presented budget. Assuming an unchanged fiscal policy stance in 2000, the budget surplus should reach $2^1/_2$ per cent of GDP.

GDP growth should moderate

The household saving ratio has risen, but firm employment and real wage growth should sustain private consumption growth. The housing investment outlook remains positive and business fixed investment should continue to respond to capacity constraints and favourable financial conditions. Import growth will outstrip export growth, as market share losses continue and export market growth weakens. Overall GDP growth should stabilise at 2 per cent, near to potential growth. Employment growth of nearly 1 per cent should allow unemployment to fall further, and this is projected to bring a gradual pickup in wage inflation. As the impact of lower import prices abates, consumer price inflation could move up to around $2^1/_2$ per cent in 1999 and 3 per cent in 2000.

Inflation is a risk, but potential output may have increased

The impact of the 1994-96 labour market reforms on supply potential is now close to complete, so that the scope for a further fall in structural unemployment depends on the effectiveness of the new reform initiative with respect to taxation, active labour market policies, education and competition policies. In this context, the inflation outlook is probably the most important element of domestic risk. The proposed labour-market reforms may be less effective than expected in raising employment capacity and controlling wage inflation. On the other hand, the process of labour-market reform has been unexpectedly successful in raising potential output and lowering structural unemployment so far, and this favourable experience could well be repeated.

Finland

Strong household and business confidence, underpinned by easy monetary conditions and buoyant foreign trade have continued to boost economic activity. While the crisis in Russia and other emerging economies might be increasingly felt, domestic demand is likely to remain robust, with unemployment staying on a downward trend. A tight stance of fiscal policy and a two-year pay deal to keep wages in check should ensure virtually stable consumer prices and a smooth entry into the European Economic and Monetary Union.

The government should maintain its firm rein on public expenditure in the years ahead as monetary policy in the euro-area may be too easy for the cyclical requirements of the Finnish economy. This would ultimately also allow a decline in the heavy tax burden which, together with efforts to strengthen work incentives and to enhance the scope for flexible wage setting, should reduce unemployment further.

Robust economic growth and low inflation…

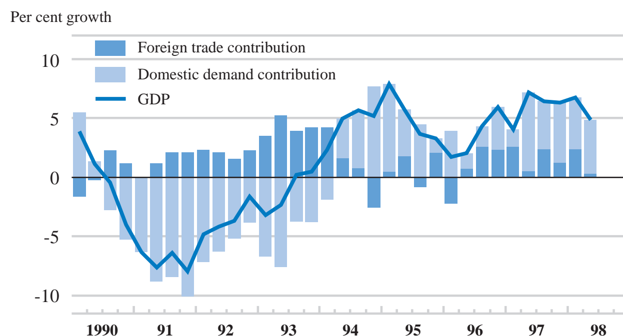
Output seems likely to grow by about 5 per cent in 1998, nearly as rapidly as in 1997. Domestic demand has been boosted by robust household earnings, soaring real estate prices and strong business profits, while a drop in exports to Russia following the rouble collapse has been more than offset thus far by expanding trade with continental Europe. Job creation, especially in the telecommunication equipment and construction industries, has been strong, pushing the unemployment rate down from 12 3/4 per cent in 1997 to well below 11 per cent in the third quarter of 1998. Although these and some other industries face tight labour market conditions, wage inflation has remained moderate following the centralised two-year pay deal of December 1997. With import prices falling, consumer prices have been virtually stable. Meanwhile, the terms of trade have improved strongly and the current account surplus has moved to a historic high of 6 per cent of GDP.

… facilitate joining the euro area…

The impressive recovery of the Finnish economy from the deep slump of the early 1990s has been underpinned by rapid industrial adjustment, successful product innovation, the revival of household and business confidence and sustained efforts by the authorities to consolidate public finances. These efforts have led to a downward trend in the public debt/GDP ratio – now well below 60 per cent – and have helped to tilt the general government account into surplus in 1998. The 1999 budget includes a further tightening of fiscal policy, largely due to cuts in public investment, job programmes, business subsidies and grants to local government. Government action thus continues to bolster confidence of the financial markets, facilitating a smooth entry into the euro area. Indeed, the markka exchange rate has remained stable near its central parity in

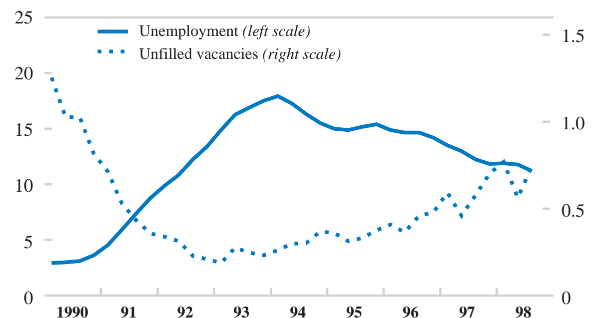
Finland

Domestic demand boosts economic growth



Labour market conditions improve

As a percentage of the labour force



Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion Mk	1996	1997	1998	1999	2000
Private consumption	298.2	3.8	3.3	4.0	3.6	2.9
Government consumption	119.8	3.5	0.7	0.6	0.4	0.8
Gross fixed capital formation	85.1	8.4	11.9	10.1	7.5	7.3
Final domestic demand	503.1	4.6	4.4	4.5	3.8	3.4
* stockbuilding	5.4[a]	–0.7	0.3	0.6	0.1	0.0
Total domestic demand	508.5	3.8	4.6	5.1	3.8	3.4
Exports of goods and services	207.2	3.9	12.8	8.1	4.0	5.5
Imports of goods and services	161.1	4.3	10.5	9.0	6.0	7.0
* net exports	46.2[a]	0.2	1.6	0.4	–0.3	0.0
GDP at market prices	549.9	3.6	6.1	5.0	3.2	3.0
GDP deflator	–	1.3	1.1	3.2	1.6	2.6
Memorandum items						
Private consumption deflator	–	1.6	1.4	1.1	1.3	2.1
Unemployment rate	–	14.6	12.6	10.9	9.7	8.8
General government financial balance[b]	–	–3.7	–1.4	0.8	1.9	1.8
Current account balance[b]	–	4.0	5.5	5.7	5.8	6.2

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.
b) As a percentage of GDP.

the European Exchange Rate Mechanism to date and short- and long-term term interest rate differentials *vis-à-vis* euro-area countries have virtually disappeared. Monetary conditions have hence become very easy, without, however, entailing an immediate inflation risk owing to declining import prices and consensus over wage moderation.

… but the global slowdown casts a shadow

Private consumption and investment, in particular residential construction, should remain buoyant, and serve as the main engine of economic activity over the projection period. Economic growth is, nevertheless, projected to taper off from 5 per cent in 1998 to around 3 per cent in both 1999 and 2000, as weaker foreign demand linked to the crisis in emerging economies also feeds through into domestic spending. While the unemployment rate is expected to fall to around 9 per cent by 2000, wage inflation should remain in the 2 to 3 per cent range until the end of 1999, with some pick-up when the two-year wage agreement expires. Consumer price inflation should also remain low, within the 1 to 2 per cent range. If the global economic slowdown should deepen, and the European upswing is nipped in the bud, Finnish export and GDP growth may turn out weaker than projected. On the other hand, easy monetary conditions in the euro-area could provide stronger impetus to household spending than currently foreseen.

Greece

Convergence towards the Maastricht criteria has progressed, while activity has continued to outpace the OECD average. Investment-led output growth, driven by the public sector, has been supported by European Union (EU) funds. Inflation has resumed a downward path after the adverse impact of the March 1998 devaluation, helped by wage moderation and tight monetary policy. Following some slowdown in 1998, activity should regain steam over the coming two years. Inflation is expected to decline, initially in response to cuts in indirect taxes, while the current account deficit is expected to remain broadly unchanged.

Macroeconomic policies will need to be tightened further to reduce inflation to the Maastricht target by mid-2000. Fiscal policy should bear the brunt of adjustment as the deficit is still large, debt exceeds 100 per cent of GDP, and successful progress toward entry into the European Economic and Monetary Union (EMU) is bound to lead to a significant easing of monetary conditions. Ambitious reforms of the public pension and health care systems are needed to provide room for the large investment programme. Rapid progress in addressing the multitude of labour and product market rigidities (specifically, public enterprise and bank reform) would facilitate non-inflationary output growth over the medium term. Structural reform would also facilitate entry into the EMU by providing a signal regarding the sustainability of the central parity.

An exchange rate adjustment slows domestic demand and reverses the downward trend in inflation

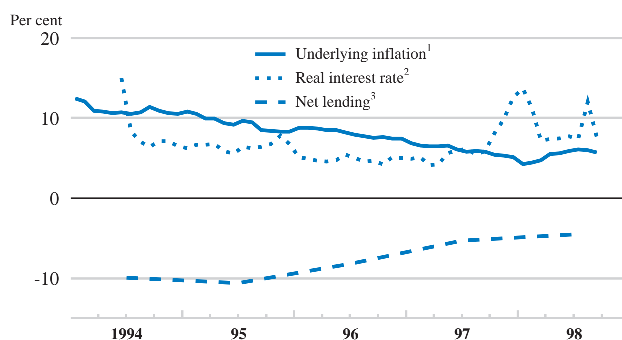
Following robust activity in 1997, growth in 1998 is set to be lower and more balanced. With a reduced drag from the external sector and some easing in the growth of domestic demand, output growth is expected to slow to about 3 per cent in 1998 from 3.2 per cent in 1997. Public sector investment (including public enterprises), which is partly financed by EU structural funds, is the main motor for growth, while strong private-sector business investment reflects capacity constraints and capital deepening. The loss in purchasing power following the March 1998 devaluation combined with wage moderation and higher taxes is dampening household expenditure. Less buoyant domestic demand and falling international commodity prices are gradually reversing the impact of the devaluation on prices, and underlying inflation fell to 5.7 per cent in September. Despite terms of trade losses, the current account deficit will remain broadly stable due to higher EU transfers and a good tourist season. The capital account has been in a large surplus through September, though experiencing large swings in flows.

EMU qualification by mid-2000 is the major policy aim

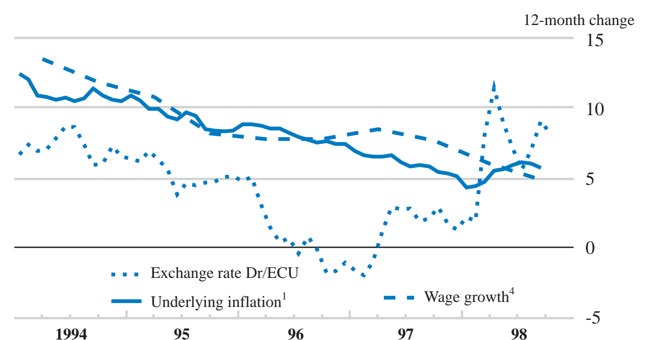
Macroeconomic policies are geared to the attainment of the Maastricht criteria by mid-2000. The objective of monetary policy is to reduce inflation to below 2 per cent

Greece

Inflation reduction is based on tight policies



While nominal anchors are less effective



1. Consumer price index excluding fresh food and energy products, year-on-year percentage change.
2. Interbank rate, 1 month deflated by the consumer price index.
3. As a per cent of GDP, reduced by amount of equity participation and increased by payments on called government guarantees. OECD estimates for 1998.
4. Minimum wage growth agreed in national collective agreement.

Demand, output and prices

Percentage changes, volume (based on previous year prices)

	1995 current prices billion Dr	1996	1997	1998	1999	2000
Private consumption	20 138.8	1.9	2.5	1.9	2.1	2.3
Government consumption	4 178.3	1.0	–0.4	0.8	0.6	0.8
Gross fixed capital formation[a]	4 981.1	8.8	9.6	8.0	8.7	9.1
Final domestic demand	29 298.2	3.1	3.6	3.1	3.4	3.8
* stockbuilding[b]	42.2[c]	–0.1	–0.1	0.0	0.0	0.0
Total domestic demand	29 340.4	3.0	3.5	3.1	3.4	3.7
Exports of goods and services	4 258.2	3.0	5.3	5.5	5.0	5.8
Imports of goods and services	6 715.1	4.9	5.4	4.5	5.0	6.0
* net exports	–2 456.9[c]	–1.0	–0.8	–0.4	–0.7	–0.9
GDP at market prices	26 883.5	2.4	3.2	3.0	3.2	3.4
GDP deflator	–	7.9	6.9	4.5	3.1	2.8
Memorandum items						
Private consumption deflator	–	8.3	5.6	4.8	3.0	2.7
Industrial production	–	0.5	1.6	7.0	8.0	9.0
Unemployment rate	–	10.3	10.3	10.0	9.8	9.4
General government financial balance[d]	–	–7.5	–4.0	–2.7	–2.5	–2.1
Current account balance[d, e]	–	–3.7	–4.1	–4.0	–4.1	–4.3

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Excluding ships operating overseas.
b) Including statistical discrepancy.
c) Actual amount.
d) As a percentage of GDP.
e) On settlement data basis.

by end 1999. Following looser monetary conditions after the devaluation, the Bank of Greece has tightened policy with intervention rates near 13 per cent, and the exchange rate about 5 per cent above the central parity in October 1998. While the Bank of Greece has maintained a tight monetary stance, the policy mix has improved. The general government budget deficit should decline from 4 per cent in 1997 to below 3 per cent in 1998, with the adjustment effort focusing on revenue enhancement and wage restraint. Despite the sizeable deficit reduction, the fiscal stance is effectively looser than the deficit suggests, because expenditure items, equivalent to about 1½ per cent of GDP, have been shifted off-budget or to past budgets (the operations being in accordance with Eurostat rules). Moreover, the rapidly increasing public investment programme is largely financed by EU capital transfers, which pump liquidity into the economy. For 1999, the Government has announced a budget deficit target of 1.9 per cent of GDP. The main measures are a freeze of tax brackets and moderate public-sector wage and employment growth, while indirect tax cuts aim to dampen inflation expectations. The OECD projects a slightly higher deficit of about 2½ per cent of GDP for 1999, reflecting higher interest rates than projected by the authorities.

In 1999-2000, output growth should strengthen and inflation gradually decline

Led by public investment, output growth is projected to grow by 3 to 3½ per cent in 1999 and 2000. Progress towards joining the euro area should boost private sector confidence, and firm profitability should be sustained due to wage moderation emanating from a collective agreement expiring in 1999. The external sector will become an increasing drag on output growth as the slowdown in world activity partly offsets the positive impact of the devaluation on exports, and the pick up in domestic demand draws in more imports. With unit labour costs slowing, international commodity prices remaining low, and monetary policy staying tight, inflation is projected to fall gradu-

ally to below 3 per cent in 2000. The key risk regards the pace of inflation reduction. Cost-side pressures could arise from the economy hitting capacity constraints and stronger wage drift, while demand could be boosted by an even larger public investment programme. On the other hand, a sharper international downturn would hurt exports, especially since a large share goes to the more volatile central and eastern European markets. This would slow demand and inflation, but also raise the current account deficit.

Hungary

Economic growth accelerated in the first half of 1998 with solid investment growth leading a strengthening of all components of final domestic demand. Exports expanded at double digit rates as past foreign direct investment improved the supply-side performance of the economy, while an even stronger increase in imports led to a widening of the current account deficit. The rapid increase in GDP is projected to continue, fuelled by domestic demand, even though the contribution of net exports to growth should become negative. The current account deficit may rise to just under 4 per cent of GDP by the year 2000. Employment is likely to continue to expand moderately and the unemployment rate fall, while further disinflation can be expected.

Given the current economic climate, it is important that the authorities maintain fiscal discipline and provide clear and credible signals concerning their planned budgetary measures. For its part, the central bank needs to respond flexibly to market events, foster confidence and assure continued disinflation, while continuing to gradually reduce the rate of crawl of the exchange rate.

Economic fundamentals were strong in 1998…

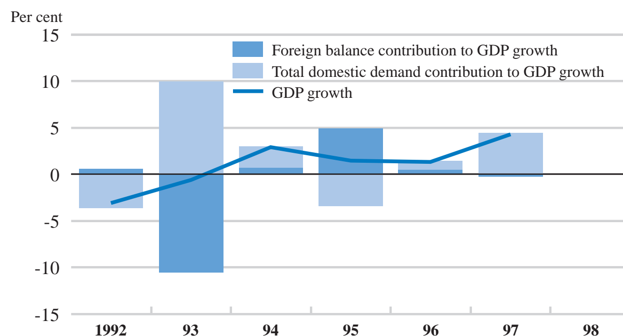
Domestic demand surged in early 1998, led by double-digit investment growth. Private consumption expenditures also picked up, sparked by real wage increases and considerable pent-up demand. Exports continued to grow strongly but showed some signs of slowing, while an acceleration in imports led to a moderate widening in the trade and current account deficits. Stagnant participation rates combined with a pick-up in employment to lower the unemployment rate to 8 per cent mid-year, while the twelve-month rate of consumer price inflation has fallen 5 percentage points since January to reach 12.5 per cent in September, already below the government's year-end target. Strong productivity growth contributed to slower price increases, overcoming a larger than expected 3 per cent increase in real wages.

… but financial market turmoil required a policy response …

The turmoil in financial markets surrounding the Russian collapse contributed to a 60 per cent drop in share prices and significant downward pressure on the forint. The Ministry of Finance and the central bank responded in August by reducing the rate of the crawling peg to 0.7 per cent per month as of 1 October 1998, and by raising nominal interest rates 100 basis points in September. Since then, the pressure on the currency appears to have eased and the stock exchange has recovered much of its earlier losses, while the authorities have announced a further reduction in the rate of the crawl to 0.6 per cent per month as of January 1999. On balance, developments since the summer have effectively raised the premium paid on forint-denominated investments, and should further contribute to the disinflation process.

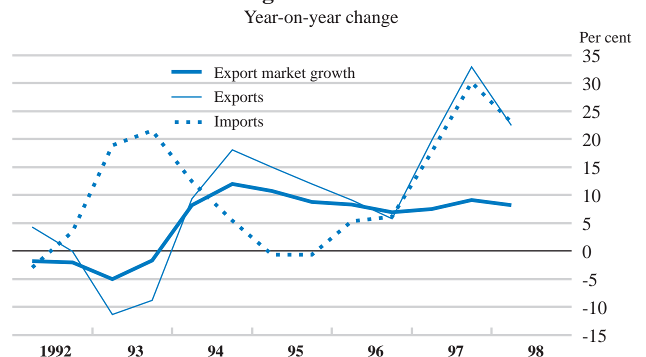
Hungary

Domestic demand leads recovery



Trade growth moderates

Year-on-year change



Demand, output and prices

Percentage changes, volume (1991 prices)

	1995 current prices billion HUF	1996	1997	1998	1999	2000
Private consumption	3 724.0	–3.1	0.9	3.8	4.0	3.7
Government consumption	617.6	–5.1	1.1	2.0	3.0	2.9
Gross fixed capital formation	1 125.4	6.3	8.8	12.0	9.2	8.8
Final domestic demand	5 467.0	–1.3	2.8	5.7	5.3	5.0
* stockbuilding	218.3[a]	2.2	1.7	1.3	0.4	0.2
Total domestic demand	5 685.3	0.9	4.3	6.4	5.2	4.8
Exports of goods and services	2 091.8	7.4	26.4	18.8	12.0	10.7
Imports of goods and services	2 163.1	5.7	24.0	20.1	12.3	10.7
* net exports	–71.3[a]	0.4	–0.2	–1.6	–0.9	–0.7
GDP at market prices	5 614.0	1.3	4.3	5.1	4.6	4.4
GDP deflator	–	20.4	18.4	14.8	10.9	9.4
Memorandum items						
Private consumption deflator	–	21.7	18.1	14.5	11.0	9.0
Industrial production	–	3.4	10.8	11.5	9.4	8.3
Unemployment rate	–	10.1	8.9	8.2	7.7	7.4
Household saving ratio[b]	–	14.1	16.2	16.4	16.5	16.7
General government financial balance[c]	–	–3.0	–4.9	–4.5	–4.3	–4.5
Current account balance[c]	–	–3.8	–2.1	–3.7	–3.7	–3.8

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.
b) As a percentage of disposable income.
c) As a percentage of GDP.

… despite a falling government budget deficit

Even though tax receipts in 1998 were higher than anticipated, the primary budget surplus is estimated to have fallen from 3 per cent to a still sustainable 2 per cent of GDP. At the same time, despite continued cost overruns on the social-security account, the consolidated government deficit is expected to have fallen to 4½ per cent of GDP in 1998, down from around 6½ per cent in 1995.

Strong domestic demand should sustain output growth…

Output is estimated to have expanded by around 5 per cent in 1998, and is projected to slow moderately in 1999 and 2000, with rising levels of private consumption and investment offset by a negative contribution from net exports as foreign sales are expected to slow and imports rise in relative terms. These two effects should see the current account deficit widen to about 4 per cent of GDP. Forward-looking wage bargaining and a 6 percentage point cut in social security charges are projected to bring the annual inflation rate down to 11 per cent in 1999, followed by single-digit rates. The projected general government deficit of 4.3 per cent of GDP in 1999 exceeds the official target incorporated in the 1999 budget presented to Parliament because of lower revenues, due to slower growth and only limited success in improving tax compliance.

… but tighter fiscal and monetary policy may be required

The Hungarian economy faces three primary risks over the near term. International developments could lead to a fall in foreign direct investment, and therefore overall investment, with a significant impact on output. Similarly, net exports and output could be weaker if growth in major trading partners, notably in the European Union, proves to be lower than projected, thus reducing foreign sales of Hungarian goods. Finally, stronger-than-expected domestic demand, either because of fiscal slippage or higher than anticipated wage settlements, would pose an upside risk for inflation that would require a further tightening of fiscal and monetary policies.

Iceland

Aggregate demand has apparently surged in 1998, and the economy faces a clear danger of overheating. Wages are growing substantially faster than contracts signed in 1997 call for, and the unemployment rate is falling. Inflation, however, decelerated in the second half of the year because of a moderate appreciation of the krona. The outlook is for output growth to slacken somewhat, but unemployment rates should continue to edge down, and the current account deficit could remain uncomfortably high.

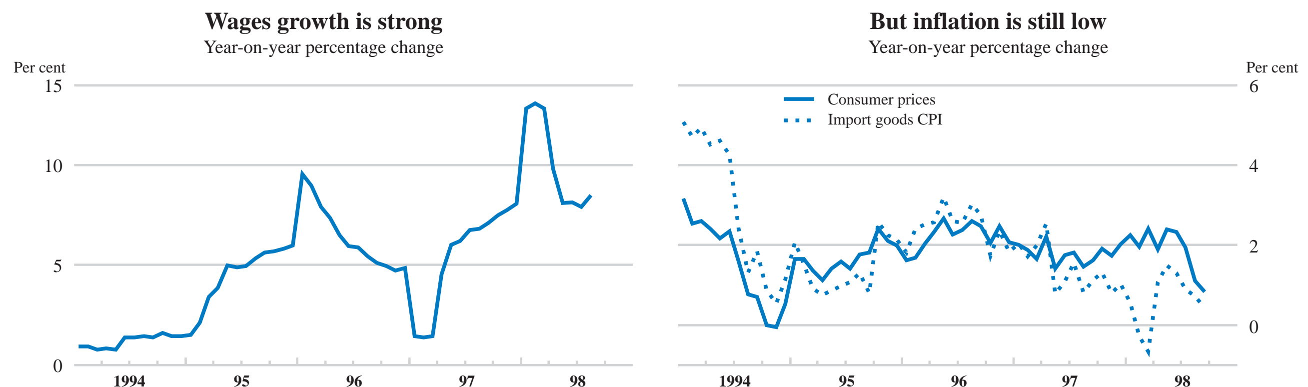
The fiscal stance should be tightened to prevent the emergence of inflationary pressures. In the interim, the monetary authorities could consider additional interest rate increases, especially in light of the rapid expansion of credit. Given the increased openness of financial markets, bank supervisors need to be vigilant to ensure the prudent behaviour of financial firms.

The economy may be overheating…

Economic activity accelerated in 1997, with GDP growing 5 per cent, and available indicators suggest that output growth in 1998 could be even higher. Year-on-year wage gains averaged 8 1/4 per cent in the middle of the year. With only modest inflation and robust employment increases, rapid real income growth has fuelled a consumption boom. Meanwhile, large-scale investment projects have pushed up total investment spending. As a result, the current account deficit looks set to widen to about 6 3/4 per cent this year.

… and with policy not significantly tighter…

The monetary authorities have allowed the krona to appreciate 3 per cent since last November. With the recent turmoil in financial markets leading to some downward pressure on the exchange rate, the Central Bank raised short-term interest rates 30 basis points in early September. Credit had been growing rapidly; total liabilities climbed 14 1/2 per cent in the twelve months through March. At the beginning of October, the Treasury announced its budget estimates for 1998 and its projections for 1999, suggesting little fiscal tightening. In spite of strong tax revenue, the OECD's projection is for only a small surplus in the next few years. Moreover, much of that surplus is accounted for by the excess of proceeds from asset sales over their book values. Indeed, the central government recently completed a successful auction of a minority stake in the newly formed investment bank and proposes to sell the rest next year. The Agricultural Bank also plans a public offering to raise additional capital, but the government has delayed a partial divestiture of its holdings until 1999.



Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion Ikr	1996	1997	1998	1999	2000
Private consumption	272.7	6.4	6.0	10.3	5.9	3.1
Government consumption	94.1	1.0	1.5	3.0	2.8	1.2
Gross fixed capital formation	65.9	26.5	11.2	28.2	–10.0	6.3
Final domestic demand	432.7	8.3	6.0	12.2	2.0	3.4
* stockbuilding	2.3[a]	–0.7	–0.2	0.2	0.0	0.0
Total domestic demand	435.0	7.5	5.8	12.5	2.0	3.4
Exports of goods and services	161.3	9.6	5.6	5.7	4.8	5.0
Imports of goods and services	144.7	16.6	8.0	25.0	–1.2	5.0
* net exports	16.5[a]	–1.7	–0.6	–6.6	2.3	–0.1
GDP at market prices	451.5	5.5	5.0	5.6	4.3	3.3
GDP deflator	–	1.9	3.5	4.4	2.0	4.0
Memorandum items						
Private consumption deflator	–	2.3	1.8	1.6	1.5	3.7
Unemployment rate	–	4.3	3.9	3.1	2.7	2.5
General government financial balance[b]	–	–1.6	–0.5	–0.1	0.1	0.1
Current account balance[b]	–	–1.8	–1.7	–6.7	–4.6	–4.6

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.
b) As a percentage of GDP.

… inflation is expected to eventually increase

Output growth is projected to remain robust, buoyed by strong consumption spending, whereas imports and investment are expected to dip in 1999 due to the timing of some projects. Because of the benign inflation performance in the second half of 1998, year-on-year average inflation in 1999 should be low, but prices are likely to accelerate through the course of the year and into 2000. In spite of good export performance, the current account deficit is projected to remain high at 4½ per cent of GDP in 2000. The biggest risk to the projection is that prices will accelerate more quickly than envisaged, creating a wage-price spiral that necessitates a drastic policy response.

Ireland

The Irish economy has recently begun to lose some momentum. Nevertheless, real GDP growth seems to have remained very strong through much of 1998, with particular buoyancy in the first half. Some further slowing is expected for next year in line with an expected moderation of inward investment flows and the exports which result therefrom. But unemployment may continue to fall, maintaining the inflationary risks that have already clearly manifested themselves over the past year.

Budget surpluses and rapid declines in public indebtedness must not be taken as signs of room for manoeuvre on the fiscal front, as it is unlikely that the economy can sustain the high levels of growth of recent years for much longer. With one less policy lever at the authorities' disposal, the onus is on fiscal policy makers to avoid overheating problems. Any net tax cuts provided in the 1999 Budget should be limited to what is required to retain the consensus-based approach to wage formation, and efforts to hold spending to budgeted levels must be maintained.

Output has again grown strongly in 1998

The extremely rapid output growth of recent years has only recently begun to moderate. Official figures for real GDP in 1997 show a rise of 9.8 per cent on an expenditure basis, the second highest outcome in the ongoing boom and, for the third year in a row, the fastest growth rate in the OECD. Year-on-year industrial production increases have averaged around 15 per cent in the first seven months of 1998, exactly last year's pace. Industrial investment in the first quarter was 24 per cent higher than year-earlier levels, and industrial stocks are still trending up. The unemployment rate is maintaining its steady decline, with the 9 per cent level breached in September.

Only recently has there been any sign of slackening

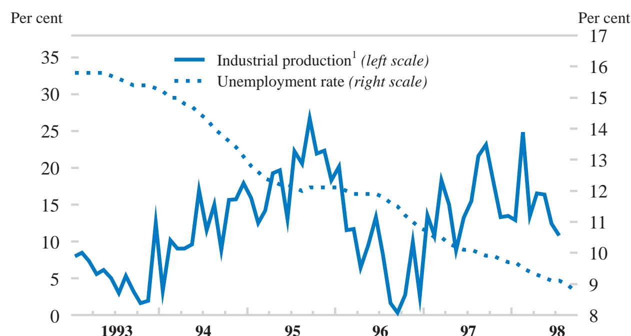
The demand side seems equally robust. Real retail sales and exports are, respectively, running nearly 10 and 27 per cent higher than in 1997. However, some let-up is apparent in some of the latest indicators with an abrupt slowdown in exports to non-EU countries and a sharp decline in the volume of retail sales in August. The current account surplus is set to move beyond 3½ per cent of GDP this year. The one black spot remains inflation: consumer prices rose 3 per cent over the 12 months to September, up from only 1 per cent about a year ago. However, wholesale prices have been slowing since March.

Macroeconomic policy has still not braked the pace of expansion

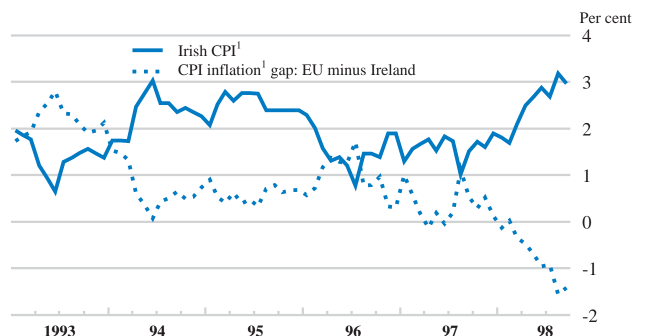
Macroeconomic policy has exerted some modest restraint. Government spending has been kept close to budget target rates, while tax receipts have been rising at a more than 12 per cent rate. The 1999 Budget, due in December, will be controversial, given the question of promised tax cuts from the Partnership 2000 agreements. In the accompanying projections it is assumed that minimal tax cuts are offset by expenditure restraint. Until

Ireland

The boom is continuing



Inflation has picked up



1. Year-on-year percentage change.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion Ir£	1996	1997	1998	1999	2000
Private consumption	21 841	6.1	6.3	6.6	6.0	5.1
Government consumption	5 871	1.5	4.8	4.1	3.2	2.9
Gross fixed capital formation	6 735	13.6	10.9	10.9	8.1	7.8
Final domestic demand	34 447	6.8	7.0	7.1	6.1	5.4
* stockbuilding	401[a]	0.2	0.4	–0.5	0.1	0.0
Total domestic demand	34 847	6.9	7.3	6.4	6.2	5.3
Exports of goods and services	30 837	11.7	16.9	17.0	9.9	9.8
Imports of goods and services	26 369	12.2	15.6	16.0	10.2	9.4
* net exports	4 468[a]	1.5	3.7	3.8	1.7	2.3
GDP at market prices	39 315	7.4	9.8	9.1	6.7	6.5
GDP deflator	–	1.7	2.3	3.9	2.9	2.9
GNP at market prices	34 807	6.4	8.1	7.6	5.6	5.5
Memorandum items						
Private consumption deflator	–	1.4	0.9	2.7	2.4	2.4
Industrial production	–	7.9	15.4	14.8	9.8	9.5
Unemployment rate	–	11.9	10.3	9.1	8.4	7.9
Household saving ratio[b]	–	9.6	10.9	10.7	10.4	10.6
General government financial balance[c]	–	–0.2	1.5	2.5	2.8	2.8
Current account balance[d]	–	2.7	2.8	3.7	2.4	2.0

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.
b) As a percentage of disposable income.
c) As a percentage of GDP
d) As a percentage of GNP.

October, the monetary authorities resisted any reductions in official interest rates. At that point the process of interest-rate convergence finally began, with cuts of a full percentage point or more. The remaining 164 basis points gap with German rates will almost certainly be eliminated through a decline in Irish rates of that amount by year-end. Long-term rates have moved down in line with those in other European countries. Private-sector credit growth is still in excess of 24 per cent per year, and robust mortgage lending is contributing to overheating pressures in the housing sector. Fortunately the effective exchange rate has appreciated sharply in recent months, thanks to weakness in the dollar and sterling, thereby tightening overall monetary conditions temporarily.

Although growth may ease because of slowing export increases, consumer price inflation is likely to stay higher than elsewhere in the euro area

There is little reason to expect much of a slowdown in domestic demand. With tight labour markets and continuing employment increases, disposable income gains should remain sufficiently robust to make any easing in private consumption growth quite gradual. Capital formation too is projected to continue to grow at a vigorous albeit moderating rate, led by expected robust growth in public infrastructure outlays and still-rapid increases in inward direct investment. But the pace of such capital inflows may decelerate in view of global financial tensions and particular problems in certain sectors of special interest to Ireland. This could hold export growth to rates which are slow only in relation to the explosive gains recorded in recent years and which should be sufficient to maintain a sizeable, albeit declining current account surplus. But the cooling-off in net exports could rein output growth back towards rates of around 6½ per cent over 1999-2000. Nonetheless, pressures on capacity will stay strong, especially in the labour market, which, despite its openness, could yield some further acceleration in wages. Overheating will nevertheless be restrained by the moderating effects of currency appreciation on traded goods prices.

Korea

In the wake of the financial crisis towards the end of 1997, the Korean economy moved into deep recession, with output down 5 per cent in the first half of 1998 from a year earlier, and an even larger drop likely in the second half of the year. Unemployment has more than tripled since the beginning of the crisis, reaching 7½ per cent by mid-1998. Output may increase slightly in 1999 as domestic demand bottoms out, with a stronger pick-up likely in 2000. The timing and strength of the recovery, though, will depend to some extent on developments elsewhere in Asia, as well as on the banks' capacity to lend, which has been reduced by the sharp rise in problem loans.

The Korean authorities have made progress in addressing the bad-loan problem and in rehabilitating the banking system to prevent a credit crunch from delaying the recovery. This needs to be accompanied by a more effective implementation of recent reforms, notably those to improve exit mechanisms and to increase labour market flexibility. Such moves, combined with the reform of the corporate governance framework, should accelerate market-based restructuring of the corporate sector. The macroeconomic policy stance, which has been substantially eased since the beginning of 1998, now appears to be conducive to economic recovery.

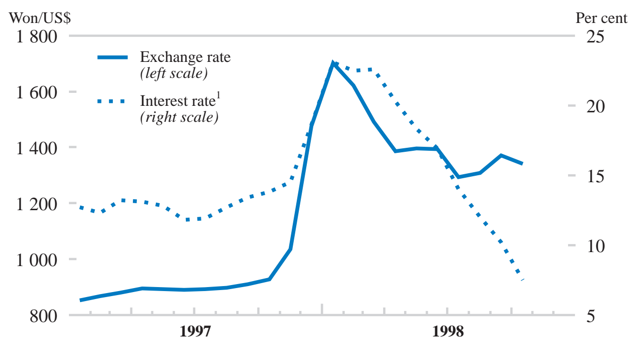
The plunge in domestic demand has tripled the number of unemployed…

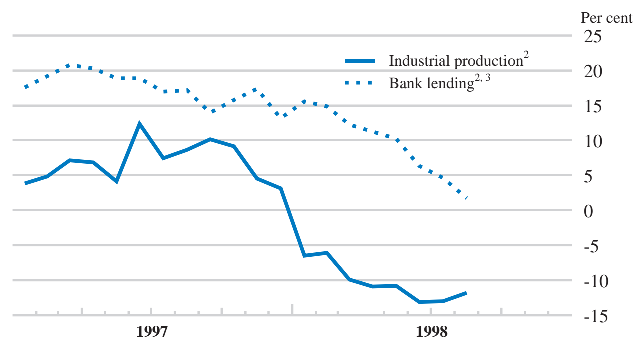
The impact of the financial crisis on the real economy became apparent in the first half of 1998 as domestic demand declined by more than a quarter. Business investment[1] was cut by 30 per cent as the highly-indebted corporate sector was forced to restructure to improve its balance sheets during a period of weak demand and exceptionally high interest rates, which boosted financial costs. In addition, firms reduced nominal wages and employment, leading to a 12 per cent drop in personal consumption in the first half of the year. The unemployment rate, which had fallen to close to 2 per cent prior to the crisis, reached 7.6 per cent in July 1998, despite a significant fall in the participation rate. Most recent indicators suggest that these negative trends have continued in the autumn of 1998. The recession has limited the inflationary impact of the won's depreciation. Consumer prices, which were 9.5 per cent above their year-earlier level in February, were essentially unchanged through October.

… despite a large positive contribution from the external balance

The decline in domestic demand was partially offset by a large positive contribution from net exports, reflecting a 24 per cent drop in import volume in the first half of 1998. With exports sustained by the large real depreciation of the won, the current

Korea





1. Yield on 91-day certificates of deposit.
2. Year-on-year percentage changes.
3. Loans and discounts of deposit money banks.
Source: Bank of Korea.

1. Year-on-year percentage change in investment in machinery and equipment and non-residential construction.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices trillion won	1996	1997	1998	1999	2000
Private consumption	186.4	6.8	3.1	–12.0	–1.5	3.0
Government consumption	36.1	7.8	5.7	–7.0	–4.0	2.6
Gross fixed capital formation	128.7	7.1	–3.5	–32.3	–7.0	7.3
Final domestic demand	351.2	7.0	0.8	–18.8	–3.4	4.2
* stockbuilding	1.7[a]	1.2	–3.7	–5.1	2.3	2.4
Total domestic demand	352.9	8.2	–2.8	–24.8	–0.7	7.7
Exports of goods and services	116.4	13.0	23.6	16.3	8.6	7.8
Imports of goods and services	120.1	14.8	3.8	–19.0	11.5	16.8
* net exports	–3.7[a]	–0.8	8.6	16.8	1.1	–1.8
* statistical discrepancy	2.8[a]	–0.4	–0.3	0.0	0.0	0.0
GDP at market prices	352.0	7.1	5.5	–6.5	0.5	4.0
GDP deflator	–	3.5	2.4	6.0	3.0	2.3
Memorandum items						
Private consumption deflator	–	5.4	4.4	8.3	3.5	2.5
Industrial production	–	7.3	6.8	–10.0	4.0	9.0
Unemployment rate	–	2.0	2.6	7.3	8.3	8.3
Household saving ratio[b]	–	17.6	18.7	14.5	13.1	13.6
General government financial balance[c]	–	4.5	4.5	–1.0	–1.5	–1.5
Current account balance[c]	–	–4.8	–1.7	12.5	9.9	6.1

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.
b) As a percentage of disposable income.
c) As a percentage of GDP.

account swung to a surplus of almost $22 billion (about 16 per cent of GDP). However, export growth has decelerated markedly in recent months, reflecting sharp declines in shipments to Japan and other Asian countries.

While interest rates have fallen to pre-crisis levels, signs of a credit crunch have emerged

Macroeconomic policies have been progressively eased as the sharp decline in output became apparent, while stability was restored in financial markets. Money market interest rates have fallen from 23 per cent in January 1998 to about 7$^1/_2$ per cent, while the yield on three-year corporate bonds has fallen to single digits for the first time ever. Declining interest rates have been accompanied by a recovery of the won, which has remained relatively stable in the range of 1 300 to 1 400 per dollar since April. In addition, Korea's useable foreign exchange reserves, which were virtually depleted during the crisis, attained the year-end target of $45 billion (about four months of imports) by the end of October, thanks to the large current account surplus, funds from international financial institutions and renewed capital inflows. Although interest rates have fallen to below pre-crisis levels, a credit crunch has emerged as banks' capacity to lend has been reduced by the rise in their non-performing loans and the need to meet capital adequacy ratios. The growth of bank loans has declined from around 20 per cent (year-on-year) in early 1997 to under 2 per cent in August 1998, with small and medium-sized enterprises particularly hard-hit. Moreover, the lack of trade credit has hindered exports and imports, despite a significant increase in government guarantees.

The government has announced an ambitious programme to rehabilitate the financial sector…

The government has made significant progress in addressing the financial sector problems underlying the credit crunch. A single, independent supervisory authority was established in April with a mandate to progressively apply international prudential standards. Since the beginning of 1998, the authorities have closed 16 merchant banks, four life insurance companies and two securities firms, while effectively closing five

troubled banks by merging them with stronger banks. The government also announced a W 64 trillion (16 per cent of GDP) plan to address the non-performing loan problem and to re-capitalise viable financial institutions. By the end of September, the government had purchased W 23 trillion of bad loans, which are now officially estimated to total W 150 trillion. There has been less visible progress in corporate restructuring and reducing debt-equity ratios, which averaged about 500 per cent for the top thirty conglomerates at the end of 1997. However, the recent reforms to improve corporate governance – notably by opening the market for corporate control, improving exit mechanisms and strengthening the rights of minority shareholders – should promote market-based restructuring of the corporate sector.

… which will contribute to a significant fiscal deficit

The restructuring of the financial sector and the rise in unemployment have led to a significant increase in government expenditures. Outlays to assist the unemployed are set to expand by about 2 per cent of GDP in 1998, while support has also been provided for small and medium-sized enterprises and exporters hurt by the credit crunch. Increased outlays have been accompanied by a decline in tax revenues, which may be as large as 3½ per cent of GDP. As a result, the consolidated central government budget, in balance during the past four years, is projected to run a deficit of about 5½ per cent of GDP.[2] Given the depth of the recession, the stance of fiscal policy appears to be broadly neutral. In 1999, the rising costs of financial restructuring may slightly widen the budget deficit.

The economy is expected to stabilise in 1999 after a sharp contraction in 1998…

Output is likely to fall by about 6½ per cent in inflation-adjusted terms in 1998, and the unemployment rate to rise further to around 8½ per cent by year-end. The current account surplus is expected to reach a record high of $38 billion for the year while year-on-year inflation is limited to around 8 per cent. Given the less restrictive macroeconomic policies now in place and resilient export growth, domestic demand should stop declining by the end of 1999. Assuming a stable exchange rate, the contribution of the external balance should remain positive, allowing output growth to resume in the second half of 1999 and to pick up in 2000. Annual growth rates, however, are likely to remain well below past rates.

… but the strength of the recovery will depend, in part, on developments elsewhere in Asia

Given the unprecedented size of the exchange rate shock, there are large risks attached to these projections. The timing and strength of the recovery will depend on several key factors: first, how quickly the corporate sector restructures in the face of credit crunch conditions, big falls in asset prices and increased international competitiveness; second, how households respond to reduced job security and the fall in nominal wages; and third, how investors respond to the further opening of the capital account in Korea. There are large uncertainties attached to each of these factors. In fact, the credit crunch may result in further large-scale bankruptcies in Korea. Furthermore, the threat of continued labour strife may slow restructuring and discourage foreign direct investment. Perhaps most important is the risk of weakening confidence in response to a fall in other Asian currencies and turmoil in Southeast Asia. However, Korea's capacity to avoid a second foreign exchange crisis has been strengthened by its record high foreign reserves, the large projected current account surplus and the reduction of the proportion of short-term external debt from two-thirds of total external debt to a fourth, as well as by the adoption of a floating exchange-rate regime.

2. On a general government basis, a deficit of about 1 per cent is expected.

Luxembourg

Economic activity has continued to expand rapidly in 1998, underpinned by a strong performance of services' exports. Due to the continuing influx of cross-border workers, labour market tensions have been avoided, but unemployment – although low compared with other OECD countries – has remained historically high. Inflationary pressures have been largely absent. These trends are likely to continue over the projection period, albeit with somewhat slower real GDP growth.

Given the favourable conjunctural situation, the pace of structural reform should be stepped up to enhance the adjustment capacity of the economy. Budget flexibility could be improved by reducing the widespread use of indexation, and adaptability in the labour market would be enhanced by relaxing working-time restrictions, especially for part-time workers.

Economic growth has been robust…

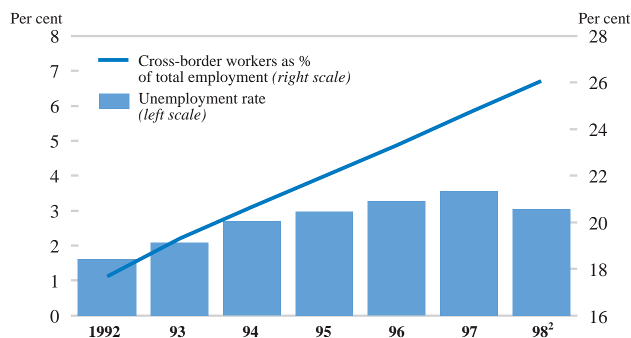
Economic activity has remained buoyant in 1998. Underpinned by a continuing rapid expansion of the financial and communications sectors, real GDP growth may have been 4¾ per cent, only slightly less than in 1997. Private consumption has been stimulated by a steady increase in national employment and a tax reduction package. The launch of a satellite and the purchase of some aircraft have supported investment. Despite strong employment growth, the labour market has not significantly tightened because cross-border workers have continued to expand the labour supply. Unemployment has declined somewhat but this has been partly the result of a change in definition at the beginning of 1998 which entailed the removal of all participants in special labour market programmes from the national unemployment definition. Wages, which had accelerated in 1997 as a result of a 2.5 per cent adjustment in conformity with the indexation system, seem to have grown more moderately in 1998, resuming a long-term decelerating trend.

… underpinned by a buoyant service sector and an expansionary fiscal stance

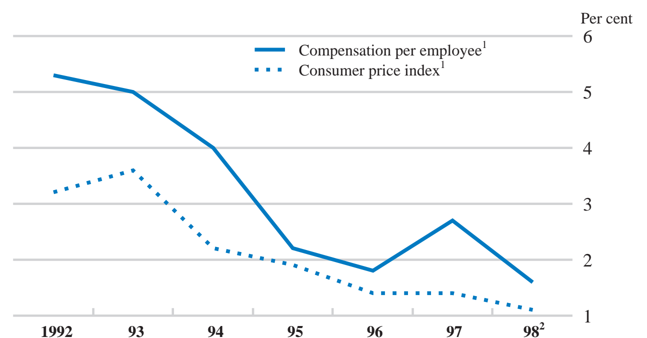
The service sector is expected to continue its robust expansion over the projection period, especially in communication services, reflecting a further expansion of the satellite network. The financial sector, on balance, should also remain buoyant: the banking sector may lose some foreign exchange earnings as a result of the introduction of the euro, but the country looks well positioned to take advantage of the creation of a single European pension market. Although the exposure of the Luxembourg financial markets to Asia and Russia is limited, the sector has reacted prudently to the international financial crisis by substantially increasing its bad debt provisions. Growth in the cyclically-sensitive manufacturing sector is expected to slow, as the current buoy-

Luxembourg

Growing presence of cross-border workers



Wages trend down as inflation falls



1. Annual percentage change.
2. Partly estimated.
Source: Statec.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion LF	1996	1997	1998	1999	2000
Private consumption	278.8	1.9	2.5	2.6	2.4	2.5
Government consumption	67.2	3.3	1.7	2.8	2.8	2.8
Gross fixed capital formation	111.4	–1.7	14.1	6.5	4.7	5.0
Final domestic demand	457.3	1.1	5.5	3.8	3.1	3.3
* stockbuilding	11.7[a]	0.7	–0.6	0.2	0.2	0.2
Total domestic demand	469.1	1.8	4.8	4.0	3.3	3.5
Exports of goods and services	467.5	2.3	6.0	7.5	5.0	5.3
Imports of goods and services	419.8	1.0	6.1	7.0	5.1	5.5
* net exports	47.7[a]	1.3	0.5	1.2	0.4	0.4
GDP at market prices	516.8	3.0	4.8	4.7	3.4	3.5
GDP deflator	–	0.1	2.4	1.5	1.4	1.6
Memorandum items						
Private consumption deflator	–	1.6	1.1	1.1	1.3	1.5
Industrial production	–	–1.9	7.1	5.1	2.5	2.6
Unemployment rate	–	3.3	3.6	3.1	3.2	3.3

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.

ancy is partly related to the start-up of new activities. Despite strong employment growth, the labour market is not expected to tighten given the elastic supply of labour from neighbouring countries. Fiscal policy has become more expansionary, as the government has reduced corporate taxes – partly to match more favourable tax regimes elsewhere – and income taxes. Furthermore, government spending has increased substantially, in particular for new infrastructure projects and the introduction of a long-term nursing care scheme. Overall, the general government budget surplus – which was nearly 3 per cent of GDP in 1997 and is estimated to have been around 1½ per cent in 1998 – may decline a bit further.

The outlook remains favourable

Real GDP growth is projected to slow only moderately – to around 3½ per cent in both 1999 and 2000. Net exports are expected to continue to support growth. Investment may lose some buoyancy but it will be underpinned by further satellite launches: two in 1999 and one in 2000. Although employment growth should remain robust, unemployment is expected to stay at current levels. Partly as a result of a continued increase in cross-border workers, the economy is unlikely to overheat: wage claims should remain moderate and consumer price inflation low – in line with developments in neighbouring countries. The major risks and uncertainties in the projections – in addition to the international financial crisis – concern the impact of European Economic and Monetary Union on the large financial sector in Luxembourg.

Mexico

Economic developments in 1998 have been dominated by the contagion effects from the Asian crisis and the related fall in oil prices. A tightening of macroeconomic policies has slowed real GDP growth and limited the deterioration of the external balance; but the depreciation of the peso has reversed the decline in inflation. Restrictive economic policies should hold back domestic demand in the near term, but activity is projected to pick up as confidence returns on financial markets. Disinflation is expected to resume once the first-round effects of the depreciation have worked through; and the current-account deficit could widen to just above 4 per cent of GDP in 2000.

Fiscal restraint and a tight monetary policy have to be maintained for as long as necessary to preserve market confidence and to ensure that inflation be put on a steady downward path. Structural reforms to strengthen tax revenue should not be delayed as this could help reduce the vulnerability of public finances to exogenous shocks.

With economic activity slowing, the current-account deficit has stopped widening

Following record 7 per cent growth in 1997, real GDP expanded by more than 5 per cent year-on-year in the first half of 1998, driven by buoyant private consumption and investment; but a tightening of policies in response to falling oil prices and pressures on the exchange rate slowed activity in the second half. Job creation remained strong in the formal sector up to mid-year – as demonstrated by the increase in the number of insured workers – and contractual wage rises were being negotiated around 18 per cent, implying some catch-up in real earnings after three years of losses. Robust manufacturing exports in the first half of 1998 and a slowdown in import growth after the first quarter boom served to offset declining revenues from oil exports, thereby slowing the deterioration in the trade balance. The current-account deficit remained below 4 per cent of GDP in the first half of the year.

As the peso depreciated inflation has accelerated

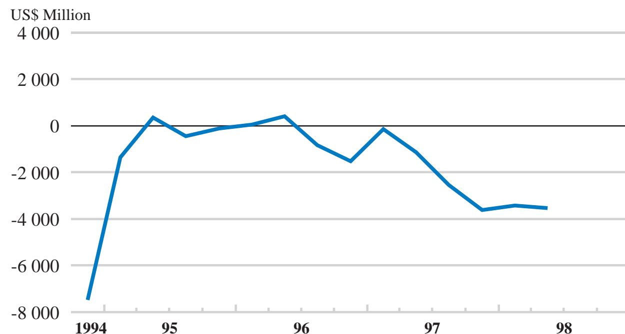
Following a gradual depreciation during the first half of 1998, the bilateral exchange rate of the peso slid sharply in the third quarter, to 10.1 pesos/dollar on 27 October, implying a 16 per cent depreciation since the start of the year. The inflationary impact of the peso depreciation reversed the earlier trend towards disinflation. By September, consumer price inflation (year-on-year) had reached almost 16 per cent, close to the end-1997 outturn, virtually ensuring an overrun on the official target of 12 per cent by December 1998.

Fiscal policy has been tightened…

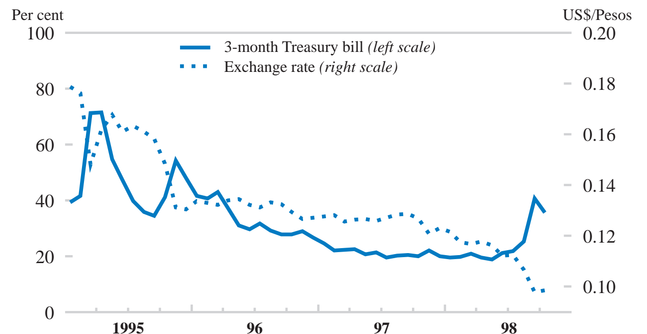
With budget outcomes vulnerable to falling oil prices (oil-related receipts account for about a third of revenue), the government announced three spending cuts – in January, March and July – and a spending freeze in September. These adjustments should

Mexico

The widening of the current account deficit has stopped



The exchange rate has depreciated



Demand, output and prices

Percentage changes, volume (1993 prices)

	1995 current prices billion Pesos	1996	1997	1998	1999	2000
Private consumption	1 232.0	2.2	6.3	6.0	3.5	4.1
Government consumption	192.0	–0.7	1.8	0.0	1.6	1.5
Gross fixed capital formation	296.7	16.4	20.9	10.7	7.0	11.0
Final domestic demand	1 720.7	4.0	8.3	6.3	4.0	5.3
* stockbuilding	70.8[a]	1.6	0.9	–0.4	0.0	0.0
Total domestic demand	1 791.5	5.6	9.0	5.7	3.9	5.1
Exports of goods and services	558.8	18.2	13.0	11.5	9.4	9.1
Imports of goods and services	509.9	22.8	22.0	15.7	10.8	11.4
* net exports	48.9[a]	–0.2	–1.7	–1.0	–0.4	–0.7
GDP at market prices	1 840.4	5.2	7.0	4.6	3.6	4.4
GDP deflator	–	29.4	18.8	15.0	12.7	10.2
Memorandum items						
Private consumption deflator	–	28.8	20.4	16.0	13.5	10.0
Unemployment rate[b]	–	5.5	3.7	3.4	3.5	3.5
Current account balance[c]	–	–0.7	–2.0	–3.8	–4.0	–4.3

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.
b) Based on the National Survey of Urban employment.
c) As a percentage of GDP.

keep the public sector deficit for 1998 close to the target (1.3 per cent of GDP). For 1999 and 2000, the projections assume that a prudent fiscal policy setting will be maintained, with the public sector financial deficit at 1.5-2 per cent of GDP.[1]

… and interest rates have surged

In response to the deteriorating external environment and the resumption of inflationary pressures related to the peso depreciation, the Central Bank tightened monetary policy during 1998, intensifying its operations after mid-August because of increased volatility in world financial markets. Short-term interest rates increased sharply, to above 40 per cent in early September, for the three-month Treasury bill rate (*Cetes*), against 20 per cent at the start of the year. Interest rates, which eased slightly in October, are assumed to remain high in the very near term, gradually moving back towards their pre-crisis levels over the projection period, the pace of the reduction depending on both the balance of payments and inflationary expectations.

Economic prospects are expected to improve through the projection period…

Real GDP growth is expected to decelerate in 1999 as high interest rates restrain private domestic demand. In 2000, business investment should be more robust, although it is unlikely to rise at the very high rates achieved over the past two years. Inflation is projected to come down gradually in the coming two years, to 10 per cent in 2000, while the current-account deficit is expected to widen slightly to just above 4 per cent of GDP. These projections hinge on the usual assumption that the exchange rate is unchanged, remaining at its 27 October level.

… but prolonged financial market turmoil would affect prospects significantly

The most important risks to the outlook are related to developments abroad, most notably in Latin America. Foreign direct investment in Mexico, after reaching $12 billion in 1997, was still strong in the first half of 1998 ($5.3 billion), while portfolio investment turned negative. But the size and the nature of capital flows are difficult to

1. The deficit includes the expected fiscal cost of the social security reform and takes into account provisions to pay part of the cost of support programmes for banks and debtors. Excluding these items, the balance would be slightly positive.

predict. Continued turbulence on financial markets world-wide and falling oil prices would force further tightening of the policy stance to prevent the emergence of major imbalances; this would pose a significant downward risk to the growth projection. Nevertheless, compared to the situation in 1994, the exchange rate is now floating and the authorities are committed to take pre-emptive action to stabilise the economy, so that it may be possible to deal with these risks in a more effective way.

Netherlands

After growing above potential for several years, economic activity is projected to slow to 2¾ per cent in 1999 and 2½ in 2000, reducing fears of overheating. Nevertheless, tensions in the labour market are expected to persist, and wage increases and inflation are projected to pick up. The fiscal stance is broadly neutral, and the general government deficit is projected to remain below 1½ per cent of GDP.

The government should use the current buoyancy of the economy to reduce the structural budget deficit closer to the medium term target of 1 per cent of GDP. Labour market policy should be directed at returning to the active labour force the older unemployed and people of working age currently in the disability and social assistance schemes.

The economy may have already peaked

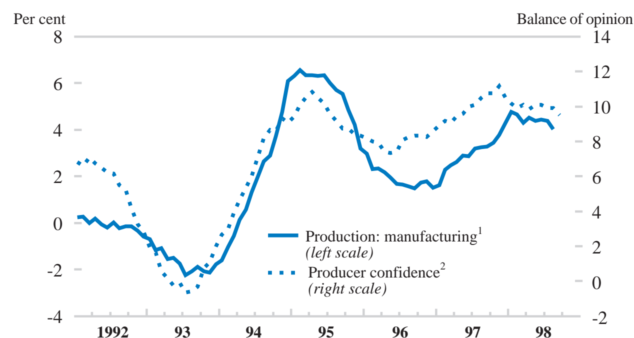
Led by private consumption, real GDP growth may have been 3¾ per cent in 1998, slightly more than in 1997. But economic activity may have already peaked. Producer confidence has started to weaken in response to the turmoil in financial markets. The Asian crisis has resulted in a substantial fall in exports to these countries but, these trade flows being relatively small, overall production has hardly been affected and capacity utilisation has remained high. Tensions in the labour market have increased as unemployment has continued to fall. Reported vacancies are around the same level as at the peak of the previous cycle in the early 1990s. The pace of wage settlements has increased steadily, but inflation has stabilised at around 2 per cent as import prices have decelerated sharply.

Forces sustaining the current boom seem to have weakened

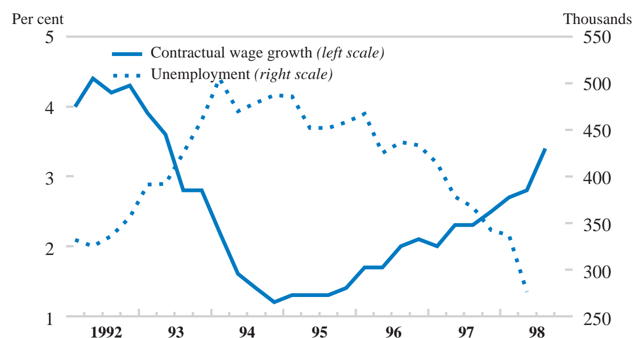
The economy has been growing above the trend rate for several years and spare capacity has largely been eliminated, with the estimated output gap becoming positive. Nevertheless, inflationary pressures have been weak, and only real and financial asset prices have increased rapidly. Indeed, substantial capital gains on real estate and equities – through their effect on private consumption – have been one of the major forces behind the current boom. However, these wealth effects are expected to play a smaller role over the projection period, as house prices may be levelling off and equity prices have already dropped markedly. Moreover, business investment is likely to lose some buoyancy: slackening world demand has reduced the need for extra capacity; and profit margins have been squeezed by the recent appreciation of the guilder in effective terms and an acceleration in the pace of wage settlements. Although unemployment has fallen below its estimated structural rate, other measures of labour utilisation – such as broad unemployment – point to a sizeable pool of unused labour.

Netherlands

Producer confidence has started to weaken



Wages edge up as the labour market tightens



1. Twelve-month moving average, year-on-year percentage change.
2. Twelve-month moving average.
Source: Central Bureau of Statistics.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion Gld	1996	1997	1998	1999	2000
Private consumption	382.2	2.7	3.0	3.7	2.8	2.5
Government consumption	91.8	1.2	1.5	2.8	1.5	1.5
Gross fixed capital formation	122.0	5.4	6.8	3.6	3.3	3.0
Final domestic demand	595.9	3.0	3.6	3.5	2.7	2.5
* stockbuilding	1.0[a]	0.0	0.0	0.1	0.0	0.0
Total domestic demand	596.9	3.0	3.6	3.7	2.7	2.5
Exports of goods and services	339.6	5.2	6.7	7.5	5.3	5.5
Imports of goods and services	296.8	5.3	7.1	7.8	5.7	5.9
* net exports	42.7[a]	0.4	0.3	0.4	0.2	0.2
GDP at market prices	639.6	3.1	3.6	3.8	2.7	2.5
GDP deflator	_	1.5	2.2	1.9	2.1	2.3
Memorandum items						
Private consumption deflator	_	1.6	2.0	2.1	2.1	2.3
Industrial production	_	3.2	4.4	3.8	2.6	2.4
Unemployment rate	_	6.6	5.5	4.1	4.2	4.4
Household saving ratio[b]	_	0.5	–0.6	0.1	–0.1	–0.1
General government financial balance[c]	_	–2.0	–0.9	–1.2	–1.3	–1.4
Current account balance[c]	_	5.8	6.1	5.8	5.7	5.7

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.
b) As a percentage of disposable income, excluding net contributions (actual and imputed) to life insurance and pension schemes.
c) As a percentage of GDP.

Ongoing structural reform in the labour market and social security system aims at limiting access to income-replacement schemes and promoting the outflow to the labour force from these schemes – notably the disability scheme. While current economic conditions should facilitate this process, the reintegration of the long-term unemployed and those in the disability scheme is often hampered by a lack of qualifications or sufficient incentives. It is thus difficult to assess precisely the degree of tightness in the labour market and associated risks of inflation. With the introduction of the euro in January 1999, monetary conditions are likely to remain relatively easy over the projection period; but fiscal policy, after being somewhat expansionary in 1998, is expected to be broadly neutral. The 1999 budget projects an increase in taxes and social security contributions, with offsetting additional expenditure for infrastructure, education and the health sector. Despite the economic slow down, the OECD expects the public sector deficit to merely edge up, to 1.4 per cent of GDP in 2000. The cyclically-adjusted deficit – at around 1¾ per cent of GDP – may remain well above the medium term target of 1 per cent of GDP.

Slower growth but inflationary pressures persist

GDP growth is projected to decelerate to 2¾ per cent in 1999 and 2½ per cent in 2000, largely as a result of less buoyant domestic demand. Job creation is expected to be weaker than in previous years, and unemployment is likely to reverse its recent trend and start edging up. However, tensions in the labour market may persist for some time, causing compensation per employee to accelerate further. Consumer price inflation is expected to increase to almost 2½ per cent in 2000. The major risks and uncertainties on the domestic side concern the reaction of wages and prices to tight labour market conditions; and, on the external side, the impact of the international financial crisis.

New Zealand

A number of factors have been weighing heavily on the New Zealand economy since late last year: a severe drought, the ongoing Asia crisis, financial market volatility, and a marked decline in both business and consumer confidence. As a result, economic performance has deteriorated considerably, with the economy in recession during the first half of 1998. While a further decline in real output cannot be excluded, in view of the unusually high degree of uncertainty now facing the global economy, there are forces in place which will encourage recovery, notably the stimulus provided by both the low value of the New Zealand dollar and the marked fall in interest rates, as well as substantial fiscal expansion.

The fiscal outlook has deteriorated both due to discretionary measures and cyclical influences, with the budget moving from substantial surplus to deficit in the next two years and the public debt-to-GDP ratio likely to rise again. While in the current difficult economic environment it is appropriate that fiscal stabilisers are allowed to work, care must be taken to avoid fiscal slippage that would lead to an erosion of financial market confidence, given the high external deficit and debt.

The economic outlook has deteriorated…

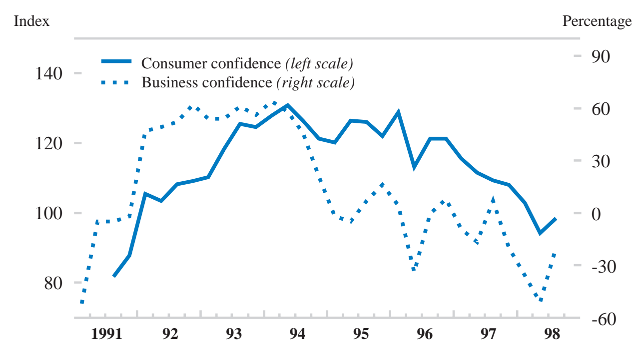
Economic activity contracted over the first six months of the year, with real GDP falling by nearly 3 per cent (at an annual rate) compared with the second half of 1997. The decline in output was led by exports, which declined by 3½ per cent, and residential investment, which plunged by more than 25 per cent. Private consumption has been weak, with apparently little impact from pre-spending of the mid-year income-tax cut or from wealth effects from the demutualisation of the Australian Mutual Provident Fund (AMP). The downturn in activity is reflected in declining full-time employment and unemployment rising to 7.7 per cent, from a low of 6 per cent two years ago. In addition to the emergence of a widening output gap, a number of developments (increased price competition, a depressed housing market, the removal of automobile tariffs) have kept consumer price inflation near the mid-point of the Reserve Bank's 0 to 3 per cent target range, despite currency depreciation. The current account deficit eased slightly to about 7 per cent of GDP in the first half of 1998.

… but the macro policy settings are now in a position…

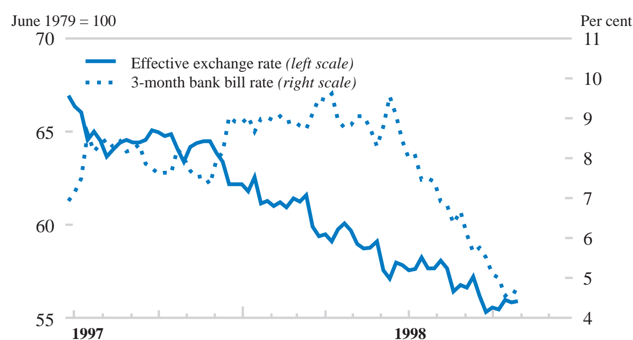
High interest rates through the second half of last year and well into 1998 were needed to maintain overall monetary conditions near their desired levels in the face of a substantial decline in the effective exchange rate (17 per cent since the middle of 1997). More recently, monetary policy has become more accommodative, short-term interest rates declining by 4½ per cent since mid-year. Despite the deterioration in economic activity, fiscal plans remained on course for the year which ended in June. In fact, several one-off factors contributed to an operating surplus which, at 2.6 per cent

New Zealand

Confidence has deteriorated



But monetary conditions have eased markedly



Demand, output and prices

Percentage changes, volume (1991/92 prices)

	1995 current prices billion NZ$	1996	1997	1998	1999	2000
Private consumption	55 527	4.7	3.1	1.4	1.9	2.8
Government consumption	13 054	2.1	5.8	–0.6	5.5	–2.5
Gross fixed capital formation	18 895	6.5	4.2	–1.8	2.9	5.3
Final domestic demand	87 476	4.7	3.8	0.4	2.7	2.5
* stockbuilding[a]	1 312[b]	–0.5	–0.1	–0.3	0.1	0.0
Total domestic demand	88 788	4.1	3.6	0.1	2.8	2.5
Exports of goods and services	27 552	3.6	2.3	0.9	5.2	6.8
Imports of goods and services	25 958	8.2	3.9	0.7	7.2	3.9
* net exports	1 594[b]	–1.5	–0.6	0.1	–0.8	0.9
GDP at market prices	90 382	2.7	3.1	0.2	2.0	3.4
GDP deflator	–	1.9	0.1	0.5	1.3	1.8
Memorandum items						
GDP (production)	–	3.2	2.4	0.2	2.0	3.4
Private consumption deflator	–	2.0	1.0	1.3	1.3	1.5
Unemployment rate	–	6.1	6.6	8.3	8.2	7.1
Current account balance[c]	–	–3.9	–7.6	–6.6	–6.9	–6.4

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Including statistical discrepancy.
b) Actual amount.
c) As a percentage of GDP.

of GDP, exceeded expectations. Nevertheless, the ongoing impact of the Asia crisis and domestic weakness has led the New Zealand Treasury to anticipate a swing into deficit over the next two years. This compares with the May Budget projections of a surplus growing to 3 per cent of GDP in the fiscal year 2000/01. To limit fiscal slippage, the government has scaled back its three-year NZ$ 5 billion expenditure programme by NZ$ 300 million in each of the next two years and lowered the wage floor for superannuation. Debt is now expected to rise instead of falling to below 20 per cent (as a share of GDP), thus making it more difficult to attain the recently announced lowering of the long-term net debt target of 15 per cent.

… to provide support for a gradual recovery, in the absence of further bad news from Asia and elsewhere

Real GDP is expected to advance slowly over the rest of this year, but to gather strength over the projection period, reaching a growth rate of $3^1/_2$ per cent in 2000. Tax cuts and additional public spending along with lower interest rates should stimulate domestic demand. At the same time, the strong competitive position associated with the low value of the effective exchange rate should give a lift to exports, particularly in North American and European markets.[1] Despite the steep currency depreciation, inflation is unlikely to pick up in the near term given the factors mitigating price increases, as noted above, and substantial remaining spare capacity in the economy. The external current account is expected to improve, with the deficit falling towards 6 per cent of GDP by the year 2000. Although economic reforms have reduced New Zealand's vulnerability to external shocks, there are important downside risks to these projections, given the country's exposure to Asian markets and its large external indebtedness.

1. It should be noted that net exports do not contribute positively to growth in 1999 due to the import of a frigate which artificially inflates imports (by around NZ$ 500 million) in that year.

Norway

After five years of strong expansion that led to very tight labour markets and incipient overheating, the Norwegian economy is now headed for a slowdown. A profit squeeze due to accelerating wages, sluggish export markets and low oil prices, coupled with a hike in short-term interest rates and an unwinding of the housing boom, are combining to dampen economic activity. Although the 1999 draft budget may help bolster financial market confidence, further oil price declines and currency turbulence would risk pushing the mainland economy into recession.

The policy framework in place since 1993, geared towards a stable exchange rate, wage moderation and a tight fiscal policy to reduce the impact of the petroleum wealth, has partly broken down. The government should encourage the social partners to resume incomes-policy co-operation while avoiding further fiscal concessions – such as paid education leave – which reduce labour supply. Rather, reform should focus on releasing labour resources, currently trapped by the generous welfare system, so as to ease labour shortages over the longer term.

The economy has reached a cyclical peak

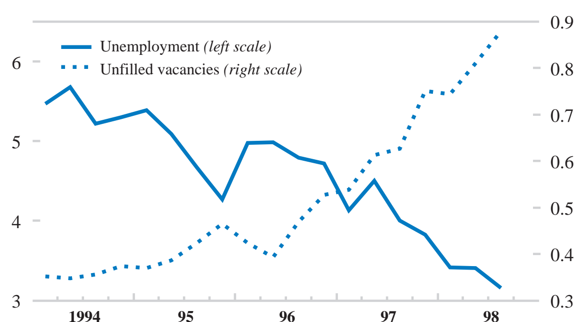
Buoyant private consumption and surging investment in the oil and gas sector continued to boost mainland activity in 1998, but a downturn in residential and other construction activity began to unfold while oil and non-oil exports were hit by slack in world commodity markets. Meanwhile, the labour market remained tight, with the unemployment rate stabilising at $3^1/_2$ per cent, unfilled vacancies soaring and wages accelerating to 6 per cent. Stable import prices and narrowing profit margins, however, kept consumer price inflation at 2 to $2^1/_2$ per cent. At the same time, plummeting prices for oil and weak prices for other commodity exports contributed to virtually eliminating the current account surplus.

Tight conditions in labour and financial markets…

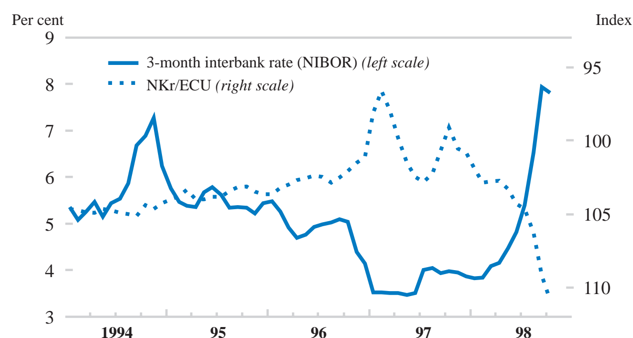
Over the past several years, the combination of mounting oil revenues, fiscal slippage and low interest rates – the latter to offset upward pressure on the exchange rate – propelled mainland economic activity to well above its potential. In particular, after several years of rapid expansion, labour force growth levelled off and wage pressure built up. These factors may have increased Norway's vulnerability to international financial turmoil. In the event, developments over the summer led to considerable turbulence and a stock market correction that was more pronounced in Norway than in most OECD countries, due to the country's dependence on crude oil and other primary products. Monetary policy was tightened sharply to curb capital flight and prevent a major currency depreciation, with a significant rise in official interest rates lifting short-term interest rates by almost $3^1/_2$ percentage points to over $8^1/_2$ per cent in August. The krone remained weak, however, and the exchange rate was floated at the end of the month. Since then, short-term interest rates have eased to just below 8 per cent, with

Norway

The labour market is still very tight
As a percentage of the labour force



Monetary conditions are unsettled



Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion NKr	1996	1997	1998	1999	2000
Private consumption	458.5	4.7	3.4	3.7	1.9	2.3
Government consumption	194.5	3.2	3.0	2.4	1.1	2.5
Gross fixed capital formation	192.5	9.6	12.6	5.0	–7.3	–4.3
Final domestic demand	845.5	5.5	5.5	3.7	–0.6	0.8
* stockbuilding	27.4[a]	–0.6	0.2	0.5	0.2	0.0
Total domestic demand	873.0	4.6	5.6	4.2	–0.4	0.8
Exports of goods and services	353.4	9.8	5.8	2.4	6.1	4.0
Imports of goods and services	297.7	8.3	12.3	7.2	0.6	2.2
* net exports	55.8[a]	1.6	–1.5	–1.5	2.7	1.1
GDP at market prices	928.7	5.5	3.4	2.3	2.3	1.8
GDP deflator	–	4.1	2.8	–1.3	2.0	2.8
Memorandum items						
Mainland GDP at market prices[b]	–	4.1	3.7	2.9	1.0	1.4
Mainland GDP deflator[b]	–	1.5	2.9	2.0	1.7	2.4
Exports of non-manufactures (incl. energy)	–	14.0	2.6	0.3	6.7	4.0
Private consumption deflator	–	1.4	2.5	2.4	3.5	2.8
Unemployment rate	–	4.8	4.1	3.4	3.7	3.9
Household saving ratio[c]	–	5.9	5.9	5.7	4.8	4.5
General government financial balance[d]	–	6.5	7.5	4.4	5.4	5.9
Current account balance[d]	–	6.7	5.2	1.2	2.0	3.6

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.
b) GDP excluding oil and shipping.
c) As a percentage of disposable income.
d) As a percentage of GDP.

the exchange rate *vis-à-vis* the ECU stabilising at around 5 per cent below the previous trading range. Based on the "technical" assumption that the exchange rate will remain at that level over the projection period, and taking into account the fiscal tightening announced in the 1999 budget proposal submitted to parliament in early October, interest rates are expected to ease further.

… prompt slower output growth

As new extraction capacity comes on stream, oil and gas production should rebound, underpinning GDP growth of 2¹/₄ and 1³/₄ per cent in 1999 and 2000, respectively, following an estimated 2¹/₄ per cent in 1998. However, mainland GDP growth (excluding oil and gas extraction) is projected to fall sharply from 3 per cent in 1998 to 1 per cent in 1999, reflecting a downturn in mainland business, residential and oil-related investment, before recovering somewhat in 2000. Employment is projected to level off accordingly, but tight labour market conditions should continue to feed through in wage demands, sustaining wage inflation at around 6 per cent and raising consumer price inflation to about 3 to 3¹/₂ per cent. A new bout of financial turbulence, sparked by a further weakening of oil and other commodity markets, would risk prompting a recession in Norway.

Poland

Macroeconomic performance has remained very good, with sustained rapid output growth, falling unemployment and inflation, and a slowdown in the deterioration of the current account deficit. Unlike other emerging markets, Poland has weathered the international crisis rather well thus far, in part thanks to its relatively prudent policy stance.

The main macroeconomic challenge facing the authorities will be to ensure that the ongoing stabilisation efforts continue even if external conditions deteriorate further. This task is all the more difficult as the implementation of the government's structural reform initiatives will be costly in the short run.

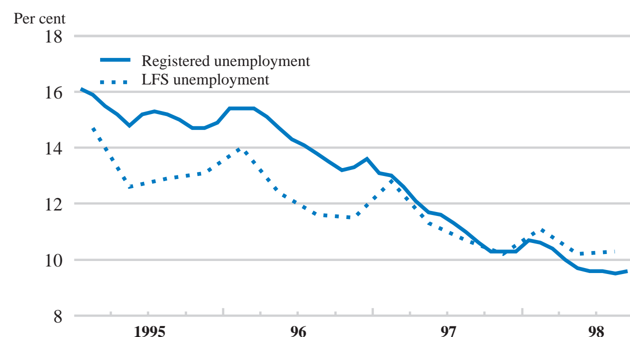
Growth has remained vigorous and disinflation continued, while the deterioration of the current account slowed somewhat

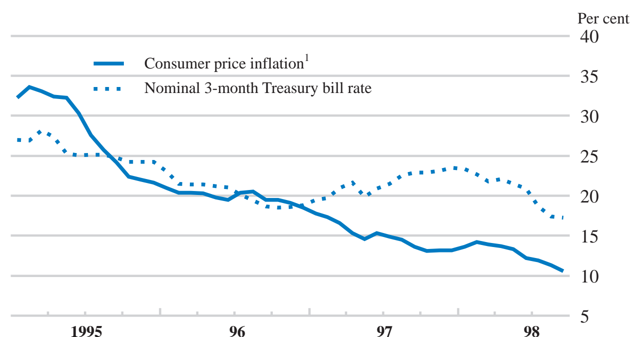
Notwithstanding some deceleration, growth has remained vigorous in the first half of 1998, with real GDP rising at an annual rate approaching 6 per cent. On the demand side, domestic consumption and investment continued to drive the expansion, while the negative contribution from foreign trade diminished. Employment has picked up somewhat, expanding at a rate of about 1½ per cent. Owing in part to large inflows into the labour force, however, unemployment is now declining less swiftly, standing at 10.3 per cent in the third quarter (labour force survey measure). Wages have slowed down somewhat but are still rising briskly, outpacing productivity in a number of enterprises and sectors where financial discipline is wanting, and contributing to a deterioration in aggregate enterprise profitability ratios. Concomitantly, disinflation is proceeding, with consumer prices up 10.6 per cent in September over a year earlier. The deceleration of prices was helped by the strength of the zloty. This was reflected, *inter alia*, in the slowdown of producer prices in industry, which by September were up by only 6.1 per cent on a year earlier. The deterioration of the current account deficit was limited during the first half thanks to the acceleration of exports and deceleration of imports, partly a lagged response to the weakening of the exchange rate in the course of 1997. Foreign direct investment inflows remained dynamic, spurred by some privatisation operations.

Interest rates and the rate of exchange rate crawl were reduced in steps

Through July 1998, coping with the inflationary pressures of capital inflows was the main challenge facing monetary policy. Capital inflows were fuelled by high interest rates (with the yield on T-bills hovering around 23 per cent in early 1998) and by a safe haven effect, Poland being perceived as a relatively secure emerging market. In addition to fiscally costly intervention on the foreign exchange market, the central

Poland





1. Year-on-year percentage change.
Sources: Central Statistical Office, National Bank of Poland and Ministry of Finance.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion Zl	1996	1997	1998	1999	2000
Private consumption	182.0	8.6	7.1	4.5	3.7	3.8
Government consumption	53.6	3.4	3.4	1.8	1.7	2.0
Gross fixed capital formation	48.7	20.6	20.6	14.8	11.5	10.1
Final domestic demand	284.4	10.4	9.9	6.9	5.7	5.6
* stockbuilding[a]	0.5[b]	1.7	0.8	0.1	0.1	0.1
Total domestic demand	284.9	12.2	10.6	7.0	5.7	5.6
Exports of goods and services	74.8	12.5	10.6	12.4	8.3	9.4
Imports of goods and services	70.9	28.0	18.3	13.9	9.1	9.3
* net exports	3.8[b]	–6.1	–4.3	–1.9	–1.3	–0.9
GDP at market prices	288.7	6.1	6.9	5.7	5.1	5.2
GDP deflator	–	18.5	14.8	12.0	9.7	7.9
Memorandum items						
Private consumption deflator	–	19.5	15.2	11.9	8.9	7.3
Industrial production	–	9.0	11.6	8.5	7.1	6.8
Unemployment rate	–	12.3	11.2	10.1	9.5	9.3
General government financial balance[c]	–	–4.4	–3.3	–3.1	–2.7	–2.5
Current account balance[c]	–	–2.4	–4.2	–5.1	–5.6	–5.7

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Including statistical discrepancy.
b) Actual amount.
c) As a percentage of GDP.

bank reduced its headline interest rates in steps, by a cumulative 5 percentage points. At the same time, it reduced the monthly rate of crawl of the central parity from 1.0 per cent in early 1998 to 0.8 per cent from February and 0.65 per cent from July. On the lending side, although credit to households decelerated during the first half, partly because of new legislation on collateral, its growth remained very rapid. Domestic corporate credit continued to rise at an annual rate approaching 30 per cent, and enterprises borrowed abroad on a significant scale.

The crisis in Russia had limited spillover effects

Following the aggravation of the crisis in Russia, Poland experienced significant capital outflows. The exchange rate depreciated sharply in the course of August, thereby essentially reverting to the centre of the ±10 per cent crawling band, while the headline stock market index lost 30 per cent. In early September, however, appreciation pressures resumed and the stock market index recovered some of the lost ground. In this context, the monetary authorities cut the rate of crawl of the central parity to 0.5 per cent and lowered its headline interest rates by one percentage point. In late October, a further interest rate cut followed, and the exchange rate band was widened to ±12.5 per cent.

While the execution of the 1998 Budget runs fairly smoothly, further fiscal consolidation is called for

On the fiscal front, the execution of the 1998 Budget has been facilitated by higher than projected GDP and falling interest rates and unemployment. In these conditions, the relatively unambitious target of 3.2 per cent of GDP for the general government deficit should be comfortably realised.[1] Further fiscal tightening is, however, called

1. On a cash basis, and excluding privatisation receipts from revenue. The fiscal balance shown by the OECD is accruals-based.

for in the context of continuing strong growth, and the draft 1999 Budget bill constitutes a step in this direction. It targets a reduction of the deficit in the state budget of 0.7 per cent of GDP despite the cost of the implementation of several ambitious structural reforms (notably devolution and pension, education and health care reforms, but also coal mine restructuring).[2] The draft bill further envisaged a surge in privatisation receipts, to $2^1/_2$ per cent of GDP. A major tax reform is also under consideration. It is envisaged that the corporate income tax rate would be cut from 36 to 32 per cent in 1999, and that more comprehensive changes will follow in 2000.

Provided external conditions do not worsen significantly, no sharp break in macroeconomic trends should occur

Overall, the outlook remains promising. Growth is projected to slow down somewhat, reflecting the continuation of the incipient deceleration of domestic demand and a weakening of exports towards neighbouring countries. Even if consumer price inflation remains in double digits this year, it should continue to decrease assuming that monetary conditions remain tight and that fiscal consolidation proceeds as envisaged.[3] The current account gap is projected to widen in the second half of 1998, owing in part to the real exchange rate appreciation recorded in the first half, but should stabilize around the turn of the century, albeit at an uncomfortably high level. A key domestic risk to this projection is the persistence of excessive wage growth, which would prevent the soft landing of domestic demand needed for the external imbalance to recede. The main external risk is that of a marked slowdown in activity in the OECD area.

2. Pension reform, however, which was to start at the beginning of 1999, has been delayed by three months.
3. The underlying exchange rate assumption is that the monthly rate of crawl is cut to 0.4 per cent in January 2000.

Portugal

The economy is in its fifth year of expansion, with output growth boosted by infrastructure investment and buoyant consumer spending. Reflecting in part the effects of Expo 98 in Lisbon, the unemployment rate declined to the lowest level in six years, while inflation picked up. Monetary policy has eased in the run-up to European Economic and Monetary Union (EMU), and the fiscal stance has loosened slightly. Risks of overheating are mitigated, however, by the end of temporary factors related to the Expo and by the effects of a deteriorating external environment. Output growth is expected to decelerate, helping to bring down inflation, although labour market conditions are likely to remain tight.

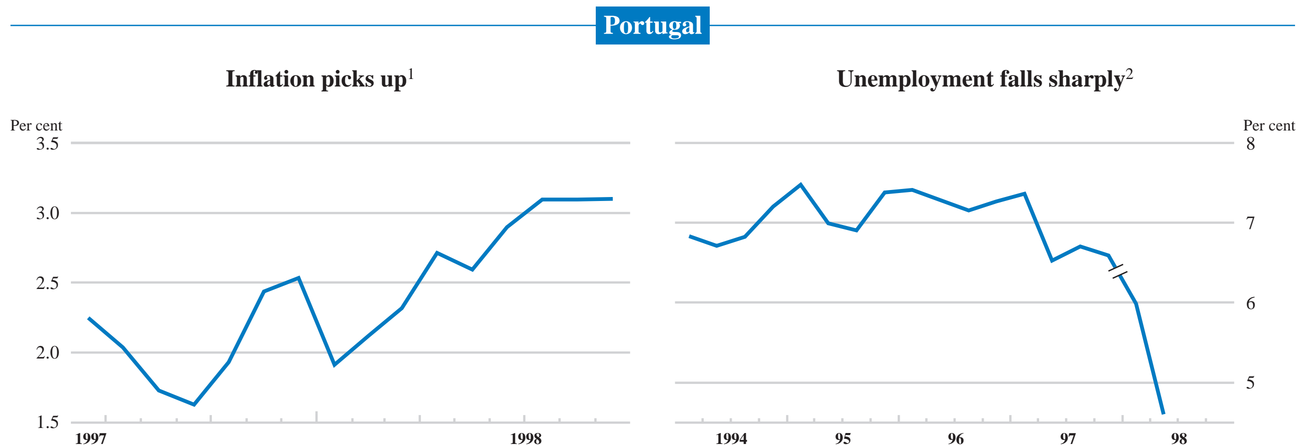
Incipient inflationary pressures make it opportune to press ahead with fiscal consolidation and structural reform. Beyond 1999, with interest rates no longer falling and revenue growth slowing, further deficit reduction will require new budget measures. Both budget and broader social objectives could be realised through effective reforms in the spheres of health, social security and education.

Strong output growth has led to reduced unemployment and has pushed inflation up

Economic activity remained buoyant in 1998, as falling interest rates boosted private spending, especially consumption. Output growth over the year is estimated at 4 per cent, helping to bring the unemployment rate sharply down. Pushed by a sharp rise in the price of foodstuffs, restaurants and hotel services, in part as a result of the Expo, inflation picked up. The 12-month rate reached 3.1 per cent in the third quarter, up from 1.8 per cent a year earlier. On the external side, increased tourism receipts have offset strong import growth to leave the current account deficit stable at less than 2 per cent of GDP.

Interest rates have continued to decline while the budget deficit is on target

The convergence of policy-controlled interest rates accelerated in the fourth quarter; with the Portuguese repo rate falling to 45 basis points above the German equivalent by early November. Long-term rates also continued to decline, mirroring developments in other euro area countries. The spread between German and Portuguese 10-year government bonds increased slightly as a result of global financial turbulence. On the fiscal side, the budget deficit in 1998 is likely to come down to 2.3 per cent of GDP, undershooting the government's target for the third year in a row, a reduction in public debt servicing costs and larger-than-expected tax revenues more than offseting significant spending overruns.



1. Measured by the consumer price index. Year-on-year percentage change.
2. Per cent of total labour force, which excludes conscripts. Break in first quarter 1998 due to changes in the survey methodology.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion Esc	1996	1997	1998	1999	2000
Private consumption	10 262.6	2.5	3.0	3.6	3.3	3.1
Government consumption	2 795.0	2.0	2.5	2.8	2.5	2.5
Gross fixed capital formation	3 734.4	5.7	11.3	7.8	6.6	6.0
Final domestic demand	16 792.0	3.3	5.1	4.6	4.1	3.9
* stockbuilding	114.9[a]	–0.5	0.2	0.0	0.0	0.0
Total domestic demand	16 907.0	2.8	5.2	4.5	4.1	3.8
Exports of goods and services	4 878.8	10.2	8.4	10.5	8.1	8.0
Imports of goods and services	5 968.1	7.5	10.4	10.0	8.5	8.0
* net exports	–1 089.3[a]	0.1	–2.1	–1.2	–1.4	–1.2
GDP at market prices	15 817.7	3.2	3.7	4.0	3.3	3.2
GDP deflator	–	2.8	2.8	2.7	2.7	2.5
Memorandum items						
Private consumption deflator	–	3.6	2.2	2.7	2.3	2.5
Industrial production[b]	–	1.4	2.5	5.3	4.8	3.5
Unemployment rate	–	7.3	6.8	5.1	5.3	5.3
Household saving ratio[c]	–	10.2	10.2	10.2	10.2	10.2
Current account balance[d]	–	–1.4	–1.8	–1.7	–1.6	–2.0

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.
b) Industrial production index.
c) As a percentage of disposable income.
d) As a percentage of GDP.

In spite of monetary easing in the run up to EMU, the economy is expected to decelerate…

The output gap is estimated to have closed in 1998, while lower interest rates are likely to continue to boost consumer and investment spending in 1999. Fears of overheating are mitigated, however, by the deteriorating external environment and by the end of temporary factors (the Expo closed in September 1998). As the growth of public investment and external demand (including tourism receipts) decelerate, output growth is likely to slow down throughout the projection period.

… helping to bring inflation down in 1999

Assuming that the 1999 draft budget is implemented without major changes, public debt servicing costs should fall sufficiently fast as to lead to a further reduction in the budget deficit to 2.0 per cent of GDP. In 2000, however, as interest rates stop falling and output growth decelerates, new measures will be necessary for Portugal to meet the budget deficit target of 1.5 per cent of GDP agreed under the Stability and Growth Pact. Consumer price inflation is projected to decline in 1999 as the effects of Expo 98 disappear. Inflation may edge up again afterwards however, especially if a tight labour market leads to wage drift. On the external side, the current account deficit is expected to widen slightly to 2 per cent of GDP in 2000.

Uncertainties attach to the effects of the emerging markets crisis

The main risk attaching to the projections concerns the evolution of the global financial crisis. This could impact on Portuguese exports through both lower market growth and increased direct competition from emerging market economies, especially in some labour-intensive industries such as clothing and footwear.

Spain

Output growth continues to be among the strongest in the OECD, and is being accompanied by brisk job creation. As a result, the unemployment rate has fallen to below 19 per cent. Despite the buoyant activity, inflation has remained subdued largely due to lower labour cost pressure and subdued world commodity prices. With monetary policy set to loosen, and a broadly neutral fiscal policy, output growth should remain near 3½ per cent through 2000, despite weak external demand. A strong initial current account position will ensure that the external position remains comfortable.

Entry into the European Economic and Monetary Union (EMU) has increased the importance of product and labour market flexibility. Regarding the former, recent regulatory reforms have quickly led to lower prices and improved quality in the telecommunications and electricity sectors. Regarding labour markets, the 1997 reform represents a first step, but the high share of workers on fixed-term contracts continues to signal the need for further reform to promote both employment creation and sustain cost competitiveness. Meeting commitment under the Stability and Growth Pact, including a rapid reduction in the debt to GDP ratio which is still close to 70 per cent, requires stronger efforts to reform burgeoning entitlement programmes, especially for pensions and health care.

EMU entry spurs activity

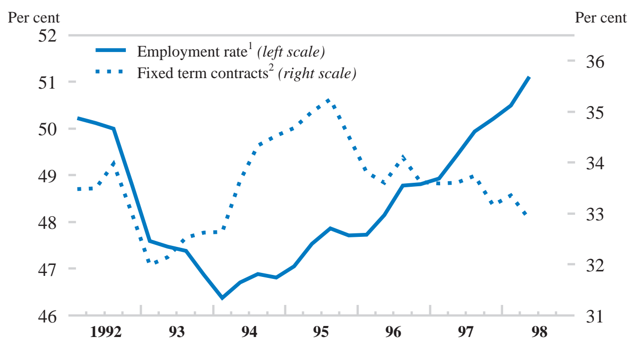
In 1998, domestic demand has been the engine of growth. Critical to its strength has been the qualification for entry into the EMU, which has resulted in a sharp fall in interest rates and boosted household and firm confidence. Business investment has accelerated as profits also benefited from falling prices of imported inputs and moderating wage increases. Household expenditure has been boosted mainly by strong employment growth. The pick up in demand has put some pressure on prices during the first 8 months of 1998. However, in September the underlying 12-month rate of inflation fell to 2.3 per cent, while the headline rate is lower due to subdued international commodity prices. While goods exports gained market share and the tourist season was good, the current account has moved from a small surplus to broad balance due to strong domestic demand.

Policies have supported output growth

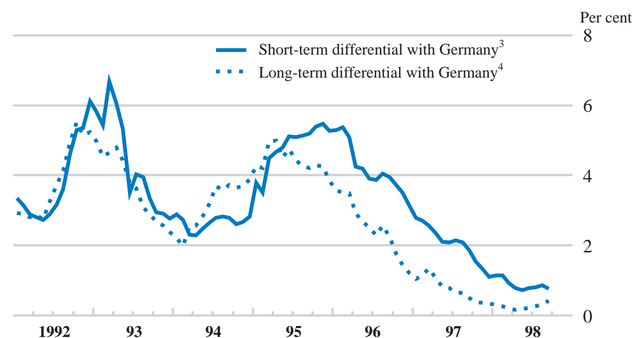
Though the objectives of monetary and fiscal policy were both met, the policy stance has not constrained activity. Specifically, the Bank of Spain's target of inflation near 2 per cent during 1998 is within reach despite an easing of financial conditions. Both long and short-term interest rates have been converging to the lower levels of the euro area, with short term interest rates declining to about 3½ per cent. Private-sector credit expansion was robust, at about 13 per cent in nominal terms through September.

Spain

The labour market improves



Interest rate spreads have fallen substantially



1. Total employment as a percentage of population aged 16-64 years old, Labour Force Survey data.
2. Ratio of fixed-term employees as a percentage of total employees.
3. Three-month interbank rate.
4. Ten-year government bonds.

Demand, output and prices

Percentage changes, volume (1986 prices)

	1995 current prices billion Ptas	1996	1997	1998	1999	2000
Private consumption	43 313.6	2.0	3.1	3.5	3.7	3.8
Government consumption	11 650.2	0.9	1.4	1.3	2.1	2.1
Gross fixed capital formation	14 494.2	1.3	5.1	8.8	7.9	8.2
Final domestic demand	69 458.0	1.7	3.3	4.3	4.5	4.6
* stockbuilding	250.5[a]	0.0	–0.3	0.1	0.1	0.0
Total domestic demand	69 708.5	1.6	2.9	4.4	4.6	4.7
Exports of goods and services	16 731.7	10.6	14.8	10.1	7.6	7.0
Imports of goods and services	16 660.1	7.4	12.2	11.5	10.5	9.9
* net exports	71.5[a]	0.7	0.5	–0.7	–1.3	–1.5
GDP at market prices	69 780.0	2.4	3.5	3.8	3.4	3.4
GDP deflator	–	3.2	2.0	2.6	2.4	2.4
Memorandum items						
Private consumption deflator	–	3.4	2.5	2.0	2.0	2.0
Industrial production	–	0.0	6.0	5.9	5.0	5.8
Unemployment rate	–	22.2	20.8	19.1	17.8	16.8
Household saving ratio[b]	–	12.3	11.0	10.7	10.5	10.1
General government financial balance[c]	–	–4.7	–2.6	–1.9	–1.8	–1.5
Current account balance[c]	–	0.1	0.4	0.3	–0.2	–0.9

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.
b) As a percentage of disposable income,
c) As a percentage of GDP.

Monetary policy easing reflects the gradual loss of monetary policy autonomy with the approach of monetary union, and monetary conditions in 1999 are likely to loosen further. Helped by lower interest rates and faster output growth, fiscal policy is set to more than meet the 1998 deficit objective (2½ per cent of GDP). The general government budget deficit could decline from 2.6 per cent of GDP in 1997 to below 2 per cent this year. However, the 1998 Budget contained few structural measures, other than the maintenance of hiring restrictions for civil servants, and in this sense, the fiscal stance has remained broadly unchanged from 1997. The 1999 Budget includes a significant tax reform which will lower marginal rates and simplify exemptions. Even so, the deficit should continue to decline due to lower interest payments and the relatively strong pace of activity, though the deficit projected by the OECD is slightly above the official target of 1.6 per cent of GDP, reflecting a somewhat less favorable projection for growth.

Activity will slow, but remain robust if the external environment does not worsen

Output growth is projected to slow from 3.8 per cent in 1998 to 3.4 per cent in 2000 due especially to weakening exports. However, domestic demand will remain strong, and its continuing dynamism should support solid job growth so that the unemployment rate could fall to below 17 per cent by 2000. Due to the existence of a high level of structural unemployment, the tightening of the labour market is projected to lead to some wage pressures. With world commodity prices projected to remain low and strong investment to ease emerging capacity constraints, inflation should nonetheless remain at 2 per cent through 2000. Output growth risks being lower, due to a worsening external environment, which would result in a more acute slowdown in exports to the detriment of output and employment. On the other hand, output growth may be stronger and inflationary pressures more prevalent if the external drag is not as strong or domestic demand is more responsive to looser monetary conditions.

Sweden

The economic expansion is slowing as weaker international prospects feed into lower real net exports. However, private consumption, business fixed investment and the general economic climate are benefiting from growing real disposable income and generally supportive financial-market conditions as the 1995-98 fiscal consolidation process is completed. A ratcheting-down in nominal wage growth has contributed to an environment of moderate price inflation, while employment gains have served to lower open unemployment to under 7 per cent, to which must be added the substantial number enrolled in education programmes and active labour-market schemes.

The completion of the fiscal consolidation programme has been followed up by a strategy of attaining an average budget surplus of 2 per cent of GDP over the economic cycle. Adherence to this objective, and the expenditure ceilings for 1998-2001 which aim to reduce public spending relative to GDP, will allow repayment of the public debt and provide room for tax rates to be lowered, thereby improving labour-market performance.

Domestic demand has taken over as the main vehicle for growth

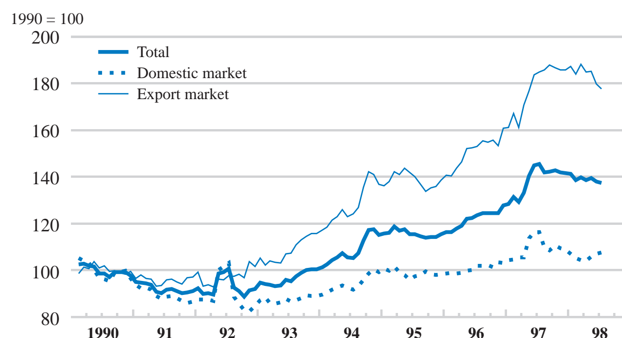
Economic growth accelerated in the first half of 1998, as domestic demand benefited from stimulatory financial-market conditions and rising asset prices. Business fixed investment registered a sharp turnaround, with a year-on-year growth rate of $9^{1}/_{2}$ per cent, and both private and public consumption were increasing. With import penetration continuing to increase and export growth subsiding, the contribution to growth from the external sector has become negative in 1998, the first year this decade.

Employment is increasing and wage growth decelerating

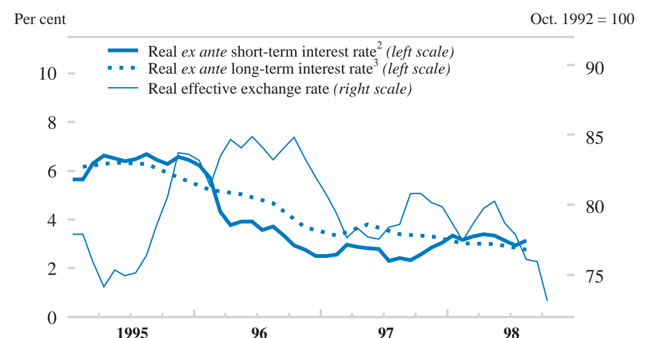
Labour demand has been rising since mid-1997 and employment is growing at an annual rate of $1^{3}/_{4}$ per cent. Open unemployment has fallen, as labour-force growth has been weak, a strong increase in education programmes offsetting the cyclical upturn in participation. Wage growth has slowed to $3^{3}/_{4}$ per cent in 1998, reflecting the spring bargaining round, which resulted in three-year agreements at central level with annual increments of about $2^{1}/_{2}$ per cent and a framework to slow locally-determined wage drift. The headline inflation rate peaked at 1.9 per cent in late 1997, and has since become negative as long-term interest rates and import prices have fallen and indirect taxes have been cut. Underlying domestically-generated inflation is running at $1^{1}/_{2}$ per cent.

Sweden

Order inflow is slowing[1]



Monetary conditions are supportive



1. Volume of new orders in manufacturing. Three-month moving average.
2. Rate of 3-month Treasury bills adjusted for the CPI change expected by households in the coming year.
3. Rate of 5-year government bonds adjusted for bond investors' CPI expectations over the next 5 years.
Sources: SCB; Sveriges Riksbank; OECD.

Demand, output and prices

Percentage changes, volume (1991 prices)

	1995 current prices billion Skr	1996	1997	1998	1999	2000
Private consumption	863.5	1.3	2.0	2.8	2.5	2.2
Government consumption	425.7	–0.2	–2.1	1.9	0.8	0.6
Gross fixed capital formation	240.4	3.7	–4.8	9.7	7.1	5.7
Final domestic demand	1 529.6	1.3	–0.3	3.7	2.9	2.4
* stockbuilding	14.2[a]	–1.1	0.7	0.1	0.0	0.0
Total domestic demand	1 543.8	0.1	0.4	3.8	2.8	2.4
Exports of goods and services	675.4	6.1	12.8	5.5	4.0	5.5
Imports of goods and services	569.2	3.7	11.7	8.7	6.0	6.3
* net exports	106.2[a]	1.2	1.4	–0.6	–0.4	0.1
GDP at market prices	1 649.9	1.3	1.8	2.8	2.2	2.4
GDP deflator	–	1.0	1.2	1.2	1.2	1.8
Memorandum items						
Private consumption deflator	–	1.2	2.2	0.8	1.0	1.7
Industrial production	–	2.3	7.4	4.5	3.8	4.5
Unemployment rate[b]	–	8.1	8.0	6.5	6.3	6.0
Household saving ratio[c]	–	4.4	0.8	1.1	1.8	1.6
General government financial balance[d, e]	–	–3.5	–0.8	1.2	0.3	1.5
Current account balance[d]	–	2.3	2.8	2.1	2.0	1.8

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.
b) Based on monthly Labour Force Surveys.
c) As a percentage of disposable income.
d) As a percentage of GDP.
e) Maastricht definition.

The budget surplus is increasing and bond yields are at a historical low

Fiscal consolidation has been rapid over the past few years, with full adherence to objectives set, and the general government balance will be in surplus in 1998. With the four-year expenditure ceilings adopted in spring 1998 having been confirmed and local governments being legally obliged to balance their books by 2000, the aim of achieving a surplus of 2 per cent of GDP by 2000 should be within reach. Reflecting the easing of inflationary pressures, the central bank lowered its key repo rate, from 4.35 to 4.10 per cent in June and again to 3.85 per cent in early November. The yield on 10-year government bonds fell below 5 per cent in June, narrowing the differential against German rates to 1/4 percentage point. The premium has since increased to between 1/2 and 3/4 percentage point accompanied by a weakening of the exchange rate, but interest differentials should decline again as and when international financial markets normalise and recently-adopted fiscal objectives are met.

Growth will moderate with weaker international prospects

Underpinned by supportive monetary conditions, and substantial real-wage gains, domestic demand should continue to support the economic upturn, with growth gradually easing back as investment growth subsides in the face of expanding capacity. In the absence of further structural reforms, employment growth will slow. However, international competitiveness remains strong, allowing import penetration to slow and exporters to retain market shares. In aggregate, output growth is projected to settle in the 2 1/4-2 1/2 per cent range in 1999-2000.

The risks are balanced apart from international uncertainties

The significant imbalances formerly evident in the balance sheets of households, enterprises and the public sector have been eliminated in recent years, reducing downside risks from the domestic side. The main element of uncertainty thus attaches to the volatile international environment.

Switzerland

Economic activity lost momentum during the first half of 1998 as the growth of exports slowed markedly in response to the Asian crisis. Leading indicators convey a mixed message but, on balance, point to a continuation of the economic expansion at modest rates. In spite of temporary upward pressures on the exchange rate, overall monetary conditions have remained rather easy. This should make domestic demand the dominant engine of growth. Employment is likely to continue to recover, while a continuing output gap will keep price and wage inflation very low, notwithstanding the increase in the VAT rate at the beginning of 1999.

With export demand weakening, the recovery of domestic demand still fragile and the output gap large, it appears appropriate to maintain easy monetary conditions in spite of the overshooting of the monetary base. Federal budgetary policy should adhere to the objectives of reducing the deficit to slightly under SF 1 billion by 2001 and of balancing the budget over the business cycle thereafter. In view of the ageing of the population, budgetary prudence should be complemented by reforms of the social security system.

Economic growth is slowing as exports to Asia fall

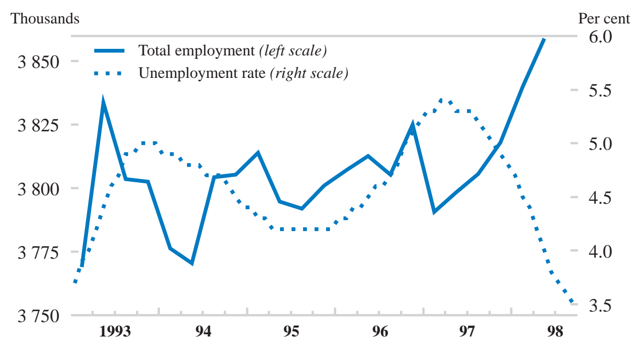
Real GDP grew at an annual rate of 1¾ per cent in the first half of 1998, down from 3½ per cent six months earlier. Total domestic demand remained quite robust although much of this is attributable to inventory accumulation.[1] Growth of machinery and equipment investment slowed markedly, but construction investment showed the first signs of recovery. Household consumption growth remained rather steady, underpinned by improving consumer confidence. The weakening of economic activity was largely due to a sharp deceleration in the expansion of exports of goods and services to an annual rate of under 2 per cent, after two-digit growth in the second half of 1997. Merchandise exports to European countries and North and South America remained robust, but shipments to troubled Asia (accounting for nearly 11 per cent of Swiss export markets in 1997 if Japan is included) contracted sharply.

On balance, current domestic economic indicators are encouraging

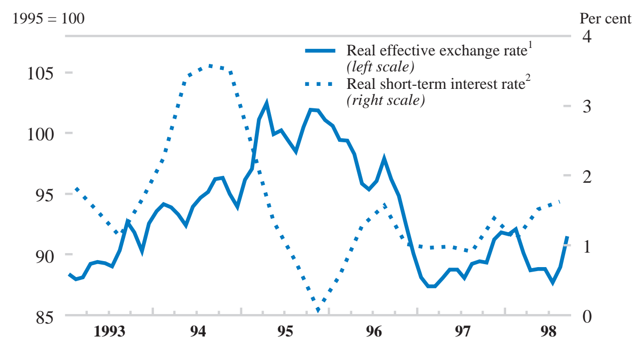
Reflecting the shock from the international financial crises, the business climate has deteriorated somewhat in the course of 1998. But other indicators have been positive; industrial capacity utilisation has improved and now exceeds its long-term average while encouraging news from dwelling permits issued suggests that housing

Switzerland

An improving labour market



Supportive monetary conditions



1. CPI based.
2. 90-day Euro-Swiss franc rate deflated by the 12-month change in the CPI.
Source: Banque Nationale Suisse, *Bulletin mensuel*.

1. This item also includes the statistical discrepancy between output-and demand-based GDP measures.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion SF	1996	1997	1998	1999	2000
Private consumption	215.9	0.4	1.2	1.7	1.6	1.9
Government consumption	55.0	1.4	–0.1	0.3	0.4	0.5
Gross fixed capital formation	77.6	–2.7	1.5	3.6	3.6	3.6
Final domestic demand	348.5	–0.2	1.1	2.0	1.9	2.1
* stockbuilding	0.4[a]	0.2	0.0	0.2	0.1	0.0
Total domestic demand	348.9	0.0	1.0	2.2	2.0	2.2
Exports of goods and services	127.5	2.5	9.0	5.5	4.5	5.0
Imports of goods and services	113.0	2.7	7.2	6.8	5.5	5.8
* net exports	14.6[a]	–0.1	0.7	–0.5	–0.4	–0.4
GDP at market prices	363.5	0.0	1.7	1.7	1.6	1.8
GDP deflator	–	0.4	–0.2	0.8	1.4	1.2
Memorandum items						
Private consumption deflator	–	1.1	0.6	0.0	0.9	0.8
Industrial production	–	–0.1	5.4	7.5	5.5	6.0
Unemployment rate	–	4.7	5.2	4.0	3.4	3.0
Current account balance[b]	–	7.2	8.2	8.4	8.5	8.6

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.
b) As a percentage of GDP.

construction may have bottomed out in late 1997. Finally, consumer confidence has continued to improve, buoyed by good news from the labour market.

Employment is recovering and unemployment falling rapidly

Employment growth resumed in early 1998, ending a long period of contraction. The registered unemployment rate has declined from a peak of 5.4 per cent (seasonally adjusted) in early 1997 – a post-war record high – to 3.6 per cent in the third quarter of 1998. However, this decline is only partly attributable to the cyclical recovery. It is also due to unemployed persons ceasing to register at labour offices because they are no longer eligible for benefits and to the rising number of job-seekers participating in labour market programmes. There are no signs of consumer inflation, which was on average zero for the first three quarters of 1998.

Supportive monetary conditions…

The partial correction in 1996 and 1997 of the earlier sharp appreciation of the real effective Swiss franc exchange rate has supported the recovery since 1997. During 1998, monetary policy remained pragmatic and allowed the monetary base to overshoot its medium-term target growth rate of 1 per cent per annum by a substantial margin. This kept the three-month euro-Swiss franc interest rate below 2 per cent in the first nine months of 1998 and helped stabilise the real effective exchange rate around its average level in 1997. The National Bank has made it clear that it stands ready to increase the money supply even more and bring money market interest rates down further if needed to counter renewed upward pressure on the exchange rate. The projection assumes stable short- and long-term interest rate differentials *vis-à-vis* the euro area at their current levels.

… combined with fiscal consolidation…

The Confederation's finances were budgeted to close with a deficit of SF 7.6 billion (2 per cent of GDP) in 1998 after SF 5.3 billion (1 1/2 per cent of GDP) in 1997, but are now expected to turn out substantially better as a result of cyclically-higher tax revenues and lower expenditures on unemployment benefits. The projections assume that fiscal policy remains on its consolidation path, which aims at a federal budget

deficit of 1 per cent of GDP in 1999 and a further deficit reduction in the year 2000. To this end, the VAT rate will be raised by 1 percentage point to 7.5 per cent at the beginning of 1999 and a fiscal consolidation package, focusing on expenditure cuts, will be introduced by mid-1999.

… favour the continuation of the recovery, the main risk coming from foreign exchange markets

Domestic demand is projected to replace exports as the major engine of growth in 1999-2000. Mildly accelerating growth in private consumption and robust fixed investment are expected to be the main pillars of activity. The effect on activity of slowing growth of machinery and equipment investment in response to less dynamic exports is likely to be offset by the expected recovery of construction investment; the latter will be assisted by the Confederation's fiscal stimulation programme for advanced infrastructure maintenance, which ends in 1999. Export growth is likely to decelerate somewhat due to contracting Asian markets. In all, real GDP growth is projected to stay at around $1^3/_4$ per cent over the 1999-2000 period. Employment is likely to recover further, bringing the rate of unemployment down to around 3 per cent in the year 2000. The large output gap will continue to keep price and wage inflation very low. In the present disinflationary climate, with strong price competition from abroad, the increase in the VAT rate in 1999 will add only little to consumer price inflation. A major uncertainty in the outlook is the possibility of a sharp appreciation of the Swiss franc and the consequent implications for the economy's international competitiveness. Such a situation could arise if, as in several past occasions of financial market turmoil, investors look for "safe haven currencies".

Turkey

Following three years of buoyant economic growth, the Turkish economy slowed markedly in mid-1998, reflecting the impact of the government's stabilisation programme and the crisis in emerging market economies. Slower growth was accompanied by a deceleration in consumer price inflation from the triple-digit rate recorded at the beginning of 1998 to less than 80 per cent by October. The deteriorating external environment and fiscal consolidation are expected to restrain growth to between 4 and 5 per cent through 2000, while allowing a further reduction in inflation.

The government's programme of quarterly targets for expenditure and revenue has produced positive results and should be strictly adhered to during the run-up to elections next year. With less uncertainty about government borrowing, the central bank has implemented a monetary programme conducive to lowering inflation. However, sustained progress in reducing chronic budget deficits will require reform of the deficit-ridden state pension system, together with continued progress in the privatisation and restructuring of state-owned enterprises.

A slowdown in growth in mid-1998 has been accompanied by a deceleration of inflation

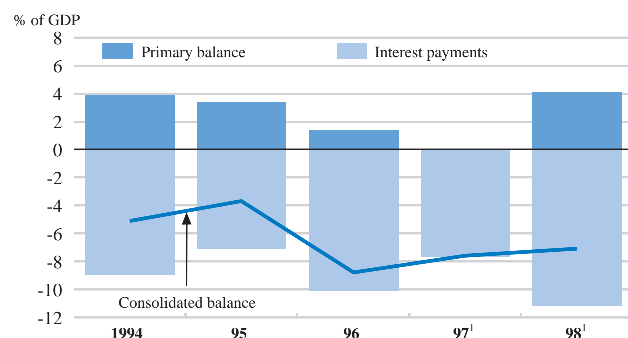
Turkey's strong economic expansion following the 1994 financial crisis faltered in the second quarter of 1998, with real GDP growth slowing to 2.6 per cent (year-on-year). The slowdown was confirmed by a sharp deceleration in industrial output growth to less than 1 per cent (year-on-year) in July and August, while the stock market fell by half in dollar terms during the two months from mid-July. Consumer price inflation, which peaked at more than 100 per cent in January (year-on-year), declined gradually to 77 per cent in October. The current account deficit in the first half of the year remained at around 1½ per cent of GDP, while the Central Bank's foreign reserves reached a record $26.4 billion at the end of June.

The government's programme to reduce the budget deficit…

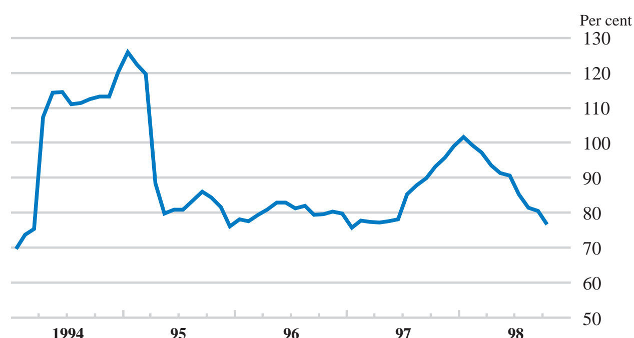
The deceleration in growth may reflect the impact of the stabilisation programme implemented at the beginning of 1998 to reduce the country's chronically high budget deficit. In the first half of the year, revenues were 15 per cent above the quarterly targets, reflecting measures to improve tax collection. With tighter spending discipline, the primary budget balance is projected to rise from balance in 1997 to a surplus of more than 4 per cent of GDP this year. However, because of a bulge in interest payments, the consolidated budget deficit is expected to remain above 7 per cent in 1998. Although the long-stalled privatisation programme finally gained some momentum in 1998 with the sale of an estimated $2.6 billion of state assets, less than half of

Turkey

Budget deficit remains high



Inflation decelerates from high levels[2]



1. Estimates.
2. Year-on-year percentage changes.
Source: State Planning Organisation.

Demand, output and prices

Percentage changes, volume (1987 prices)

	1995 current prices trillion TL	1996	1997	1998	1999	2000
Private consumption	5 458	9.1	8.4	4.9	4.3	5.1
Government consumption	837	7.7	4.1	8.0	7.5	4.0
Gross fixed capital formation	1 850	18.2	15.4	4.4	4.2	7.6
Final domestic demand	8 145	11.4	10.0	5.0	4.5	5.8
* stockbuilding	127[a]	0.1	–0.8	0.2	0.0	0.0
Total domestic demand	8 273	11.4	9.2	5.1	4.5	5.7
Exports of goods and services	1 544	15.0	19.1	9.0	6.0	7.0
Imports of goods and services	1 890	29.6	22.4	9.0	6.8	8.5
* net exports	–346[a]	–4.5	–2.7	–0.9	–0.9	–1.4
* statistical discrepancy	–164[a]	–0.1	0.2	0.0	0.0	0.0
GDP at market prices	7 762	7.2	7.5	4.7	4.0	5.0
GDP deflator	–	78.6	81.5	83.9	47.3	30.0
Memorandum items						
Private consumption deflator	–	74.1	75.1	83.9	47.3	30.0
Industrial production	–	6.8	9.5	4.9	4.5	5.3
Unemployment rate	–	6.0	6.4	6.8	7.0	6.8
Current account balance[b]	–	–1.3	–1.3	–1.8	–1.9	–2.0

* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.
b) As a percentage of GDP.

these receipts will be used to reduce the budget deficit. Nevertheless, given the improvement in budgetary discipline, the Central Bank has felt itself in a position to set money supply growth targets aimed at reducing inflation to 45 per cent by the end of 1999.

… and the adverse impact of the crisis in Russia…

In June, Turkey agreed to an 18-month "Staff-Monitored Programme" with the IMF. Under the agreement, the IMF will monitor the implementation of the stabilisation programme based on targets agreed with the government. In July, however, Turkey allowed public-sector wage increases larger than those called for in the programme. The crisis in Russia has had an adverse impact on Turkey, which had largely escaped the negative consequences of financial turmoil in Southeast Asia. The deterioration in investor sentiment led to a sharp rise in the yield on Treasury bills from 77 per cent in July to 136 per cent in September, while the Central Bank's foreign reserves fell to $21.5 billion. The situation now appears to have stabilised, due in part to recent changes in the tax system aimed at reducing tension in financial markets.

… are projected to keep growth in the 4 to 5 per cent range through 2000, while allowing further progress in slowing inflation

Given the worsening external environment and greater fiscal discipline, output growth is projected to slow to 4¾ per cent this year and 4 per cent in 1999 before picking up to about 5 per cent in 2000. More subdued growth is projected to be accompanied by a further deceleration in inflation, which could fall to about 20 per cent by the end of 2000 if programme commitments are adhered to. The current account is projected to record deficits of around 2 per cent of GDP in the coming two years. In the current environment, though, capital flight remains a constant threat to Turkey despite its strengths, such as the low level of short-term foreign debt and a relatively small amount of problem loans in the banking system. The risk of a financial crisis would be reduced by continued progress in cutting government deficits and implementing key structural reforms – notably in the area of the pension system.

III. DEVELOPMENTS IN SELECTED NON-MEMBER COUNTRIES

The widening of the crisis in emerging markets over the past six months has worsened the economic situation and prospects for the majority of non-member countries. Nearly all the Dynamic Asian Economies (DAE) are now in recession, and growth in China has also slowed compared to the pace of 1997. The instability on Russian financial markets since the fall of 1997 evolved into a full blown financial crisis by mid-1998, which is having reverberation effects throughout that region. In South America, renewed tension over the sustainability of the Real currency regime in Brazil added to the downward pressures on growth deriving from the generally tight policy mix adopted after the start of the Asian crisis last year and the worsening of the terms of trade of the region's commodity exporting countries.

Little if any recovery is expected before the second half of 1999. Recovery in all three regions depends on mutually-reinforcing successes in three areas: visible progress on fundamental macroeconomic and structural reforms; more supportive financial market conditions; and sustained social and political consensus. The particular circumstances of the countries in each region condition the concrete challenges they are now facing in this regard. In Asia, where the crisis is now more than a year old, the key requirement is to lay the basis for recovery by implementing structural reforms needed to facilitate financial restructuring and to rebuild confidence. The authorities in Russia now face enormous challenges to avoid hyperinflation, to rebuild financial markets and banking, and to accelerate vital structural reforms that will determine prospects for stabilisation and growth in the medium term. In South America, where structural reforms have progressed considerably, the focus is on Brazil as it seeks to avoid crisis by rationalising the federal fiscal system and cutting the large fiscal deficit.

Dynamic Asian Economies and China

Economic activity has been weaker than earlier expected

The economic downturns in the Dynamic Asian Economies (DAE) have deepened and become more widespread since the spring of this year. The deterioration has been worst in Thailand and Indonesia, the two countries that first entered the crisis. The situation is particularly severe in Indonesia, where the social and political turmoil of last spring has accentuated and probably prolonged the severe contraction already under way. Despite earlier success in avoiding crisis, Malaysia is now experiencing a sharp output decline. The economy of Hong Kong, China entered recession in the second quarter of this year while growth has come to a virtual halt in the Philippines and Singapore. Only Chinese Taipei is still maintaining robust growth. Domestic demand in these economies has been even weaker than GDP, whose decline has been cushioned by severe import compressions along with substantial increases in export volumes that have not been reflected in their dollar values because of marked declines in prices. The economic downturns in most of the DAE seem to have continued into the second half of 1998, and could extend into 1999 in some cases. Growth in China slowed in the first half of 1998, due to a marked deceleration in exports and a more moderate decline in private consumption growth, partly offset by a pickup in government investment. However, recent data suggest that growth began to pick up in the latter portion of this year in response to the government's fiscal stimulus measures.

Severe import compressions and high real interest rates have aggravated the downturns

Part of the economic worsening in the DAE is attributable to the spill-over effects of the severe import compressions in the crisis countries on the exports of neighbouring economies. These spillovers have been magnified by the dependence of exports on intra-Asian trade; by the relatively high ratios of exports to GDP; and by the knock-on effects on consumer and business confidence produced by the downturns themselves. Economic weakness has been further aggravated by pressures on short-term interest rates, which have been quite high in real terms for much of this year in Hong Kong, China, in the Philippines, and until recently, in Malaysia and Thailand – particularly given their depressed levels of activity. Recurrent surges in currency pressures, most recently in the wake of the Russian crisis, and renewed political tensions in Indonesia and Malaysia, are largely responsible for these high interest rates. While these pressures eased in late summer, they remain a potential constraint on monetary policy in most of the region. In these countries as well as in Indonesia, credit supply constraints stemming from the financial problems of the banking and enterprise sectors are greatly accentuating the deflationary effects of high interest rate levels. Credit conditions in China are also tighter than the low level of nominal interest rates might suggest, given that inflation has become negative and given the severe balance sheet problems of banks and enterprises.

Recovery in Dynamic Asia depends on three factors

The timing and sustainability of a recovery in the DAE will depend on three factors: first, the speed with which external financial conditions stabilise and so allow for real interest rate levels that support economic expansion; second, the pace of restructuring of both banks and enterprises to achieve more sustainable balance sheets and thus allow normal financing mechanisms to begin to operate again; and third, the appropriate use of macroeconomic instruments to rebuild confidence while smoothing the worst of the current hardships faced by the populations in these countries. Situations differ among the DAE with respect to each of these elements.

Moves by a number of countries to limit speculation carry risks

Financial conditions in the region remain unsettled, with new tensions emanating from risks of renewed contagion from developments elsewhere. Continued currency pressures have prompted authorities in a number of DAE to take direct measures to reduce market speculation. In early September the government of Malaysia imposed stringent restrictions on capital outflows (excepting profits and dividends from foreign-owned operations within the country) and pegged the exchange rate against the US dollar as part of a broader strategy to reflate the economy, in part through directed lending to certain large enterprises. The authorities in Hong Kong, China intervened heavily in the stock market in August in an effort to squeeze short positions they felt were being used to speculate against the Hong Kong dollar. More limited measures to curb dealings between domestic financial institutions and certain foreign hedge funds have been taken in Chinese Taipei. The degree to which these moves have achieved their short-term objectives is difficult to determine, while the risks they can pose, both for neighbouring governments as well as those imposing the controls, are already evident. Malaysia's capital controls have had disruptive near-term effects on several financial markets in Singapore. A broader concern is that investor fears of the imposition of further controls will add to risk premia and make regional markets even more vulnerable to shocks. Beyond the near term, whether recovery prospects in Malaysia have been enhanced or set back depends importantly on whether direct investment flows, which have been major contributors to capital formation in manufacturing, are seriously discouraged by the capital controls; and even more importantly on the degree to which the breathing space from external pressures is used to address underlying structural problems.

Extensive financial restructurings are required

Requirements for financial restructuring are very substantial but differ among the countries of the region. In Hong Kong, China, in Singapore, and in the Philippines, the banks were relatively adequately capitalised before the crisis, prudential standards were

Table III.1. Projections for selected Asian economies[a]

	1997	1998	1999	2000
China				
Real GDP growth	8.8	7.6	7.7	7.2
Domestic demand growth	6.7	7.4	8.2	7.3
Inflation	0.8	–2.5	1.0	2.0
Current account balance (US$ bn)	29.7	25.0	16.8	15.4
Current account balance (% of GDP)	3.3	2.6	1.6	1.4
Indonesia				
Real GDP growth	4.7	–15.5	–3.0	3.0
Domestic demand growth	6.0	–28.0	–7.0	4.5
Inflation	11.1	60.0	25.0	10.0
Current account balance (US$ bn)	–5.0	8.6	11.3	8.4
Current account balance (% of GDP)	–2.3	10.1	8.1	5.3
Thailand				
Real GDP growth	–0.4	–7.0	2.0	4.5
Domestic demand growth	–2.5	–20.0	–1.0	5.8
Inflation	6.0	8.5	5.5	5.0
Current account balance (US$ bn)	–3.0	13.5	15.0	13.2
Current account balance (% of GDP)	–1.9	11.5	10.7	8.6
Malaysia				
Real GDP growth	7.8	–4.7	–0.5	3.5
Domestic demand growth	6.4	–15.0	–2.0	3.6
Inflation	2.7	5.3	4.0	4.5
Current account balance (US$ bn)	–4.8	4.6	4.0	4.4
Current account balance (% of GDP)	–4.8	6.4	5.2	5.3
Philippines				
Real GDP growth	5.1	–0.5	2.0	4.5
Domestic demand growth	4.4	–7.5	0.8	5.0
Inflation	5.0	9.5	6.5	4.5
Current account balance (US$ bn)	–3.7	1.8	2.0	1.4
Current account balance (% of GDP)	–4.6	2.8	2.9	1.9
Chinese Taipei				
Real GDP growth	6.8	4.5	4.0	5.5
Domestic demand growth	6.8	5.1	4.0	5.8
Inflation	0.9	1.2	0.0	1.7
Current account balance (US$ bn)	7.8	5.0	3.6	2.5
Current account balance (% of GDP)	2.7	1.9	1.3	0.8
Singapore				
Real GDP growth	7.5	0.0	0.5	3.2
Domestic demand growth	2.0	–8.0	–1.5	2.5
Inflation	2.0	–0.2	0.5	1.5
Current account balance (US$ bn)	14.7	16.0	16.3	16.4
Current account balance (% of GDP)	15.1	18.5	18.1	17.4
Hong Kong, China				
Real GDP Growth	5.2	–4.5	1.5	5.5
Domestic demand growth	7.7	–8.5	0.8	5.0
Inflation	5.9	3.5	3.0	3.5
Current account balance (US$ bn)	–6.6	–1.9	–0.4	0.4
Current account balance (% of GDP)	–3.8	–1.1	–0.2	0.2
Memorandum item: **DAE**[b]				
Current account balance (US$ bn)	–0.6	47.7	51.8	46.7

a) The figures given for GDP and inflation are percentage changes from the previous period. Inflation refers to the Consumer Price Index except in China, where the retail price index is used. Current account estimates for Hong Kong, China correspond to net exports of goods and services on a national accounts basis and therefore exclude investment income and transfers.

b) Dynamic Asian Economies (DAE): Indonesia; Hong Kong, China; Malaysia; the Philippines; Singapore; Chinese Taipei; and Thailand.

Source: Figures for 1997 are preliminary figures from national sources or OECD estimates. Figures for 1998-2000 are OECD projections.

better maintained than in most other countries in the region, and the downturns have been moderate. For these reasons, the credit crunches now evident should ease with lower interest rates and as activity begins to recover. Financial strains experienced by banks and corporations may well damp the initial stages of the recovery, as they did in the United States and several other OECD countries during the early 1990s. However, provided there are no further outside shocks that make them substantially worse, the financial problems are unlikely to prevent a recovery, and any public outlays needed for financial restructuring should remain moderate.

Banking and corporate restructuring in Thailand and Indonesia are especially complex and intertwined

The financial problems are much worse in Indonesia, in Thailand, and to a lesser extent in Malaysia. Most financial institutions in the first two countries are either insolvent or severely depleted of capital and much of the corporate sector is effectively bankrupt. Financial restructuring is much more complex in these cases, will take longer, and will unavoidably involve large-scale government outlays as well as other interventions. In Thailand, immediate steps focused on the closing of insolvent institutions, and the taking over of their bad assets by a government agency. These assets are now being sold, and the authorities expect to complete the sale of assets acquired from the finance companies by the end of this year. The more difficult tasks are to recapitalise the banks while at the same time restoring the financial conditions of corporations to the point that they have access to financing for working capital and can resume their debt-servicing, at least to some extent. Detailed plans for financial restructuring were announced by the government in August and September. These plans involve substantial public outlays to recapitalise the banks but also require much burden sharing from the private sector: the banks will have to write down shareholders' equity before receiving injections of public funds, and seek funds from other domestic sources or foreign institutions. The plans rely heavily on negotiations among the private parties involved to work out problem debts and restructure enterprises, but provide incentives in the form of additional capital injections for banks to reach agreement with their corporate debtors and to extend new loans to businesses that are creditworthy. In these respects, their approach is much more aggressive than the gradualist approach pursued by Japan over the past several years, but falls short of the more radical interventions taken by authorities in several Nordic countries during their banking crises earlier in this decade. Private sector debt negotiations are likely to proceed most rapidly when all parties stand to gain economically from coming to agreement. In the case of Thailand, the hope is that the process will engender a virtuous circle whereby initial successes will allow profits and liquidity to begin to recover and thereby generate the financial resources to catalyse further progress. The risk is that negotiations bog down and stall the restructuring process; in that event, public outlays for restructuring are likely to have to increase and the overall economic recovery could be delayed or at least weakened.

Restructuring in Indonesia is greatly complicated by the huge external debt of the corporate sector

Indonesia has adopted approaches that in many respects parallel those in Thailand: the plans entail somewhat more direct government intervention and public outlays initially but also rely on private sector initiatives. Restoring financial viability to the private sector is, however, rendered enormously more complicated by the huge foreign debt obligations of the private corporate sector. An important first step toward dealing with these obligations was taken with the agreement in June between representatives of foreign creditors and of Indonesian corporations on a framework for dealing with the debts similar to the *Ficorca* plan applied in Mexico during the early 1980s. This framework provides important incentives, in particular a hedge against further exchange rate depreciation, for corporate debtors and their foreign creditors to agree on rescheduling terms. However, implementation involves numerous bilateral negotiations that are likely to stretch out over a number of years.

Other structural reforms are being taken to facilitate financial restructuring...

Governments are undertaking reforms in three other areas to facilitate financial restructuring. First, major reforms to bankruptcy and foreclosure laws, whose lack of clarity and cumbersome enforcement have been an important source of business uncertainty in a number of countries in the region, have been introduced in Indonesia and Thailand. Second, authorities in the two countries have tightened prudential standards governing loan classification, provisioning, and capital standards, in part to help provide accurate information on financial conditions that will be needed during the restructuring process. The authorities in Malaysia instituted extensive reforms of their prudential regulations earlier in 1998, although tighter standards for loan provisions announced at that time were partially relaxed in September as part of the effort to boost credit expansion. Third, the authorities in Thailand and Indonesia are attempting to attract additional foreign capital into their banking systems by relaxing restrictions on the permissible level of foreign ownership.

... while there is room for supportive macroeconomic policies

Macroeconomic policies also have an important role to play in supporting economic recovery. In this regard, the Asian countries do have some room for manoeuvre. The authorities have been largely successful in containing the inflation pressures arising from their currency depreciations. There has been little or no increase in inflation in Singapore or Chinese Taipei and only moderate increases in Malaysia, Thailand, and the Philippines. Moreover, inflation pressures have begun to recede throughout the DAE region. These successes – provided they are maintained – should allow room for monetary stimulus once currency pressures abate. On the fiscal side, government debt levels are moderate as a share of GDP. Government budget deficits, although they have increased considerably as a result of the weakening in activity, otherwise remain in reasonably favourable shape. The authorities thus have some scope for fiscal measures needed to cushion the effects of the downturn on the most severely affected segments of their populations and to facilitate recovery, though the simultaneous need to spend large amounts for financial restructuring does set limits on discretionary easing.

China faces a major challenge in pursuing necessary reforms while maintaining growth in the near term

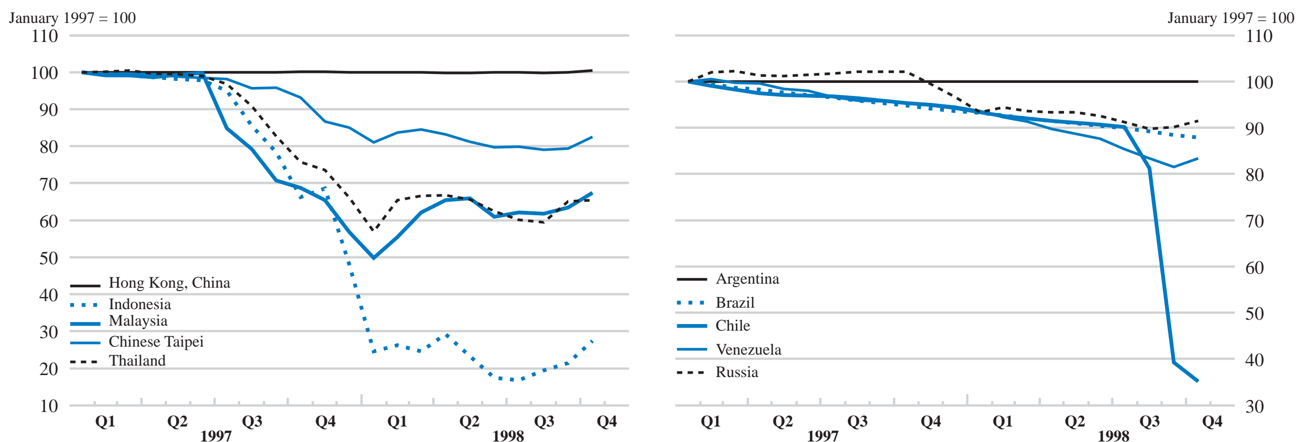
The authorities in China are also facing the difficult challenge of undertaking essential structural reforms in the face of slowing domestic demand and the external drag from the economic downturns in other Asian countries. The structural problems of China's economy, especially the weak financial system and the loss-making state enterprise sector, have led to a gradual slowdown in growth over the past two years and are further threatening medium-to-longer-term growth prospects. With inflation now virtually eliminated, the authorities have moved to ease monetary policy by lowering interest rates and increasing banks' liquidity. However, the impact of this stimulus has been substantially blunted as banks – burdened with non-performing loans and pressed by supervisory authorities to apply sound commercial standards to their activities – have become increasingly reluctant to lend in 1998. Consumption spending has been lagging because urban households have become very cautious in the light of massive layoffs from state enterprises and the phasing out of cradle-to-grave socialist welfare for state workers. Structural reforms to address these problems were at the heart of the ambitious reform programme announced early this year by the government. The programme included financial reforms: to recapitalise the banks; to write off their bad debts to the state-owned enterprises; and to tighten prudential and supervisory standards. Another key element was a three-year programme for restructuring the state enterprises by encouraging mergers and acquisitions, developing shareholding, and relieving enterprises of their social welfare responsibilities such as housing, health care and pensions.

Reforms have been slowed

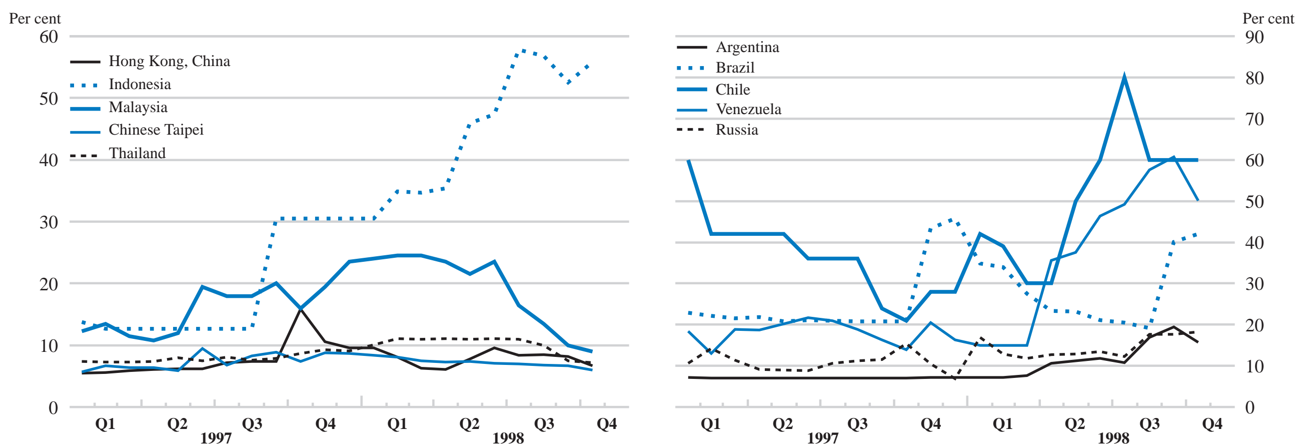
To sustain the consensus needed for reforms in the face of the near-term dislocations they entail, real growth needs to remain strong enough to prevent unemployment from

Figure III.1 Financial market reactions in selected non-OECD countries

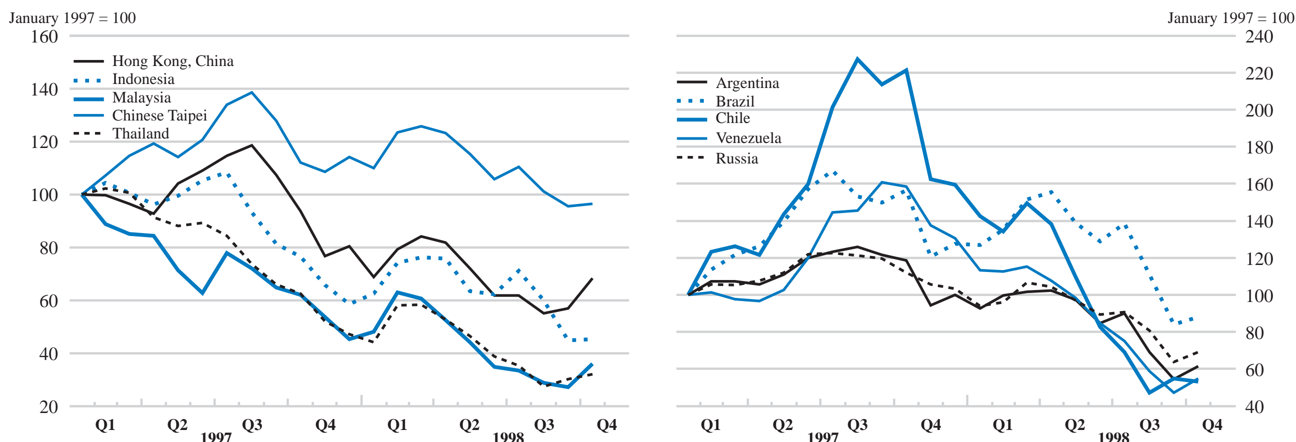
Currencies have fallen sharply since 1997



Short-term interest rates have remained high for most of the year...



... and equity markets continue to be depressed



Notes: Exchange rates are indexes of the dollar value of the foreign currency; short-term interest rates are representative 3-month money market rates; equity prices are standardly quoted indexes from the country stock exchange. Monthly data.
Sources: *The Economist* and Bloomberg.

rising substantially. However, despite the easing of monetary and fiscal policies adopted during the first half of this year, growth in China has slowed more than expected, prompting the government to postpone some of the reforms as it attempts to bolster the economy through further fiscal stimulus. The authorities have accelerated the massive public investment spending package announced early this year and have announced plans to help finance the package by issuing 100 billion yuan (US$12 billion) in government bonds along with additional lending by the four largest state banks of an equivalent amount; the banks have also been urged to increase their lending to enterprises. The planned infrastructure spending through large public works projects is intended to relieve some of the unemployment pressures in the provinces where the problem is more pronounced. At the same time, the government has postponed the privatisation of small and medium-sized enterprises as well as housing reforms aimed at encouraging home ownership and at ending rent subsidies by state-owned enterprises (SOEs) to their employees. So far the Chinese authorities have resisted the pressure to devalue the currency; instead, tax and other benefits have been given to exporting firms to compensate for lost competitiveness. The government has also taken measures to tighten regulations governing capital outflows in response to signs that unauthorised outflows are on the rise.

However, there are risks which could exacerbate the more fundamental problems

The current temporary pause in the reform process reflects the authorities' concerns that mounting unemployment pressures and other dislocations could become a serious problem, particularly given the uneven geographical distribution of income and employment opportunities. However, there are risks that substituting fiscal stimulus for reforms, even in the near term, could exacerbate the more fundamental problems. The prudent scope for aggregate fiscal stimulus is limited by the already large general government deficit, the large outlays that will be needed for financial sector and enterprise reforms, and by the eventual need to take back on-budget the social programmes that enterprises are now burdened with. While China's infrastructure needs will require massive expenditures over the longer term, the experience of other countries indicates that accelerating such spending in the near term can result in inefficient projects that simply waste scarce resources. Moreover, increasing credit to inefficient state enterprises risks adding to their already serious problems of over-capacity, excess inventories, and non-performing loans; and could divert resources away from more dynamic sectors of the economy.

Restoring the financial viability of banks and enterprises is also needed

Restoring the financial viability of the banking system and enterprises will also be important to bolster international confidence in China's economic prospects and to promote its further integration into the world economy. China will continue to need stable inflows of foreign capital, to bolster domestic capital formation and to provide essential technology and other expertise in its transition to a market economy. While China has weathered the regional crisis quite well, the financial crisis of other Asian countries which shared similar structural problems with China has raised concerns that its current strains could develop into something considerably worse. Moreover, banking and enterprise reforms are essential if other key reforms, notably trade liberalisation, the reduction of the now considerable economic barriers among its regions, and reform of social welfare programmes are to proceed at acceptable social cost.

Russia and Central and Eastern Europe

Russia is experiencing a major economic crisis

The instability on Russian financial markets since the fall of 1997 evolved into a full-blown financial crisis by mid-1998. The approval of an international aid package in July 1998, worth more than US$22 billion, proved insufficient to restore investor confidence or bring interest rates down to levels consistent with the realisation of Russia's emergency fiscal consolidation programme. After repeated struggles to defend the rouble and manage government debt, the Russian government and central bank finally succumbed to mounting pressure and rapidly-declining foreign reserves on 17 August. A series of emergency measures allowed for the depreciation of the rouble, effective default on domestic government debt, an imposed 90-day moratorium on the servicing of foreign credit by private (financial and non-financial) Russian institutions, and the elimination of foreign investment in Russian short-term assets. Russia has since entered a period of very high political and economic uncertainty and instability. A new government and central bank management took power in September 1998, facing continued pressure on the currency, a revival of inflation, a collapse in financial markets, a severely distressed commercial banking system, and significant demands for foreign debt service.

Output was flat in the first half of 1998, but has subsequently turned downward

Before the Russian government changed policy course in mid-August, the real economy had been somewhat insulated from the financial crisis. This reflects a rather low dependency of most Russian firms on financial markets. Growth in GDP and industrial output were virtually flat for the first half of 1998 relative to the same period in 1997, while retail trade increased by an estimated 3.1 per cent. But GDP for the first nine months of 1998 was already an estimated 3 per cent lower than the corresponding period in 1997. A fall in consumer expenditure, a disruption of the payment system, low liquidity, and the overall chaotic environment contributed to the output decline.

Russia's current account weakened in the first half of 1998

Further declines in oil and other key export prices weakened Russia's current account beyond expectations. According to preliminary figures, the first half of the year witnessed a slight trade deficit of US$339 million (relative to a US$7.5 billion surplus in the first half of 1997) and a current account deficit of US$6 billion (as opposed to a surplus of US$3.9 billion a year before). During this period, the dollar value of exports declined by an estimated 14 per cent relative to the same period in 1997, almost entirely due to price declines, while imports increased by 7 per cent. The deterioration of the current account, together with a widening budget deficit and short-term debt spiral, set the stage for the financial turmoil of the second half of the year.

Price and exchange rate movements have become very uncertain

Price and exchange rate movements have become very uncertain since the announcement of the emergency measures in mid-August. The rouble had lost more than half of its value by mid-September. While monthly inflation averaged 0.6 per cent for the first seven months of the year, it accelerated to almost 40 per cent in September. Many regions have reportedly responded with price controls, while the central bank has taken measures to limit trading on the interbank currency market that is used to set the official exchange rate.

Restructuring the banking sector poses a major challenge

Russia now faces a major banking crisis. While many small and medium-sized Russian banks have been experiencing distress since 1995, the situation in the larger Moscow banks began to deteriorate seriously only in the last quarter of 1997. The primary cause of this deterioration was a sharp decline in the value of government and corporate securities, a major source of investments and profits for many banks.

Table III.2. **Projections for European Economies in transition**[a]

	1997	1998	1999	2000
Bulgaria				
Real GDP growth	–6.9	4.0	2.0	2.0
Inflation	579.0	8.0	8.0	8.0
Unemployment	13.7	13.0	12.0	12.0
Fiscal balance (% of GDP)	–2.8	1.0	0.0	0.0
Current account balance (US$ bn)	0.5	–0.4	–0.5	–0.5
Current account balance (% of GDP)	4.3	–3.5	–4.5	–4.4
Romania				
Real GDP growth	–6.5	–4.0	0.0	2.0
Inflation	151.0	40.0	30.0	25.0
Unemployment	9.0	10.0	10.0	10.0
Fiscal balance (% of GDP)[b]	–3.5	–5.0	–4.0	–3.0
Current account balance (US$ bn)	–2.5	–2.0	–2.0	–2.0
Current account balance (% of GDP)	–7.0	–7.0	–5.0	–4.0
Russia				
Real GDP growth	0.8	–6.0	–6.0	1.0
Inflation	11.0	70.0	150.0	80.0
Unemployment	11.3	12.0	12.5	12.5
Fiscal balance (% of GDP)	–8.4	–4.0	–3.0	–2.0
Current account balance (US$ bn)	2.9	0.0	9.0	13.0
Current account balance (% of GDP)	0.6	0.0	2.2	3.1
Slovak Republic				
Real GDP growth	6.5	5.0	3.0	4.0
Inflation	6.4	7.0	8.0	7.0
Unemployment	11.5	11.0	12.0	12.0
Fiscal balance (% of GDP)	–4.1	–4.0	–3.0	–2.0
Current account balance (US$ bn)	–1.4	–1.8	–1.5	–1.2
Current account balance (% of GDP)	–7.0	–10.0	–8.0	–6.0
Slovenia				
Real GDP growth	3.8	4.0	4.0	4.0
Inflation	9.4	8.0	7.0	6.5
Unemployment	7.1	7.0	7.0	7.0
Fiscal balance (% of GDP)	–1.1	–1.0	–1.0	–1.0
Current account balance (US$ bn)	0.0	–0.1	–0.2	–0.2
Current account balance (% of GDP)	0.0	0.0	0.0	0.0

a) The figures given for GDP and inflation are percentage changes from the previous period. Unemployment definitions may differ significantly across countries; where available, survey-based estimates (by ILO definition) are used.

b) Budget deficit on an accrual basis and including quasi-fiscal refinancing from the Central Bank.

Source: Figures for 1997 are preliminary figures from national sources or OECD estimates. Figures for 1998-2000 are OECD projections.

Regrettably, the current banking crisis follows a period of impressive progress in the regulation of commercial banks, during which time the majority of larger banks pursued cautious credit policies that helped to bring the volume of non-performing loans under control. The design of an effective comprehensive programme for the reconstruction of the banking sector presents a fundamental policy challenge for the Russian government.

The current account should strengthen, while output will fall

An immediate effect of the crisis and weaker rouble should be a strong contraction in imports, many of which are concentrated in food products and other consumer goods. Import growth is likely to be strongly negative in the second half of 1998, possibly bringing the current account back close to balance by the end of the year. A strong supply response from a weaker rouble in a number of export-oriented or import-substituting industries is possible in the medium term. This response could be weakened, however, by a generally high degree of uncertainty, increased taxes and controls, higher

prices on imported intermediate goods, and a severe shortage of liquidity. The overall disruptive effects of the current crisis, combined with weakened domestic demand, are expected to lead to a further decline in GDP in the fourth quarter of 1998.

Prospects for stabilisation in the medium term depend on current policy choices

The outlook in Russia is highly uncertain at the present time. While the potential for instability in the short-term remains high, prospects for 1999 and the medium-term will depend strongly on policy choices made by the new government. Most important will be the degree to which incomes of the population and distressed commercial banks are supported by a monetary expansion. In the current Russian context, such an expansion could very likely produce a hyperinflationary spiral. If price controls and administrative planning were to be introduced on a large scale to deal with such a situation, Russia could stand to lose the years of progress towards market reform and institutional development in the 1990s. On the other hand, if responsible financial policies are put in place, the significant strengthening of the current account, combined with new prospects for fiscal consolidation due to lower domestic debt service, could provide the foundation for achieving some degree of stability in 1999.

The direct impact of the Russian crisis on non-members in the region has been limited...

Following the crisis in Russia, financial market volatility increased in many of the countries of the region, but the real effects of the crisis have so far been limited. In Central and Eastern Europe, a major shift in market orientation accomplished during the transition period appears to have largely sheltered these economies from the turmoil in Russia, with the exception of the Baltic countries and especially the Commonwealth of Independent States (CIS). Indeed, Ukraine has been under particularly strong pressure, and has also taken measures to devalue its currency. The Russian economic crisis is also being felt in the Baltic countries, which face large trade exposure to the CIS and in particular to Russia, which absorbs from 20 to 25 per cent of their exports. From the point of view of continued recovery, the key influence would nevertheless be developments in Western Europe, particularly Germany. Overall, the sharp differences

Table III.3. **Developments in the Baltic states**[a]

	1997	1998
Estonia		
Real GDP growth	11.4	6.0
Inflation	12.5	11.0
Unemployment	4.6	5.0
Fiscal balance (% of GDP)	2.0	2.5
Current account balance (US$ bn)	–0.6	–0.6
Current account balance (% of GDP)	–12.0	–11.0
Latvia		
Real GDP growth	6.5	5.0
Inflation	7.0	6.0
Unemployment	7.0	7.0
Fiscal balance (% of GDP)	1.2	0.0
Current account balance (US$ bn)	–0.3	–0.3
Current account balance (% of GDP)	6.3	–7.0
Lithuania		
Real GDP growth	5.7	4.0
Inflation	8.4	6.0
Unemployment	6.7	7.0
Fiscal balance (% of GDP)	–1.8	–1.6
Current account balance (US$ bn)	–1.0	–1.0
Current account balance (% of GDP)	–10.0	–10.0

a) The figures given for GDP and inflation are percentage changes from the previous period. Unemployment definitions may differ significantly across countries; where available, survey-based estimates (by ILO definition) are used.
Source: Preliminary figures from national sources or OECD estimates and projections.

in transition experiences have, if anything, increased recently. While in Romania output has contracted further since last year, GDP growth has continued in Slovakia and Slovenia. The currency board arrangement and the macroeconomic situation remain stable in Bulgaria, although the recovery of the real economy has been sluggish.

... but countries with large external imbalances may face increasing difficulties in attracting finance

The prospects for Romania are very uncertain, but probably weak, particularly given that progress in macroeconomic stabilisation is hampered by continued delays in restructuring programmes. The sustainability of growth in the other countries is also not assured. A particularly worrisome development is the accumulation of current account deficits at typically unsustainable levels in Slovakia and the Baltics (at 10 per cent of GDP and higher). This and related pressures led the Slovak central bank to float the currency in early October. A major source of uncertainty in the outlook is whether these countries will be able to adopt progressive adjustment strategies or whether the present situation in international financial markets will imply sharper constraints on these economies. In the presence of such external imbalances, a further tightening of the fiscal position would be warranted in some cases (*e.g.* Slovakia). Balance of payment constraints and difficulties in attracting foreign capital are expected to keep economic recovery in Bulgaria very modest. In general, inflation has continued to come down. There has been a sharp decline in inflation in Romania, though from very high levels following the adjustment shock of 1997. In most cases, Latvia being an exception, the banking sectors do not appear to be heavily exposed to developments in Russia. Nevertheless, banks could face indirect exposures through dealings with companies that trade with Russia. Moreover, problems of bad debts and undercapitalisation of banks are still present in Romania and Slovakia. Unemployment has generally been stable and little change is projected.

The biggest risk to growth prospects in the transition countries would be a slowdown of EU growth

In considering the risks to the projections for this group of transition countries, there are three specific concerns which could lead to significantly worse outcomes. First, these countries are, for many products, still the marginal suppliers to Western markets, so that even a mild slowdown in growth in European Union (EU) imports would hit them particularly hard. Second, the banking sectors are fragile, and not well placed to cope with a further increase in financial distress arising from a sharp downturn in activity. Third, the abrupt change in exchange rates that could be forced on these countries in the event of a major loss in confidence could pose severe problems for the inflation outlook and external debt exposure.

South America

The Asian crisis started to bite in the first half of 1998

One year after the start of the Asian financial crisis, its direct and indirect impacts on South America have become much clearer. The "flight to quality" hitting all emerging markets has led to an overall increase in risk premia and interest rates, and the change in investor sentiment has been accompanied by growing volatility. Terms of trade have been negatively affected by the crisis, with demand for some leading export commodities – notably oil, copper, fishmeal, and tropical beverages – weakening substantially and DAE cutting prices on export markets. The changed international environment has taken its toll on real activity. In all major countries, estimates of first-half growth are lower than for the corresponding period in 1997, with construction activities, cement production, and purchases of credit-sensitive consumer durables – automobiles in particular – leading the slowdown. The *El Niño* has also had a significant impact on economic growth, especially in Peru.

International developments dominate the short-term outlook

Short-term economic prospects in the region hinge crucially on the restoration of confidence on world financial markets. In the first part of the year, investors seemed reluctant to decouple South America from other emerging markets. While capital flows to the region have been more resilient than commonly thought late last year, investors have demanded much higher risk premia. Current account deficits have remained considerable, with financing largely covered by foreign direct investment. Most South American governments reacted swiftly to changed external circumstances, confirming their newly-found policy credibility and continuing structural reforms. Up to the summer, the build-up of international reserves generally continued and credit ratings were maintained. Chile, Colombia and Ecuador decided to widen their currencies' fluctuation bands, but so far no country has had to abandon its exchange rate regime. While monetary policy was generally used at an early stage, the situation has deteriorated more recently and the burden of adjustment is increasingly falling on fiscal policy.

In Brazil, fiscal problems posed considerable risks...

As in the fall of 1997, investors' worries centre on Brazil, although the nature of risks has changed. While last year most concerns focused on the sustainability of the current account deficit, the deterioration of the fiscal situation has since posed the highest risks. Incompletely implemented, the November 1997 emergency package failed to generate the anticipated fiscal adjustment, and the deficit in the first half of 1998 reached 7.3 per cent of GDP. An increase of interest payments was not offset by a larger primary budget surplus, as the growth of tax revenues lost steam and federal and state spending rose in the run-up to the election. Beside growing in stock terms, the composition of net public sector debt has also changed, with an increasing reliance on floating-rate bills and dollar-linked paper. Some progress has been made with structural reforms, notably on the privatisation front with the July 1998 Telebrás (telecom) sell-off fetching prices well above the minimum. However, the impact of structural reforms on the fiscal outcome will only become significant early next century.

... which have been managed up to now...

Against the background of its unsustainable policy mix, investors' confidence in Brazil deteriorated sharply in August following the Russian debt moratorium. The monetary tightening in early September and the simultaneous announcement of supplementary fiscal measures succeeded only marginally in slowing the decline in foreign currency reserves. Investors' worries centred on the unusually high stock of short-term paper being rolled over in the few weeks before the elections. Nonetheless, the situation did not deteriorate further as the government and international financial institutions succeeded in highlighting the differences between Brazil and other countries in crisis. The level of official reserves, while shrinking, is still sizeable; moreover, despite slower growth and tougher lending conditions, the performance of the country's largest banks has improved since 1994 and the sector's financial soundness appears in line with international requirements.

... and a significant fiscal package was announced in October

Following the October elections, which saw the confirmation of President Cardoso, a fiscal plan was announced (see box) and the government started to negotiate a financial package with the International Monetary Fund (IMF). The fiscal plan aims at sharply improving the public sector primary balance, and hence reinforcing the credibility of the current economic policy regime and allowing a substantial reduction in interest rates. With interest rates very high in real terms, consumption and investment have shown erratic behaviour, and a contraction is projected to occur in the next few months, possibly extending well into 1999. The fiscal adjustment will also hit demand.

Electoral uncertainties emerge in other countries

Political considerations loom large in most other countries where presidential elections are due in the next 18 months. In Venezuela, in particular, the uncertainty surrounding the results of the December 1998 polls is impeding a tighter rein on public

Table III.4. Projections for selected South American countries[a]

	1997	1998	1999	2000
Argentina				
Real GDP growth	8.6	4.0	1.5	3.0
Inflation	0.5	1.0	1.0	1.0
Fiscal balance (% of GDP)	–1.4	–1.2	–1.3	–1.0
Current account balance (US$ bn)	–9.5	–13.6	–8.0	–8.0
Current account balance (% of GDP)	–3.0	–4.0	–2.0	–2.0
Brazil				
Real GDP growth	3.7	0.8	–1.5	1.0
Inflation	6.1	3.8	4.0	3.0
Fiscal balance (% of GDP)	–6.1	–7.5	–3.5	–2.0
Current account balance (US$ bn)	–33.8	–30.8	–20.0	–17.5
Current account balance (% of GDP)	–4.2	–4.0	–2.5	–2.0
Chile				
Real GDP growth	7.1	5.0	2.0	4.0
Inflation	6.2	5.0	4.3	4.0
Fiscal balance[b] (% of GDP)	1.0	1.5	1.5	1.0
Current account balance (US$ bn)	–4.1	–5.2	–4.0	–3.5
Current account balance (% of GDP)	–5.3	–6.8	–5.0	–4.0
Colombia				
Real GDP growth	3.1	2.5	1.5	3.0
Inflation	18.5	19.0	18.0	13.0
Fiscal balance[c] (% of GDP)	–4.5	–5.0	–3.5	–3.0
Current account balance (US$ bn)	–5.7	–5.9	–4.0	–2.5
Current account balance (% of GDP)	–5.9	–6.0	–4.0	–2.5
Peru				
Real GDP growth	7.2	2.5	4.0	5.0
Inflation	8.5	7.3	5.0	4.0
Fiscal balance (% of GDP)	–0.2	–1.0	–2.2	–2.0
Current account balance (US$ bn)	–3.4	–4.0	–3.3	–3.0
Current account balance (% of GDP)	–5.2	–6.0	–4.5	–4.0
Venezuela				
Real GDP growth	5.1	–1.0	–1.0	3.0
Inflation	53.6	36.5	30.0	25.0
Fiscal balance[d] (% of GDP)	0.2	–2.5	–2.0	–1.0
Current account balance (US$ bn)	5.9	–0.9	–1.0	0.0
Current account balance (% of GDP)	6.9	–1.0	–1.0	0.0

a) The figures given for GDP and inflation are percentage changes from previous year. The Brazilian inflation figure refers to the INPC-IBGE index.
b) Overall balance adjusted for the operation of the Copper Stabilisation Fund.
c) Central government balance excludes transfers from the oil and coffee sectors.
d) Overall balance includes assistance to banks and transfers to central government from the oil sector.
Source: Figures for 1997 are preliminary figures from national sources or OECD estimates. Figures for 1998-2000 are OECD projections.

spending and a more aggressive implementation of privatisation plans required by falling oil prices. The currency came under repeated stress in the summer, prompting the central bank to raise money rates significantly. In Chile, as in Colombia, the economy is still reacting to the 1997 monetary tightening: while obviously deleterious in the near term for growth and employment, such developments may assist disinflation and prevent cyclically-adjusted external imbalances from widening further. Here the parallel ends, since the mid-1998 Chilean fiscal adjustment still has no equivalent in Colombia, although the newly-appointed administration has expressed determination to act soon. Argentina also presented supplementary fiscal measures aimed at highlighting the differences between the country's record of structural adjustment and the situation in other emerging markets.

Box III.1.

Brazil's Programme for Fiscal Stability

The Programme for Fiscal Stability announced by the Brazilian government on 28 October 1998 aims at stabilising the debt/GDP ratio by 2000. In 1999, the Programme foresees an adjustment of R$ 28 billion (US$23.5 billion), more or less evenly split between spending cuts, structural measures and tax hikes.

	1999	2000	2001
		Billion R$	
Cuts in government discretionary spending	8.7	8.8	9.0
Structural reform (government salary cuts, etc.)	3.5	9.2	12.6
Social security system reform (pensions)	2.6	4.3	4.4
Tax increases	13.3	11.4	12.0
Total	28.0	34.0	38.0
Total (in per cent of 1998 GDP)	*2.9*	*3.5*	*4.5*

Spending cuts are equivalent to around 20 per cent of the discretionary federal budget, net of pre-committed spending. Regarding *revenue measures*, the government is proposing an increase in the CPMF (financial transactions tax) to 0.38 per cent (and then to reduce it to 0.3 per cent in 2000), up from 0.2 per cent. Pension contributions paid by companies (Cofins) are to be raised from 2 to 3 per cent of revenue. Further, banks and financial institutions, which are now exempted, will also be required to pay Cofins. Retired civil servants are also required to pay the minimum 11 per cent pension contribution currently levied on working civil servants. Additionally, civil servants earning over R$ 1 200 per month will be charged an additional 9 per cent of salary for 5 years. The government is going to propose that the *Fiscal Stabilisation Fund* (FEF) be extended to 2006. Any increase in the FEF will be proposed as a cut in expenditures since it is a withholding of transfers to the state governments.

The most likely scenario is low-growth till 2000, with both domestic and external imbalances progressively adjusting

At this stage, projecting near-term economic developments in South America amounts to a large extent to weighing the probability of two different policy scenarios. The preferred scenario is that of a 1998-99 transition period, with growth low in Argentina and the Andean countries and negative in Brazil and Venezuela, followed by a recovery that gains momentum thereafter. This scenario requires the realisation of a number of important assumptions: the stabilisation package announced in Brazil proves credible; the administration achieves passage of constitutional reforms aimed at reducing fiscal imbalances, and it effectively implements fiscal retrenchment; and a contingency fund is made available to Brazil, and possibly to Argentina, on a scale sufficient to meet markets' expectations. The discussions between the IMF and Brazil on a financial package have been concluded and an agreement reached. In this picture, the risks of a disordered exchange rate adjustment are receding, especially if falling interest rates reduce the fiscal cost of domestic debt and larger productivity gains broaden the basis for the foreseen acceleration of growth in the new century. On the other hand, the downside risk is that of a major crisis in Brazil. If the Real Plan were to be abandoned in a disordered fashion, inducing an immediate burst of inflation, the risk of a severe contraction of real economic activity would be very serious indeed. Other countries, Argentina in particular, would also greatly suffer, as the financial system would work as a transmission belt for any shock from Brazil.

IV. CHALLENGES FOR MONETARY AND FISCAL POLICIES IN THE EURO AREA

Economic and monetary union has been thoroughly prepared

With the Treaty on European Union, signed in 1992, the Union set for itself the objective of establishing the European Economic and Monetary Union (EMU), ultimately including a single currency. Sustained convergence in economic performance and close co-ordination of Member States' economic objectives, set out in a timetable, were key elements of this process. Convergence towards low rates of inflation and a sound fiscal position were the two most important criteria to be fulfilled before countries could join monetary union. By mid-1998, eleven out of the fifteen member countries had qualified and agreed to participate from the outset in the project. At the Community level, policy co-ordination has been strengthened over the past five years with the annual "broad economic policy guidelines" and the "excessive deficit procedure", while the European Monetary Institute laid the groundwork for the start of the European System of Central Banks (ESCB).

Concerning macroeconomic conditions, monetary union will begin under reasonably favourable conditions: unemployment rates are falling, inflation is at a 40-year low and public finances in most countries have improved substantially in recent years. Furthermore, the European Central Bank (ECB) is to be independent, with price stability as its primary objective, and governments have pledged to continue the process aimed at achieving fiscal balance.

EMU raises new policy issues

Inevitably there will be uncharted water ahead, despite all the preparatory efforts. Unlike fully-fledged federations, virtually all fiscal competencies are to remain at the national level, but the European Central Bank will set monetary policy for the area as a whole. This raises familiar issues in a new context; in particular, how to safeguard monetary policy credibility and to ensure fiscal prudence. But new issues are also raised; for example, the need for stronger policy co-ordination at the euro-area level which is still characterised by a fair amount of structural diversity despite the closer integration achieved over the last forty years. While there are important unsolved structural issues raised by monetary union,[1] this chapter focuses on the macroeconomic ones which will face the euro area in the years ahead.

The first part of this chapter focuses on the fact that the ESCB will be charged with setting and implementing monetary policy for eleven sovereign countries. Furthermore, the new institution and, to a lesser extent, the euro-area economy will not be well-known entities with their own historical experiences. A number of policy issues that arise from these features and which relate to: the operational structure; the objectives and strategies for implementing policy; some of the challenges that will be faced early on in the mandate; and how decisions should be communicated to the public, defined as both the citizens of the area as well as financial markets in general.

1. The Community has launched several initiatives to raise flexibility in labour and product markets. Greater flexibility would make it easier to absorb adverse national economic disturbances.

The second part deals with a number of important fiscal policy issues. While countries have agreed to respect certain constraints on their budgetary behaviour in order to safeguard fiscal sustainability and monetary policy credibility, subsidiarity – a presumption in favour of national sovereignty – remains the guiding principle in matters of fiscal policy. Athough many important decisions have already been made, questions remain about the implementation of fiscal policies within the new framework. These include the required degree of further fiscal consolidation; and the appropriate degree of centralisation, harmonization or co-ordination of national policies.

Monetary policy issues in the euro area

Operational structure[2]

The current institutional framework gives the ESCB a high degree of independence

The Maastricht Treaty assures that the ESCB will enjoy a very high degree of formal independence (Article 7 of the ESCB Statute) and enshrines as its primary objective the maintenance of price stability (not defined in a precise manner). The definition and pursuit of intermediate targets is left to the decision-making bodies of the European Central Bank (ECB). Instrument independence is supported by the attribution of control over key interest rates, reserve ratios and central bank money.

Policy decisions of the new bank will be implemented by the NCBs

With the start of the third stage of EMU on 1 January 1999, the conduct of the common monetary policy will be transferred to the ESCB, consisting of the ECB and the national central banks (NCBs) of the EU member states.[3] The ESCB will be governed by the decision-making bodies of the ECB (see Box IV.1). Implementation of the single monetary policy will be carried out by the NCBs. Each participating central bank will have two main tasks: *a)* to contribute, through its representative Governor, to the policy decisions of the Governing Council of the ECB; and *b)* to execute these decisions within the borders of its own country. Concerning the latter, it will be necessary to reconcile the requirement of a common monetary policy with the "subsidiarity" principle[4] which aims at achieving the highest possible degree of decentralisation at an operational level. The implementation of decentralised money market operations, conducted simultaneously at several financial centres in the euro area, as well as differences in the types of eligible counter-parties and collateral, will present challenges, in part due to the process of structural change that is likely to be occurring in various national financial markets. The Treaty gives responsibility for the conduct of foreign exchange operations to the ECB and allows for either centralised or decentralised implementation.

2. The new institutional framework is described in the Treaty of Maastricht and in the Protocol annexed to the Treaty on the Statute of the European System of Central Banks and of the European Central Bank.
3. The NCBs of the Member States which will not be participating in the third stage from 1999 are members of the ESCB with a special status: while they will conduct their respective national monetary policies, they will not take part in the decision-making process concerning euro area monetary policy and in the implementation of such decisions.
4. Article 12 of the Statute: "To the extent deemed possible and appropriate... the ECB shall have recourse to the national central banks to carry out operations which form part of the tasks of the ESCB". This is the *subsidiarity* principle. The NCBs may also perform other functions (*e.g.* those related to prudential supervision of credit institutions and the stability of the financial system) on their own account, unless the Governing Council rules that such activities interfere with the objectives and tasks of the ECB.

Box IV.1.

The decision-making structure of the ESCB

All the activities of the ESCB will be governed by the two principal decision-making bodies of the ECB. The *Governing Council* will be charged with the formulation of the single monetary policy and for setting the guidelines for its implementation; its responsibilities include decisions relating to intermediate monetary objectives, key interest rates and the supply of reserves in the ESCB. Each member of the Governing Council has one vote and monetary policy decisions require only a simple majority. The Governing Council is composed of 11 governors of the NCBs, which fully participate in EMU, and the six members of the Executive Board. The *Executive Board,* in turn, is composed of the President, the Vice-President and four other members and will be mainly responsible for the implementation of monetary policy. In this role it will provide instructions to the 11 NCBs.

There is as well a third body, the *General Council,* consisting of the President and Vice-President of the ECB and the governors of all EU national central banks which will mainly act in an advisory role. The General Council will also contribute to: the collection of statistical information; the reporting activities of the ECB; the establishment of rules for standardising the accounting operations undertaken by the NCBs; as well as to the preparations for irrevocably fixing the exchange rates of the currencies of the Member States with a derogation.

Prudential supervision is left to national authorities

The ECB is not entrusted with any general responsibility related to prudential supervision of credit institutions and the stability of the financial system which lies with the competent national authorities (including, in most European countries, the NCBs). No explicit reference is made in the Treaty to the role of the ESCB as a lender of last resort. It is to have, however, responsibility for promoting the smooth operation of payment systems (Treaty, Article 105(2)), including the provision of financing facilities to credit institutions. In this respect there is a potential for the ECB to act in the capacity as a lender of last resort as far as the provision of short-term liquidity is concerned. For interventions going beyond the provision of short-term liquidity, other competent national institutions are responsible.

There will be a need for increased collaboration among supervisors in the euro area

National central banks are likely to play an important role in European banking supervision. Although recently there has been a trend towards a separation of regulatory and monetary policy responsibilities, it is always the case that at least a working relationship exists between bank supervision, the monetary authorities and policy makers. These relationships will have to adapt in the face of the changing environment. The greater integration of Europe's banking and securities markets is reflected in increased collaboration among NCBs within the Banking Supervision Committee. Regulators will have to rely increasingly on information from their counterparts in order to understand market developments. While significant progress in the areas of exchange of data and information as well as harmonization of statistics has been made, further efforts, *e.g.* regarding harmonization of accounting standards, would be helpful so that a Europe-wide perspective could be adopted.

Although the costs of financial institution rescues will continue to be borne by national authorities, the trend towards greater financial integration will make it increasingly difficult to establish national dividing lines. Even when a banking-sector problem can be identified as a national one, it may quickly become European in scope, warranting action by European institutions. This increases the importance of co-ordination, both among national banking supervision authorities and between them and the ESCB, with regard to policy interventions aimed at ensuring financial stability. Already there is a high degree of co-operation at the working level within committees at the ECB as well as in international fora like the BIS. In this regard it is of vital importance to ensure that there will be sufficient flexibility to react swiftly to events.

ECB policy decisions should not be influenced by political pressures...

The ECB will be the only European institution with ready control over an area-wide macroeconomic policy instrument. As such, it could become a focus of public pressure to change policy which could increase if current structural rigidities, in both labour and product markets, remain. It is important that area-wide political bodies, like the European Parliament, ECOFIN (which consists of EU ministers of finance or economic affairs) or informal meetings, like the Euro-11 Group (composed of those ministers from the euro area countries), do not become vehicles for such pressures. In this regard, national governments, along with NCBs, could play a useful role by communicating to their respective publics both the potential and the limits of monetary policy.

... or unwarranted regional considerations

Also of concern is the possibility that considerations about regional conditions could have an unwarranted influence (in addition to that on the aggregate averages) on policy. Even in the United States, despite the high degree of centralisation of decision making, there is some evidence that local conditions have an influence on the votes of Federal Reserve district presidents.[5] The ECB could be more vulnerable in this regard. The composition of the Governing Council (11 seats for NCB Governors, who will continue to be largely confronted with issues of national concern as part of their routine activity, and 6 for members of the Executive Board), may carry the risk of undue weight being placed on regional conditions. Pressures could arise if the performances of various economies diverged. Even if conditions were relatively similar, however, there could be heterogeneity of preferences about the output-inflation trade-off. This, in turn, could make for inefficient choices in ECB policies.[6] On the other hand, members could see that their own national interests were best served by joining other members in a sort of price stability coalition, resulting in the adoption of a euro-wide perspective.[7]

Developing institutional structures that promote a euro-area-wide perspective will be important

For a smooth transition to a single monetary policy, it is vital to develop institutions and arrangements so as to promote euro-wide perspectives. The exchange of information within the ESCB, its research activities, and the organisation of key monetary policy meetings will be important and necessary elements for the development of a common monetary policy. In this regard, the development of a broad range of euro-area statistics and in-depth analysis of this economy will continue to be a challenge. A logical place to locate a good part of such efforts, particularly analytical capabilities, would be the ECB. Apart from having a leading role in the development of concepts and the compilation of monetary-policy-relevant euro-area statistics, as well as producing central forecasts for the area, the ECB should have an important role in the interpretation of area-wide data and analysis, implying a significant presence of research and analytic capabilities there. This does not imply that the NCBs could not have a constructive research role. Indeed an important characteristic of the Federal Reserve System is the significant research activity at the Board, complemented by similar efforts by Federal Reserve district banks.

---

5. Havrilesky and Gildea (1992, 1995), McGregor (1996) and Gildea (1992) argue that Federal Reserve Bank presidents' voting reflects their political and regional background. They also argue that there are differences between Board members, who are political appointees, and presidents of the Federal Reserve district banks, the latter being always more conservative. These findings are challenged by Tootell (1991, 1996). On these issues see Dornbusch, Favero and Giavazzi (1998) and *The Journal of Monetary Economics* 38 (1996) for a debate on the congressional influence on US monetary policy.
6. It has been argued that the diffusion of power and responsibilities between the regional reserve banks contributed to the poor performance of the Fed in the late 1920s and 1930s. The 1935 Banking Act centralised responsibility for monetary policy establishing the Federal Open Market Committee (FOMC).
7. Monticelli (1998) develops a model of voting behaviour in which individual members in pursuit of their national interests may find it advantageous to form such a coalition.

As yet, however, this has not taken place. At the beginning of Stage III, the number of staff devoted to research and analytical functions at the largest NCBs is estimated to exceed the number of those performing these functions at the ECB by a wide margin (Gros *et al.,* 1998). Accordingly, at least initially, it is likely that the national central banks will have a greater role in economic analysis and forecasting than enjoyed by the Federal Reserve district banks. To date much of the work of the NCBs has naturally been directed towards their own national issues. To contribute better to area-wide decision making, the focus of their analysis will have to be broadened and a high degree of co-operation between the NCBs and the ECB will be necessary.

Objectives and strategy

Two monetary policy strategies were under consideration...

The Maastricht Treaty states that the ESCB is to maintain price stability and to support general macroeconomic policy "without prejudice to the price stability objective"; however, it leaves the choice of a strategy to achieve this objective to the Governing Council of the ECB. Generally speaking, countries' experiences with approaches that can meet the Treaty's broad requirements fall into two categories: using monetary aggregates as an intermediate target; and direct inflation forecast targeting. Reflecting the positive experiences that countries have had with each (albeit in the case of direct inflation targeting, only over the more recent period) and analysis showing that operationally there is not a great deal of difference between them (Svensson, 1998), the preparatory work at the EMI (EMI, 1997*a* and *b*), suggested some mixture of both as an option.

... and a mixed strategy has been chosen consisting of...

The ECB has publicly defined its choice of monetary policy strategy. The strategy is characterised by three elements. The first is the quantitative definition of the primary objective of monetary policy: "Price stability shall be defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2 per cent (ECB, 1998)." This is to be maintained over the medium term, using "a monetary policy strategy which will consist of two elements: Money will be assigned a prominent role. This role will be signalled by the announcement of a quantitative reference value for the growth of a broad monetary aggregate". Finally, "in parallel with the analysis of monetary growth in relation to the reference value, a broadly-based assessment of the outlook for price developments and the risks to price stability in the euro area will play a major role in the ESCB's strategy (ECB, 1998)".

The exact nature of this strategy appears to be open to interpretation. Some commentators have pointed to a close resemblance of this strategy to that used by the Bundesbank where monetary aggregates occupy a place at the top of a hierarchy of several indicators. Others, however, have noted that there has been no decision about the relative weights to be attached to the indicators, and argue that the ECB is likely to use an eclectic approach similar to the Fed's. An explicit inflation targeting approach, whereby the central bank's own published inflation forecast provides a benchmark for an assessment of the current policy stance seems to be ruled out as, at least initially, the ECB's own inflation forecasts will not be published.

... monetary aggregates targeting...

Concerning monetary targeting,[8] a possible advantage is that the ECB, which initially will not have its own inflation track record, may be able to appropriate some part of the Bundesbank's credibility, although the effect is likely to be only transitory and by no

8. On the general case for using a monetary aggregates strategy, see von Hagen (1998).

means a substitute for establishing its own credibility. As well the strategy does have an empirical basis which is easy to communicate – over longer time periods, broad trends in money growth, beyond that required to meet transaction needs, are eventually reflected in higher trend inflation rates. However, these correlations are not as tight over time periods which are often more relevant to policy makers partly because money growth is not the sole predictor of inflation over such time frames.

In choosing to target a broad aggregate, the ECB had to balance the desire to have a controllable aggregate against the need to take account of possible substitution effects associated with financial innovation. Given that considerable financial innovation is expected over the next few years in the euro area, a relatively broad aggregate is more likely to preserve a reasonably stable relationship to nominal output. In any case, the construction of euro-wide aggregates is complicated; not all countries have traditionally published the same types of monetary aggregates and, even when broad aggregates had the same name, their asset composition often differed significantly. To date, the ECB has agreed upon a unified EMU-wide reporting scheme for all financial institutions which could potentially create money-like instruments.[9] This will permit the calculation of consolidated aggregates which take account of cross-border holdings, enhancing their use as a gauge of the stance of policy. Thus, the ECB should have available a set of harmonized and comprehensive euro area-wide monetary aggregates from the outset of Stage Three. However, it would have been preferable to have had these aggregates in place and in the public domain earlier. This would have allowed analysis and debate about the advantages and disadvantages of monetary aggregates targeting in general.

... and inflation forecast targeting

Nevertheless, it cannot be excluded that even a broad aggregate would be subject to enough instability to reduce its usefulness. This is all the more likely given expected changes in financial markets with the advent of the single currency. Accordingly, elements of an inflation forecast targeting strategy may have some attraction. Because this approach, in theory, is forward looking and uses all relevant information, it is considered to be welfare maximising under certain conditions. However, monitoring by the public is complicated because the ECB will not publish its own inflation forecast; moreover, even when such forecasts are published, their derivation may be difficult to understand and their comparison with actual outcomes generally occurs with a two year lag.

An advantage of any strategy is that it tends to impose structure on internal and external policy debates. For the ESCB this could help to keep the focus of policy discussions on area-wide considerations that have a bearing on the ECB's policy objectives. To the extent that a mixture of two strategies is used, some of this advantage could be diminished unless the relative importance attached to each is made clear. Also, due account will have to be taken of the possibility of conflicting signals and how these would be resolved.

The strategy is likely to be implemented in a pragmatic manner

The ECB's monetary policy strategy is likely to be implemented in a pragmatic way, reflecting actual practice. For example, the Bundesbank, which has consistently employed an aggregates strategy, has followed a policy of "pragmatic monetarism", missing its targets in about half the cases since 1974. Such misses have "only rarely been of a completely involuntary nature" and the Bundesbank has taken pains to explain both the reasons why the targets were missed and the implications for policy (Issing, 1997). The Swiss National Bank also implements its monetary targeting strategy in a flexible manner (Rich, 1998) as do countries which follow an inflation forecast strategy.

9. The statistical frameworks are described in EMI (1996).

This implies a focus on the underlying determinants of the changes in the target variable as well as a need to monitor other indicators. The recent economics literature on monetary strategies suggests that responding to the determinants of target variables leads to more efficient outcomes (Svensson, 1998). For any central bank, this is a difficult task; for the EMU it will be especially so given problems with area-wide data and uncertainties about the transmission mechanism.

Challenges in the period ahead

A reading of the preliminary evidence indicates not much difference across major economies from a change in interest rates

Having an understanding of how the euro area economy will be affected by interest rate changes (the transmission mechanism[10]) will be important to the successful implementation of policy. If individual responses of various euro-area economies to an interest rate change were dramatically different, implementing area-wide strategies would be complicated. A synthesis of a number of the findings on this issue, using a variety of techniques, is given in Table IV.1.[11] For ease of comparison, only the estimated GDP changes from baseline, in the second year after a change in short-term interest rates, are shown. Those studies that are based on structural models suggest a relatively similar response for the major economies in the area. While a number of them identify differences in responses, they do not agree on one particular economy as being more sensitive to interest rate changes than another. Only the structural VAR models (the lower part of Table IV.1) consistently show one economy (Germany) as more sensitive to interest rate changes. However, the ranking of the other economies examined, using this approach, varies. Consistent with these patterns, a large number of the cross-country differences reported appear to be statistically insignificant (Kieler and Saarenheimo, 1998). A tentative conclusion, taking this evidence at face value, is that there could be a fairly even response of the major economies to interest rate changes.

The role of interest rates is likely to increase

While this is helpful, it is also likely that the response of the euro area economy to interest rates will change. One area important to the transmission mechanism that is likely to come under increasing pressure is the financial sector and how it allocates credit (White, 1998). The extent of this pressure will depend on current differences across countries and the opportunities for agents or institutions to arbitrage. Looking at private sector balance sheets, the net assets of both households and enterprises (measured relative to overall GDP) are fairly similar across countries, but the composition of gross assets and liabilities does vary significantly (Table IV.2). As well, the response of key lending rates to a change in policy interest rates also varies. Increasing competition between financial institutions in the euro area will give households and enterprises a larger choice of financial instruments and more freedom in the allocation of consumption over their life cycles. Financial institutions are also likely to change the manner in which they react to developments. These factors will place more emphasis on interest rates and less on credit availability.[12] How quickly these differences are reduced will depend on the speed of financial market integration but they are unlikely to be completely eliminated. National preferences about the levels

10. Technically there are several channels in the transmission mechanism but most generally work in response to actual and expected interest rate changes.
11. See Britton and Whitley (1997); Kieler and Saarenheimo (1998); and Dornbusch *et al.* (1998). Differences in methodology make the comparison of such studies notoriously difficult; no less than four modelling strategies have been attempted: *i)* simulating existing macroeconomic models (single or multi-country); *ii)* small structural models; *iii)* reduced form equations; and *iv)* structural VAR models. Furthermore, various methodologies are open to their own particular criticisms. Structural models may not capture well how the new economy is likely to change, while VARs suffer from linearity assumptions and identification problems.
12. While some recent studies have found weak evidence of a credit channel in Germany, France and Italy (Bernanke and Gertler, 1995; Stöss, 1996; Candelon and Cudeville, 1997; and Angeloni *et al.*, 1995), others suggest that it is important (de Bondt, 1998 and references cited there).

Table IV.1. Empirical assessments of the impact of monetary policy on output in various European countries

Impact on real GDP, percentage deviation from baseline in second year after shock

Study	Type of shock	Germany	France	Italy	United Kingdom	Spain	Netherlands
Single country Macro Models[a]							
National Central Bank models (BIS, 1995)	1	–0.4	–0.4	–0.4	–0.9	0.0[a]	–0.2
Multi-country Macro Models[b]							
Fed MCM model (BIS, 1995)	1	–0.7	–0.7	–0.3	–1.2	..	..
IMF Multimod standard multiplier	2	–0.5	..	..	–0.5	..	..
Quest II (Commission Services)	2	–0.4	–0.4	–0.3	–0.4	–0.4	–0.3
Taylor (1995)	2	–0.4	–0.4	–0.4	–0.1	..	..
Small structural models							
Britton and Whitley (1997)[c]	1	–0.5	–0.5	..	–0.3	..	..
Britton and Whitley (1997)[d]	1	–0.4	–0.4	..	–0.4	..	..
Reduced form equation							
Dornbusch, Favero and Giavazzi (1998)[e]	3	–0.5	–0.5	–1.1	–0.5	–0.4	..
Dornbusch, Favero and Giavazzi (1998)[f]	3	–1.4	–1.5	–2.1	–0.9	–1.5	..
Structural VARs							
Ehrman (1998)	4	–0.6	–0.4	–0.1	–0.2	–0.1	0.0
Ramaswamy and Sloek (1997)[g]	4	–0.6	–0.4	–0.5	–0.5	–0.3	–0.6
Barran, Coudert and Mojon (1996)[h]	4	–0.6	–0.4	–0.3	–0.4	–0.4	–0.3
Gerlach and Smets (1995)[i]	4	–0.3	–0.2	–0.2	–0.6	..	..
Gerlach and Smets (1995)[j]	1	–1.0	–0.5	–0.5	–0.7	..	..

a) Fixed ERM rates for Germany, France and Italy; endogenous exchange rate for United Kingdom.
b) Endogenous exchange rates.
c) Each country estimated separately.
d) All countries estimated jointly.
e) Effect after 8-12 months. Response variable is monthly output data.
f) Effect after 2 years. Response variable is monthly output data.
g) Baseline model.
h) Baseline model (model 1).
i) 1 standard deviation shock.
j) 1 per cent interest rate hike for 2 years.
Types of monetary shock: Type 1: 1 per cent point rise in short-term interest rates sustained for at least two years; Type 2: 1 per cent permanent decrease in money target; Type 3: 1 per cent simultaneous permanent increase in short-term interest rates; Type 4: 1 standard deviation interest rate shock which in many cases is close to one percentage point.
Sources: Kieler, M. and T. Saarenheimo (1998) and Ehrman (1998).

and composition of household wealth, owning versus renting a home, and the use of equity markets, for example, are likely to continue to be of importance. Indeed, if recent US evidence can be used as a guideline, the possible outcome could be that there will be some differences among the larger economies of the euro area (Carlino and DeFina, 1995).

The exchange rate will also play a role...

The exchange rate will also be an important part of the transmission mechanism. Because the euro will be a new currency, understanding the host of forces that will affect its level in international markets will be difficult. Those factors that are likely to be important are: the initial cyclical position of the economy compared with that of other major trading partners; market views about the current and prospective interest rate developments; and, over time, fundamental determinants of savings and investment across the euro area; relative trends in inflation; and the potential use of the euro as an international currency. The exposure of the euro-area economy to foreign trade will be

Table IV.2. **Financial position of the private sector in selected euro area countries**

1996, as per cent of GDP

	Germany[f]	France	Italy	Spain[g]	Belgium
Non-financial enterprises					
Net assets	–35	–73	–67	–43	–81
Gross assets	70	249	39	80	135
of which:					
Short-term[a]	21	24	9	39	26
Long-term[b]	9	4	4	19	38
Equity	23	176	20	16	71
Gross liabilities[c]	105	322	106	123	216
of which:					
Short-term loans	21	16	25	n.a.	21
Long-term loans[d]	45	42	17	n.a.	63
Households					
Net assets	124	138	163	78	217
Gross assets	134	186	187	139	257
of which:					
Short-term[a]	59	21	44	73	75
Long-term[e]	54	41	60	7	79
Equity	17	71	36	40	102
Gross liabilities	11	49	24	61	40
of which:					
Short-term loans	2	8	7	n.a.	4
Long-term loans	8	32	12	n.a.	36

a) Cash, deposits and short-term loans and securities.
b) Bonds and long-term loans.
c) Including own shares.
d) Including, in some cases, corporate bonds.
e) Bonds and net equity of life insurance reserves and pension funds.
f) Figures relate to 1995.
g) Data for long vs. short loans not available. It is assumed that half of total loans on the asset side are short and the other half long.
Source: *Financial Accounts of OECD Countries*.

about that of the United States and Japan but individual countries within the area will be differently affected by exchange rate developments. Over time these may wane, depending on how the structures of these national economies respond to the forces of integration.

... as will inflation expectations

Inflation expectations are also likely to play a role. Over the past decade, this channel has been instrumental in helping to bring down inflation and to contain it, once reduced (BIS, 1996; Brayton *et al.*, 1997; Pigott and Christiansen, 1998; Siviero *et al.*, 1997; and Visco, 1995). For example, increases in official interest rates in Italy in recent years have been found to lower expectations of inflation very rapidly and significantly (Buttiglione *et al.*, 1997). In addition, there is evidence that longer-term expectations as well as their dispersion have also declined. Links of this sort can help to reinforce monetary policy actions to contain inflation pressures, for example, by altering the behaviour underlying wage and price strategies. Certainly the current environment of low inflation that will exist in the euro area when the ECB begins operation, as well as a number of aspects guaranteeing the independence of the central bank, will have beneficial effects on expectations.

The effect on liquidity will be difficult to determine

Considering transition issues, if the euro is more liquid than the sum of the individual 11 currencies, the move to a single currency might lead to an undesirable increase in liquidity (Mundell, 1998). Over the medium term, however, the impact of the advent of the euro on private portfolio composition is difficult to assess: on the one hand, private economic agents within the euro area, that previously held different European currencies to diversify their risk, may be faced with a surplus of euros for transaction purposes; on the other hand, investors that were previously not interested in European currencies, because of the limited size of the money markets, may increase their demand for euros. In the securities markets, the re-denomination[13] of government and corporate bonds and the adoption of a uniform set of conventions will result in a market in euro-denominated bonds of about half the size of the market in the United States and larger than that in Japan, enhancing the liquidity of these assets.

The NCBs may also be confronted with higher levels of foreign exchange reserves than needed

A liquidity effect could also arise from the pooling of official reserves at the ECB.[14] At the end of 1997, euro-area central banks had $389 billion of foreign exchange and gold reserves. Of this, around $270 billion were in foreign currency, 17 per cent of which in euro area currencies. In the absence of the ERM, the NCBs will no longer have an obligation to intervene in order to stabilize exchange rates and this will lower their demand for reserves. In addition, the euro area is a large, relatively closed economy where total trade exposure is estimated to be about 16 per cent of GDP. Some studies have estimated that monetary union will leave the NCBs with up to $125-190 billion in excess reserves;[15] however, changes in their level and composition are likely to occur only gradually (Funke and Kennedy, 1997) although the greater integration of financial markets could speed up the process. The size and variability of the ESCB foreign reserves will be primarily determined by capital flows and the exchange rate policy.[16] Indeed, there might be a desire to hold precautionary reserve levels to smooth out any possible volatility in exchange markets. Over the longer run, the ESCB's need for foreign exchange reserves will depend on such things as the use of the euro as an international reserve currency and a currency of denomination for international financial transactions.

Communicating policy to the public

The ECB will be accountable to the European institutions and to the public

All OECD central banks are accountable, in the sense that they are "obliged to give a reckoning for their actions", or are "legally or morally obliged to carry out a duty, and to be liable to be blamed for failure" (Briault *et al.*, 1995). The Maastricht Treaty provides for the ECB to be accountable to European institutions (Article 109*b*, section 3). Specifically the ECB will have to present an annual report to the European Parliament, the Council, the Commission and the European Council. Furthermore the ECB President, as well as other members of the Executive Board, could be invited to appear before the relevant committees of the European Parliament. These arrangements may seem to lack force because these bodies have limited political strength and there is a lack of explicit penalties for any target failures. However, the ECB will be open to the public

---

13. EU governments agreed at the Madrid summit in December 1995 that all new government debt issued by members of EMU will be denominated in euros from 1 January 1999. Subsequently governments (and the European Investment Bank) have committed themselves to redenominate existing debt from national currencies into euros.
14. The NCBs will provide the ECB with foreign reserve assets, other than Member States' currencies, ECUs, IMF reserve positions and SDRs, up to an amount equivalent to ECU 50 billion. The contribution of each NCB is fixed in proportion to its share in the subscribed capital of the ECB (where the weighting of each national central bank is equal to the sum of 50 per cent of the share of the country in the EU population and 50 per cent of its share in the EU GDP over the past 5 years). In exchange for these transfers, each NCB is credited by the ECB with a claim equivalent to its contribution.
15. See, for example, JP Morgan (1998). Masson and Turtelboom (1997), on the basis of the 1995 ratio of reserves to imports, estimate $105 billion excess foreign exchange reserves.
16. Some analysts suggest that the size of excess foreign assets will enable the ESCB to split reserves into two portfolios: one portfolio, focused on liquidity, will continue to be held as traditional currency reserves; the remaining excess reserves, over time, will become more oriented towards investment (JP Morgan, 1998).

through the press. Indeed, the ECB can hold itself accountable to the public by setting clear intermediate targets and commenting regularly on key policy developments (Issing, 1992). Such a communication strategy could be very helpful in winning, over time, the necessary broad support for the new institution from the European public.

In communicating to the public, the ECB will have to make clear that there is a separation of responsibilities between the monetary and fiscal authorities as well as other policy-making bodies and economic interest groups. This type of clarification could have two positive effects. First, by clearly delimiting its responsibilities, the ECB could help prevent monetary policy from being the object of undue pressures which could arise because of the unresolved structural problems in the area. Second, to the extent that the fulfilment of the respective responsibilities can be accurately monitored by the public, other parties may be made more aware of the full consequences of their actions. A caveat, however, is in order on this final point. Many economic interest groups, who were aware that they were in a position to affect national aggregate economic variables (in particular on national prices), may now conclude that their influence is less important on euro-wide area developments and would therefore feel less inhibited in pursuing their goals. On the other hand, a heightened awareness of possible effects on their own competitive positions *vis-à-vis* other euro area counterparts could limit this effect.

While there are benefits to transparency...

National central banks, in practice, differ regarding transparency about their objectives and strategy, short-term implementation goals, views of the transmission mechanism and decision-making processes (Table IV.3). To the extent that transparency reveals private information, it could facilitate the co-ordination of the public's expectations and lower the risk of misinterpretations of policy signals. This could in principle reduce uncertainty about the future course of interest rates provided that the public interprets the information "correctly". Transparency about monetary policy objectives and strategies is common to most central banks, while transparency about short-term policy implementation goals has recently increased (Borio, 1997).

Table IV.3. **Transparency of central banks**

United States	Germany	Japan	Canada	France	Italy	United Kingdom	ECB
Formal scheduling and publication of calendar of monetary policy decision making process							
Yes	Yes	Yes	No	Yes	No	Yes	Yes
Interest rate decisions taken at scheduled meetings under normal circumstances							
Yes	Yes	Yes	No	Yes	No	Yes	Yes
Publication of explanatory press releases at the time of each official interest rate change							
Yes	No	Yes	Yes	Yes	Yes	Yes	Yes
Minutes or summary of meetings of monetary policy decision-making body published							
Yes	No	Yes	No	No	No	Yes	No
Voting behaviour of individual members published							
No	No	Yes	No	No	No	Yes	No
Regular publication of monetary policy or inflation report							
Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Publication of internal forecasts for intermediate or final target variables							
No	No	No	No	No	No	Yes	No
Reporting to/monitoring by the Parliament							
Yes	No	Yes	Yes	Yes	Yes	Yes	Yes

... practices differ among central banks, depending on their circumstances

On the other hand, information about the central banks' own views of the transmission mechanism, inflation outlook and reaction function is not widely shared with the public. Only a few central banks publish their own inflation forecasts, such as the Swedish Riksbank and the Bank of England, or lay out publicly something like a contingent action plan. There is as well no common model regarding the degree of transparency about the actual decision-making process. While some central banks publish minutes and detailed transcripts of the meetings of policy-making bodies within a few weeks or months, others only make them available after decades. Sometimes the monetary policy decision-making process does not even follow a formalised pre-announced schedule. In sum, reflecting each country's unique historical circumstances, there does not appear to be a unique model of transparency.

The ECB can use a number of vehicles to communicate to the public...

How transparent the ECB should be is difficult to evaluate. Unlike those central banks which have become more transparent, the ECB will be a newly established entity and will be under intense scrutiny of the financial markets who will be trying to understand the ECB's views on the economy and how policy is implemented. To reduce the risks of misinterpretation, the ECB could use the publication of its research, as well as speeches by executive board members, to communicate to the public and markets both the changing nature of this economy as well as the fact that these are areas of importance to the ECB. In this regard, a useful device could be the publishing of a summary of meetings to explain the rationale of actions when they have been taken. Over time, when key aspects of policy implementation are better understood, a greater degree of transparency could be extended to such things as the ECB's view of the transmission mechanism, as well as details of the decision-making process, for example.

... before it decides if a greater degree of transparency is warranted

The fact that ECB Governing Council members not only have different political but national backgrounds could complicate transparency about the decision-making process. While the ECB Council may decide to make the outcome of its deliberations public, the Statute (Article 10.4) also states that the proceedings of these meetings are to remain confidential. This stipulation partly reflects the view that too much transparency about the debate and voting behaviour of national representatives may well make it more difficult for members to change their views in the course of debate (Duisenberg, 1998*b*), take a perspective that covers the full euro area, or have a frank discussion. Only if there were a strong general European public opinion against members taking a narrow national view would this type of transparency be beneficial.

Fiscal policy issues in the euro area

Fiscal consolidation issues

The role of fiscal rules in monetary union: the Stability and Growth Pact

Incentives for fiscal prudence have been strengthened

The Stability and Growth Pact is designed to avoid budgetary free-riding and to make credible the Maastricht Treaty's "no bail-out rule", and thus to limit the extent to which budgetary developments in individual countries impinge on their neighbours. Elaborating on the fiscal rules written into the Maastricht Treaty, the Pact considers budget deficits above the Treaty's 3 per cent of GDP limit as excessive, though with a derogation for modest temporary overshoots due to exceptional circumstances. By

"exceptional circumstances" is meant an annual fall of real GDP of at least 2 per cent. An annual fall of less than 2 per cent – but at least 0.75 per cent – may also, at the discretion of the Council of Ministers, be considered exceptional in light of supporting evidence such as the abruptness of the downturn or the size of the cumulative shortfall in output in relation to past trends. By "temporary" is meant that, according to the projections of the Commission, the deficit would fall below the 3 per cent threshold in the year following that within which the exceptional circumstances occurred. Thus, the waivers foreseen in the Pact are subject to such stringent conditions that the 3 per cent of GDP threshold should be viewed as a *de facto* strict upper limit for the deficit.

The Pact provides for enforcement of this rule with a new institutional framework, which includes both an "excessive deficit procedure" with a specification of possible sanctions, and an early warning mechanism involving strengthened surveillance and co-ordination of economic policies via the annual review of national programmes. In the case of an excessive deficit, the Council of Ministers will, on the recommendation of the Commission, propose a course of action to be immediately undertaken by the country if sanctions are to be avoided. If corrective measures have not been implemented within ten months of identification of the excessive deficit, sanctions will be imposed. These would initially take the form of non-remunerated deposits, with a fixed component equal to 0.2 per cent of GDP and a variable component rising in line with the size of the excessive deficit. Such deposits are limited to a maximum of 0.5 per cent of GDP per year, but would accumulate each year until the excessive deficit is eliminated. Provided the excessive deficit is corrected within two years, the deposits are returned to the country, otherwise the deposits will become non-refundable. In the event that the measures taken by a country are ineffective, the whole process will be restarted but sanctions will be imposed within three months.

Flexibility will require better structural budget positions

The Pact further states that cyclically-neutral targets of "close-to-balance" or surplus will be required in order to provide sufficient scope for flexibility over the cycle. Studies by the OECD and others generally corroborate the "close-to-balance" norm.[17] But such assessments are based on the extrapolation of past behaviour and largely allow for the operation of the automatic stabilisers only. Moreover, they could be subject to greater than usual uncertainty given that EMU implies a "regime change" that may lead to changes in behaviour.

Governments will need to adopt more ambitious consolidation plans

To compare actual plans with the assessment that governments should aim for a "close-to-balance" rule, Table IV.4 summarises the current fiscal targets announced by EU Member governments. Eight out of eleven countries of the euro area have deficit targets in the range of 1 to 2 per cent of GDP, which will not achieve sufficient flexibility to allow automatic stabilizers to work under the Stability and Growth Pact, let alone to allow for discretionary counter-cyclical measures. These targets will be superseded by the forthcoming Stability Programmes which are expected to reflect new commitments to achieve close-to-balance targets by 2002.[18] In the meantime, nevertheless, most countries will be in a period of transition during which fiscal policy risks being pro-cyclical in the event of an unexpected downturn.

17. See work by the OECD (1997), the European Commission (Buti *et al.,* 1997 and 1998), and the IMF (1998*b*).
18. Finland and the Netherlands have already submitted their new Stability Programmes.

Table IV.4. **Fiscal targets in EU countries**

Country	Current budgetary objectives	Specific time horizon
Germany	Reduce general government deficit and debt-to-GDP ratio to 1.5 per cent and under 60 per cent of GDP respectively: reduce public spending to 46 per cent of GDP (pre-unification spending level); lower tax burden and budget deficit and lower social security contributions below 40% of gross wages.	2000
France	General government deficit below 2 per cent of GDP; stabilization of debt-to-GDP around 1999-2000.	2000
Italy	Reduce general government deficit and debt-to-GDP ratio to 1 per cent and 107 per cent of GDP, respectively. Maintain primary surplus of 5.5 per cent of GDP.	2001
United Kingdom	Golden rule over economic cycle; net public sector debt-to-GDP ratio stable and prudent over the economic cycle.	Fiscal year 2000
Austria	Reduce federal deficit to 2.1 per cent of GDP; freeze public expenditures on personnel, operating costs, social spending and subsidies to firms in nominal terms.	2000
Belgium	Maintain general government primary surplus around 6 per cent of GDP; reduce budget deficit to around 1 per cent of GDP and reduce debt-to-GDP ratio.	2000
Denmark	General government balance in surplus over the business cycle. Debt-to-GDP ratio reduced to 40 per cent.	2005
Finland	General government surplus of 2.3 per cent of GDP. Debt to GDP ratio should fall to 43.2 per cent.	2002
Greece	Reduce general government deficit and debt-to-GDP ratio to 0.8 per cent and 99.8 per cent of GDP, respectively.	2001
Ireland	General government surplus of 1.3 per cent of GDP (0.6 per cent after contingency fund).	2000
Luxembourg	Central government expenditure to grow in line with medium-term GDP growth.	
Netherlands	In the context of a prudent growth scenario the budget deficit is projected to fall to 1 per cent of GDP by the end of 2002.	2002
Portugal	General government deficit of 1.5 per cent of GDP, debt-to-GDP ratio 59.4 per cent.	2000
Spain	Reduce general government deficit and debt-to-GDP ratio to 1.6 per cent and 65 per cent of GDP, respectively.	2000
Sweden	Surplus of 2 per cent of GDP on the general government balance over the cycle to be approached incrementally over the 1998-2000 period; balanced budget for municipalities and counties by 2000.	2000

Fiscal sustainability and inter-generational equity

Adhering to the Pact assures fiscal sustainability

Adherence to the Stability and Growth Pact not only has implications for fiscal policy settings over the cycle, but also for long-term budgetary developments. The OECD Secretariat has in the past attempted to gauge the sustainability of policies by calculating a "tax gap", *i.e.* an immediate and permanent rise in the tax ratio (or fall in the spending ratio) that would be needed to keep the debt ratio from rising over the medium and long run (Blanchard *et al.*, 1990 and Leibfritz *et al.,* 1995). Work at the European Commission (Franco and Munzi, 1997) has extended this methodology for selected EU countries, starting from 1997 actual budget balances and allowing for achievement of three alternative fiscal targets by 2030: end-period debt ratios consistent with structural budget positions of close-to-balance (interpreted as deficits not exceeding 1 per cent of GDP), an average 60 per cent debt ratio, and an unchanged debt ratio. The calculations include estimates of the costs of population ageing beyond the year 2010 based on current pension expenditure projections of national authorities and mechanical estimates of the effects of demographic changes on other age-related expenditures (*e.g.* health, education, family allowances). The results can only be seen as illustrative

because they depend on given growth and interest rate assumptions and, most importantly, do not take account of probable reforms to pension policies. They suggest that the close-to-balance rule is considerably more stringent than the stable public debt rule in that achieving it requires larger tax increases or expenditure cuts, while generating significant falls in public debt ratios (Table IV.5).[19] For the less indebted countries, implementation of the close-to-balance rule also implies larger adjustments than would be required by the Maastricht 60 per cent debt criterion, while for the highly indebted countries, it would bring debt ratios down to or close to 60 per cent by 2030. Thus, by implication, adherence to the close-to-balance rule would appear to be a sustainable path (on the basis of the illustrative calculations here).

Table IV.5. **"Tax gaps" needed to achieve alternative fiscal targets over the period 1998-2030**[a]

	1 per cent of GDP average deficit over the cycle	**(Implied end-level of public debt ratio)**	**60 per cent debt criterion**	**Stable public debt**	**(1997 level of debt ratio)**	***Memo. item:* 1997 primary balances (as per cent of GDP)**[b]
Belgium	1.2	(63)	1.3	0.0	(122)	5.8
Denmark	–1.1	(42)	–1.5	–1.6	(67)	2.8
Finland	0.6	(35)	0.1	0.2	(56)	0.4
Germany	3.3	(43)	3.0	3.0	(65)	0.6
Italy	–0.4	(66)	–0.3	–1.4	(122)	6.4
Netherlands	1.2	(46)	1.0	0.7	(71)	3.6
Spain	0.6	(43)	0.2	0.1	(74)	1.7
Sweden	–0.1	(43)	–0.5	–0.8	(77)	2.3

a) Based on methodology described in Blanchard (1990) and Blanchard *et al.* (1990), the tax gap is calculated over the base year 1997 as the change in tax to GDP ratio immediately required in order to reach, by the end of the period considered, the indicated debt to GDP ratio. Age-related expenditures based on present policies (average of favourable and unfavourable pension scenarios, where applicable) and non-age-related expenditures based on 1997 unchanged ratios to GDP. Macroeconomic assumptions: real interest rate on government debt 4 per cent (representing the approximate long-run real interest rate observed for Germany in 1997), productivity growth 1.5 per cent. A negative gap means that the actual primary balance was already sufficiently large in 1997 to meet the given objective. The calculations are very sensitive not only to the policy and macroeconomic assumptions, but also to the primary balance levels in the base year (1997). For example, the 1997 primary surplus for Italy was relatively high, in part helping to explain the calculated negative tax gap.

b) May differ somewhat from the 1997 estimated levels used in the calculations.

Source: Franco and Munzi (1997).

Preparing for ageing populations may require budget surpluses

The achievement of a close-to-balance budget over the next decade would also allow countries to meet the worsening of the demographic situation after 2010 with smaller public debts. Even so, sizeable tax increases after 2010 would still be required in most countries in order to stay on the close-to-balance rule. Hence, greater ambition in medium-term fiscal targets might be warranted by the future fiscal burden associated with population ageing. It is difficult to gauge the ultimate size of this problem in the sense that policies to address it are rapidly evolving. Some countries have begun to encourage privately funded systems, while the OECD has recommended policies to lower future dependency ratios as well (OECD, 1998*b*). Nonetheless, a significant burden is likely to remain. Some countries have concluded that a larger down payment on the debt, via current surpluses, must be one of the major policies to tackle the problems raised by ageing (Ministry of Finance, Denmark, 1995). This implies that even though the close to balance rule may be sufficient to achieve tax smoothing via cyclical flexibility over the medium run, tax smoothing over the longer run may require a more ambitious target.

19. Adjustments and tax gaps would be larger if the analysis were extended to 2050.

Achieving budget targets

Emphasis should be on expenditure restraint

The fiscal targets of the Stability and Growth Pact can of course be fulfilled in a variety of ways. The foregoing analysis of fiscal targets was not sensitive to the method of consolidation, and in the end this must be taken into account, as economic feedbacks of different measures can differ significantly. Increasing taxes could intensify economic distortions, and may not be feasible in any event given the pressures of tax competition (see below).[20] Regarding expenditure restraint, the European Commission has recommended that particular attention be given to government consumption, health care costs, public pension reform, and "passive" labour market measures and subsidies (European Commission, 1998). By contrast, under recent fiscal consolidation efforts in the run-up to EMU, on a cyclically adjusted basis, tax increases and cuts in investment and "other" capital transactions figured prominently, while transfers generally increased and subsidies were reduced only slightly overall (Table IV.6).[21] Some observers fear that investment levels may now be too low, jeopardising long-run growth – although the quality of such investments also matters.[22]

Table IV.6. **Sources of budget consolidation in EU countries in the 1990s**

Changes over 1990-97 in percentage points of potential GDP

	Consumption	Transfers[a]	Investment[b]	Other capital transactions	Subsidies	Total taxes[a,c]	Property income[d]	Primary balance[a]
Germany	0.4	0.3	–0.5	–0.3	–0.2	2.3	–0.3	2.3
France	0.7	2.0	–0.5	–1.0	0.5	2.8	–0.3	0.9
Italy	–2.0	0.7	–1.1	–1.9	–0.7	3.5	1.3	9.9
United Kingdom	–1.9	3.0	–1.5	–1.3	–0.3	0.4	–0.5	1.9
Austria	–0.9	0.8	–1.2	1.1	–0.5	2.2	–0.2	2.7
Belgium	–0.2	0.0	0.1	–0.1	–0.9	2.4	0.1	3.7
Denmark	0.7	2.5	0.3	0.3	0.2	2.8	–0.3	–1.6
Finland	–1.1	5.5	–1.0	–0.8	–0.5	1.0	0.4	–0.6
Greece	–0.7	0.4	0.6	–4.9	–0.8	4.0	2.7	12.2
Ireland	–1.5	–0.6	0.5	–0.3	0.1	–0.1	0.1	1.7
Netherlands	–1.1	–2.3	–0.1	–1.0	–0.9	0.5	–0.7	5.2
Portugal	2.2	4.0	0.7	–1.0	–0.6	5.1	0.6	0.2
Spain	–0.4	–0.3	–2.3	–0.6	–0.4	1.9	0.4	6.1
Sweden	–3.2	1.5	–0.4	0.7	–0.7	–0.6	0.8	2.1
European Union	–0.6	1.1	–0.8	–0.9	–0.3	2.2	0.1	3.8

a) Cyclically-adjusted.
b) Gross investment less consumption of fixed capital.
c) Direct and indirect taxes and social security contributions.
d) Net non-interest; includes also receipts of current transfers other than social security contributions.

Structural reforms are complementary

In addition, structural reform in product and labour markets could potentially make a significant contribution to budget consolidation, both by lowering structural unemployment and the number of transfer recipients in general, and by allowing for higher growth and tax receipts. Fundamental tax and public expenditure reforms, in turn, will be a critical component of any such structural reform effort.

20. There is a body of literature suggesting also that tax-based consolidation may not be sustainable insofar as it expands the scope for future spending increases. See, *e.g.,* Alesina and Perotti (1995).
21. A number of "one-off" measures were included in the final push to meet Maastricht targets in 1997, accounting for one-quarter to one half of the total deficit reduction in that year in 8 out of 11 countries. (*European Monetary Institute,* 1998). To a significant extent, these were reflected in "other" capital transactions: *e.g.* shifting expenditures from above to below the line, or one-time receipts of capital transfers.
22. Another approach, which is being given some consideration in the EU context, is to aim for a balanced budget excluding public investment, which would be debt financed, *i.e.* the "golden rule".

Reforms to achieve better spending control will help

Reforms in the budget framework and process could help achieve budget objectives. For example, countries might gain better control of spending with the adoption of multi-year budget frameworks and expenditure ceilings. To avoid free riding at the sub-national level, the Stability and Growth Pact could be reinforced by "internal stability pacts" which share the burden across different levels of government, an approach under discussion in both Italy and Germany. To help guard against a "short-termist" approach to spending cuts, countries might improve budget accounting methods, for example by producing "whole of government" accounts, including off-balance sheet commitments, to complement the regular accounts of the government. Public provision of full information on past, present, and prospective budget trends would also help to increase transparency, which is especially important in the face of fixed budget rules.[23] Finally, the Stability and Growth Pact requires that detailed medium-term Stability Programmes be made public and be evaluated by the ECOFIN Council based on recommendations of the EU Commission. The policy dialogue, strengthened by improved internal budget processes, could help to improve the quality of consolidation in EU countries.

Fiscal federalism

Regional adjustment will require both effective fiscal stabilization and flexible markets

With a common monetary policy and slow adjustment in product and labour markets, EU fiscal policy will have to bear the brunt of asymmetric shocks (or symmetric shocks with asymmetric effects). Whether, in fact, such shocks will intensify with monetary union remains unclear (Box IV.2), but the enhanced role for fiscal stabilization requires that it be as effective as possible. It needs to be recognised, however, that fiscal stabilization is best suited to assisting countries to adapt to shocks that temporarily reduce their income. In the case of permanent (supply) shocks, countries are permanently worse off and changes in relative prices are needed to adjust to the new situation. In these cases, attempts at fiscal stabilization may be ineffective or even counter-productive because they hinder the necessary adjustment of relative prices.

Centralisation of fiscal stabilization might help

In respect of fiscal stabilization, there is an issue as to whether the decentralised form of fiscal federalism in Europe helps or hinders policy effectiveness. In established monetary unions with diverse federal regions like the United States and Canada, fiscal federalism with centralisation of the stabilization function plays a significant role in compensating for the absence of internal exchange rates and in fostering cohesion. A central stabilization function offers two major benefits, namely the insurance pooling of risks and internalisation of policy spillovers.[24] However, member countries of the EU have not yet planned for a macroeconomic stabilization role at the Community level.[25]

But the case for a decentralised EU is strong

On the other hand, individual EU countries have fiscal autonomy (albeit constrained), with the large size of governments and progressive income taxation allowing for a high degree of income smoothing. By comparison, regions in other federations tend to have much narrower tax bases, with tax policies in some instances constrained by

23. The IMF (1998*a*) provides guidelines for more transparency in public accounts.
24. Also, if consumers are partly forward looking, a federal stabilization policy could be more effective than a regional one, since consumers will anticipate the taxes needed to repay their own regional debt, and raise their savings rates accordingly, whereas the anticipated costs of a federal debt issue are more diffuse. Bayoumi and Masson (1998) provide empirical evidence of such an effect in the Canadian provinces.
25. This is despite reports by various experts, *e.g.* the MacDougall Report (EC, 1977), the Forte Report (EC, 1979), and EC (1993), which have argued in favour of more centralisation. This in part reflects the difficulty of aggregating diverse political preferences in the EU.

Box IV.2

Asymmetric shocks and shock absorbers in EMU

Deeper economic integration in the context of a common currency may affect the prevalence of asymmetric economic shocks. Insofar as a common currency enables Europe to increase regional specialisation (*e.g.* in the car industry) in order to achieve a better division of labour and exploit scale and agglomeration economies, it could entail greater vulnerability in the various regions to product-specific changes in technology, input prices, or demand.[1] Insofar as the new regional agglomerations overlap national borders, however, such disturbances would be less amenable to national solutions. But integration could, conversely, also lead to stronger co-movements in economic activity, *e.g.* due to intra-industry trade,[2] which would allow shocks to be more quickly transmitted to all countries in which case monetary policy could play a stabilizing role, reducing the burden on fiscal policy. It is hard to say *a priori* which effect will dominate. Evidence from the United States shows that over time, regional specialisation remained strong in agriculture and grew (until the mid-20th century) in manufacturing industry, whereas services industries became steadily more integrated across state borders; as services became more dominant in the overall economy and factors more mobile so that even manufacturing started to converge, on balance the correlation of economic cycles across regions increased and regional differences in land and resources became less important.[3] The tables below show that in Europe, the process of convergence is already well established in terms of both the intensity of intra-industry (manufacturing) trade and intra-area flows of direct investment.

Indicators of convergence in the euro area

	Intensity of intra-industry trade[a] (as a per cent of total manufactures trade)				Foreign direct investment flows (as a per cent of GDP; yearly averages)			
					Inward investment from other euro area countries		Outward investment to other euro area countries	
	1970	1980	1990	1997[b]	1986-90	1991-95	1986-90	1991-95
Austria	53	65	79	78	0.26	0.28	0.17	0.24
Belgium	77	86	83	89	1.86	2.93	1.32	3.01
Finland	21	35	41	51	0.07	0.13	0.45	0.28
France	82	84	86	90	0.29	0.45	0.63	0.58
Germany	70	75	79	81	0.12	0.10	0.46	0.56
Ireland	27	61	54	42	0.15	0.07	0.00	0.00
Italy	70	61	67	70	0.16	0.17	0.28	0.28
Netherlands	68	69	77	77	0.62	0.98	0.65	1.44
Portugal	28	41	53	64	0.88	0.93	0.05	0.37
Spain	43	69	75	81	1.12	1.03	0.122	0.18

a) Intra euro-area trade.
b) 1996 for the Netherlands, Portugal and Spain.
Source: OECD, *Foreign Trade Statistics* and *International Direct Investment Statistics Yearbook*.

Policy shocks are likely to be attenuated in EMU, moreover. Even though a monetary policy geared to average euro-area price stability may not be well-suited to the economic situation in every country, policy shocks may diminish. Indeed, in the pre-EMU period, policies may often have acted as shock generators rather than shock absorbers. For example, monetary policy dominated by German economic conditions under the EMS probably was more asymmetrical than a common monetary policy will be. Fiscal policy was (apart from the 1974-75 recession) often pro-cyclical or only weakly counter-cyclical, while the failure to correct budget positions in subsequent upturns perpetuated the fiscal problem (see figure opposite).[4] On the other hand, adherence to the Stability and Growth Pact could ultimately enhance fiscal flexibility by establishing lower starting deficits, reducing sovereign risk premia, and enforcing greater symmetry over the cycle.

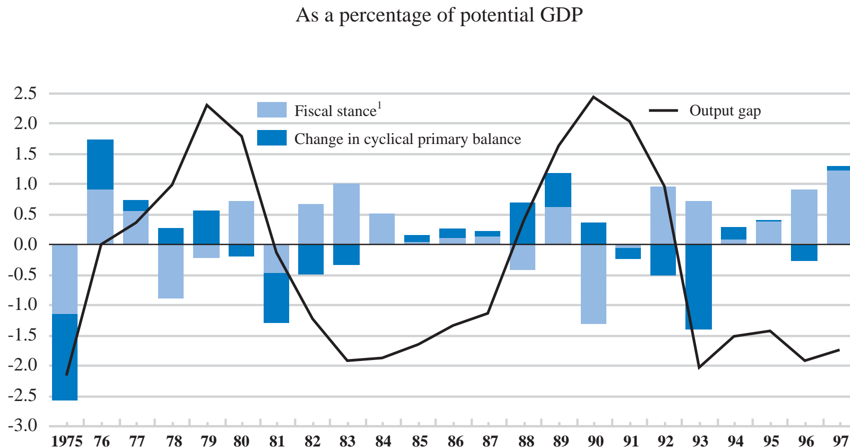
1. This is the view taken by the "new trade and growth" models, which emphasize increasing returns to production, among other things. See Krugman (1991).
2. This represents the view of the "neo-classical growth" models, *e.g.* Barro and Sala-i-Martin (1991).
3. See Kim (1997). Frankel and Rose (1998) also present more generalised empirical evidence that greater integration historically has resulted in more highly synchronised cycles.
4. Buti *et al*. (1998) show that this behaviour was entirely due to the group of the high-debt countries, whereas low-debt countries followed a *de facto* Stability Pact rule.

Box IV.2

Asymmetric shocks and shock absorbers in EMU *(continued)*

Fiscal policy and cyclical conditions in the euro area

As a percentage of potential GDP



1. Fiscal stance defined as change in primary structural balance as a percentage of potential GDP.

Integration could affect the effectiveness of fiscal stabilization, however. Deeper product market integration implies that trade leakages would shift much of the demand benefit of any fiscal stimulus to monetary union partners.[5] With increased debt and future tax costs of the fiscal expansion being fully borne by the home country, this would act as a strong disincentive to undertake stabilization policy. By contrast, increased asset market integration means that interest rate leakages would shift part of the adverse "crowding out" effects of a fiscal stimulus to other countries, making stabilization more effective (the Mundell-Fleming model result). Empirical work suggests that the impacts of financial leakages tended to dominate those in trade leakages in the past.[6] However, if intra-area trade and trade elasticities were to increase sufficiently under monetary union, the negative trade effects could come to dominate.

Another question pertains to the impact of EMU on endogenous adjustment mechanisms. The experience of Austria and the Netherlands, which have long been in *de facto* currency unions with Germany, shows that further trade integration and structural adjustment following the tight exchange rate link reduced the likelihood of wage shocks and improved aggregate wage flexibility, thus preserving national competitiveness. On the other hand, there is the risk that unions resist greater wage flexibility and a move towards EU-wide centralised wage bargaining cannot be excluded. Labour mobility is not likely to increase significantly, given cultural and linguistic barriers. Thus, it is not assured that, in the absence of government regulatory and fiscal reforms, endogenous adjustment mechanisms will automatically improve with the move to a common currency.

5. Although insofar as the common currency appreciates in response to a fiscal stimulus, all countries' net exports would suffer.
6. See empirical work cited in Van der Ploeg (1989). Englander and Egebo (1993) however find evidence of a dominance of trade leakage effects in Europe under EMS.

federal rules, hence only limited possibilities to stabilize demand. Work by the OECD Secretariat shows that in most European countries, stabilization of output shocks by automatic fiscal stabilizers fall within the 20 to 40 per cent range observed in other OECD countries (Table IV.7). Thus, existing stabilization mechanisms should prove adequate for EMU, and a member country's access to world capital markets could proxy very well for centralised fiscal transfers (*i.e*. insurance across time rather than across regions).

Table IV.7. **Effects of automatic stabilizers**

Per cent

	First year	Full cycle
United States	16	32
Japan	32	28
Germany	41	40
France	20	24
Italy	8	10
United Kingdom	23	32
Canada	27	38
Southern Europe[a]	14	13
Other small EU[b]	23	33
Australia and New Zealand	16	20

Note: The results represent the percentage differences in the deviation of output from its base-line value in the cases where automatic stabilizers are, and are not, allowed to operate in response to a standard demand shock. They should be seen as indicative only as they reflect the properties of the OECD's INTERLINK model. Stabilization in the model is a result of two separate effects: *i)* the impact on the budget from a change in output gap, which depends on the size of government, the progressiveness of the tax and transfer system, and the cyclicality of government investment and consumption; *ii)* the size of the fiscal multipliers, which depends on the openness of the economy, the marginal propensity to consume, and the level and structure of taxation.

a) Unweighted average of Greece, Portugal and Spain.

b) Unweighted average of Austria, Belgium, Denmark, Finland, Ireland, the Netherlands and Sweden.

Source: OECD INTERLINK model simulations.

Policy co-ordination

The institutional basis for policy co-ordination is in place

With fiscal decentralisation, the question arises of whether co-ordination is possible and/or desirable in the area of public finances. The institutions and processes for co-ordination are already in place. First, there are the excess deficit procedures, noted above, which bring significant peer pressure to bear on budget policies. Second, there are the "Broad Economic Policy Guidelines" which allow the EU Council to make country-specific recommendations on both macroeconomic and structural policies, and which could be of help in achieving a policy consensus. Third, there are the high-level EU policy groups such as ECOFIN Council (Economics and Finance Ministers), the Euro-11 Group (a subgroup of ECOFIN specific to EMU), and the Taxation Policy Group (group of personal representatives of the Ministry of Finance).[26]

Harmful tax competition is a major concern

As economic integration within the euro area deepens, spillovers due to increasing mobility of tax bases could limit the ability of Member countries to achieve social goals and carry out stabilization. There is now active discussion in the EU and at the OECD regarding greater co-ordination of tax systems in order to foster tax efficiency and discourage harmful tax competition. The main concern driving efforts towards tax co-ordination is that cross-border tax competition could lead to emigration of the capital tax base, leading to a shift of part of the tax burden from capital to labour if expenditure levels are to be maintained. This problem will become more serious and evident with the implementation of EMU.[27]

26. Policy dialogue is nonetheless constrained by the fact that it must respect the strict independence of ECB and the autonomy of national fiscal policies.
27. See Hoeller *et al.* (1996) for more information on tax and spending harmonization issues in the EU.

Mobile capital is particularly vulnerable

Given the high mobility of capital (including highly skilled human capital), taxes levied on capital income are the most vulnerable to tax competition. Such mobility will increase with the move to EMU given the elimination of currency conversion costs and exchange risk. On the level of individual bank deposits and portfolio investments, there is ample (even if anecdotal) evidence of substantial flows to countries which do not tax interest paid to non-residents and do not exchange information with tax authorities in other countries. In response to this problem, there has been a recent European Commission proposal, a Directive to establish a "co-existence model" for the taxation of cross border interest flows of individuals. It would oblige EU countries to withhold tax on such flows within the Community or to provide exchange of information on cross-border interest payments to individuals. There is some question as to whether such arrangements would work well in the absence of wider multilateral agreements, as EU citizens could place their savings in non-EU countries. In effect, this would require that capital mobility remain significantly lower between the euro area and the rest of the world than within the euro area.

Attention is being paid to co-ordination of corporate tax systems

Attention has also been paid to greater co-ordination of corporate tax systems. These differ markedly across EU countries, not least because of differences in accounting and legal practices, causing non-neutral treatment of many activities. Besides differences in tax rates and tax bases, the tax treatment of cross-border income flows varies. Differences in tax treatment arise from the imposition of withholding taxes at source, the method and extent of relief of double taxation, and methods of allowing losses in one country to be offset by profits in another. But in particular, preferential tax regimes both in and outside the EU open up new avenues for avoidance. A recent ECOFIN resolution on a code of conduct for business taxation addresses such preferential regimes in EU Member states.[28] The European Commission is also planning to eliminate withholding taxes on cross-border interest and royalty payments between companies.

Tax harmonization is the objective for indirect taxes

In the area of indirect taxes, the EC Treaty provides for the principle of harmonization. As regards VAT, the European Union is committed to modernise and simplify the existing VAT system and, in due course, to transform it into a real common system, fully based on the origin principle. In the area of excise taxes, reducing the remaining wide dispersion of rates remains a goal, given the impacts on trade flows and tax base flight to low tax countries, though this may be difficult to achieve given the varying interests of industry and government.

Spending co-ordination is warranted in certain areas

Spending co-ordination could prove beneficial in areas characterised by strong international spillovers. For example, state aids to industry may distort intra-EU competition and prevent an efficient functioning of the internal market, which in turn has justified a centralised vetting of subsidies. As the conditions under which the Commission may grant derogations on a case-by-case basis have become stricter over the past few years, the overall level of subsidisation in the EU has come down, although not significantly. In the area of pensions, a move to defined contribution pensions that are portable across the EU could support a higher degree of labour mobility and regional adjustment while easing the public finance problem. Moving in this direction would require sorting out such issues as which country bears the cost of tax breaks on contributions during working life and of pension payments during retirement age when these differ.

28. Similar measures are proposed in the OECD Guidelines on Harmful Preferential Tax Regions. See OECD (1998*a*).

BIBLIOGRAPHY

ALESINA, A. and R. Perotti (1995)
"Fiscal Adjustment: Fiscal Expansions and Adjustment in OECD Countries", *Economic Policy*, No. 21.

ANGELONI, I., L. Buttiglione, G. Ferri and E. Gaiotti (1995)
"The Credit Channel of Monetary Policy across Heterogeneous Banks: The Case of Italy", Banca d'Italia *Temi di Discussione del Servizio Studi* No. 256,

BANK FOR INTERNATIONAL SETTLEMENTS, (1995)
Financial Structure and the Monetary Policy Transmission Mechanism, C.B. 394, Basle.

BANK FOR INTERNATIONAL SETTLEMENTS, (1996)
The Determination of Long-Term Interest Rates and Exchange Rates and the Role of Expectations, Conference Papers, Vol. II.

BANK FOR INTERNATIONAL SETTLEMENTS, (1997)
"The Evolution of Central Banking", Chapter VIII of its *67th Annual Report*, Basle, June, pp. 140-160.

BARRAN, F., V. Coudert and B. Mojon (1996)
"The Transmission of Monetary Policy in the European Countries", CEPII *Working Paper*, No. 96-03.

BARRO, R. and X. Sala-i-Martin (1991)
"Convergence Across States and Regions", *Brookings Papers on Economic Activity*, 1, pp. 107-182.

BAYOUMI, T. and P. R. Masson (1998)
"Liability-Creating versus Non-Liability-Creating Fiscal Stabilization Policies: Ricardian Equivalence, Fiscal Stabilization and EMU", *The Economic Journal*, Vol. 108, No. 449, pp. 1026-1045.

BERNANKE, B.S. and M. Gertler (1995)
"The Credit Channel of Monetary Policy Transmission", NBER *Working Paper*, No. 5146.

BLANCHARD, O. (1990)
"Suggestions for a New Set of Fiscal Indicators", OECD *Department of Economics and Statistics Working Paper*, No. 79.

BLANCHARD, O., J.-C. Chouraqui, R. P. Hagemann and N. Sartor (1990)
"The Sustainability of Fiscal Policy: New Answers to an Old Question", OECD *Economic Studies*, No. 15, pp. 7-36.

BONDT, G.J. de (1998)
"Credit and Asymmetric Effects of Monetary Policy in Six EU countries: An Overview", De Nederlandsche Bank *Staff Reports*.

BORIO, C.E.V. (1997)
"Monetary Policy Operating Procedures in Industrial Countries", BIS *Working Paper* No. 40, March.

BRAYTON, F., E. Mauskopf, D. Reifschneider, P. Tinsley and J. Williams (1997)
"The Role of Expectations in the FRB/US Macroeconomic Model", Federal Reserve *Bulletin*, Vol. 83, No. 4, April, pp. 227-245.

BRIAULT, C.B., A.G. Haldane and M. King (1995)
"Independence and Accountability", paper prepared for the *Seventh International Conference of the Institute for Monetary and Economic Studies* at the Bank of Japan in Tokyo, 26-27 October.

BRITTON, E. and J. Whitley (1997)
"Comparing the Monetary Transmission Mechanism in France, Germany and the United Kingdom: Some Issues and Results", Bank of England *Quarterly Bulletin*, Vol. 37, No. 2.

BUTI, M., D. Franco and H. Ongena (1997)
"Budgeting Policies During Recessions – Retrospective Application of the Stability and Growth Pact to the Post-War Period", European Commission, *Economic Papers*, No. 121.

BUTI, M., D. Franco and H. Ongena (1998)
"Fiscal Discipline and Flexibility in EMU: The Implementation of the Stability and Growth Pact", *Oxford Review of Economic Policy*, Autumn.

BUTTIGLIONE, L., P. Del Giovane and O. Tristani (1997)
"The Role of the Different Central Bank Rates in the Transmission of Monetary Policy", Banca d'Italia *Temi di Discussione del Servizio Studi* No. 305, April.

CANDELON, B. and E. Cudeville (1997)
"Politique monétaire et canal du crédit : Une estimation empirique sur l'économie française", *Revue d'Économie Politique*, 107(6).

CARLINO, G. and R. Defina (1995)
"The Differential Effects of Monetary Policy Shocks on Regional Economic Activity", Federal Reserve Bank of Philadelphia*, Working Paper,* No. 95-15.

DORNBUSCH, R., C.A. Favero and F. Giavazzi (1998)
"A Red Letter Day?", CEPR *Discussion Paper* No. 1804.

DUISENBERG, W.F., (1998*a*)
Hearing of Mr. Duisenberg, President designate of the ECB, at the Committee on Economics and Monetary Affairs and Industrial Policy of the European Parliament, 7-8 May.

DUISENBERG, W.F., (1998*b*)
"Europäische Währungsunion – Garant für Stabilität", Speech by the President of the ECB to the Wirtschaftsbeirat der Union in Munich, 24 August.

EHRMANN, M. (1998)
"Will EMU Generate Asymmetry? Comparing Monetary Policy Transmission across European Countries", paper presented at the Conference on Monetary Policy of the ESCB, Università Bocconi, Milan.

ENGLANDER, A.S. and T. Egebo (1993)
"Adjustment Under Fixed Exchange Rates: Application to the European Monetary Union", OECD *Economic Studies*, No. 20, pp. 7-40.

EUROPEAN CENTRAL BANK (1998)
"A Stability-Oriented Monetary Policy Strategy for the ESCB", Press release, www.ecb.int/press/, 13 October.

EUROPEAN COMMISSION (1977)
Report of the Study Group on the Role of Public Finance in European Integration (MacDougall Report).

EUROPEAN COMMISSION (1979)
Report of the Study Group on the Economic Effects of Budget and Financial Transfers in the Community (Forte Report).

EUROPEAN COMMISSION (1993)
"The Economics of Community Public Finance", *European Economy, Reports and Studies*, No. 5.

EUROPEAN COMMISSION (1998)
Commission's Recommendation for the Broad Guidelines of the Economic Policies of Member States and the Community, May.

EUROPEAN MONETARY INSTITUTE (1996)
Die statistischen Anforderungen für die Währungsunion, Frankfurt a.M., July.

EUROPEAN MONETARY INSTITUTE (1997*a*)
The Single Monetary Policy in Stage Three – Specification of the Operational Framework, Frankfurt a.M., January.

EUROPEAN MONETARY INSTITUTE (1997*b*)
The Single Monetary Policy in Stage Three – Elements of the Monetary Policy Strategy of the ESCB, Frankfurt a.M., February.

EUROPEAN MONETARY INSTITUTE (1998)
Convergence Report, Frankfurt a.M., March.

FRANCO, D. and T. Munzi (1997)
"Ageing and Fiscal Policies in the European Union", European Commission, *European Economy, Reports and Studies*, No. 4.

FRANKEL, J. A. and A. K. Rose (1998)
"The Endogeneity of the Optimum Currency Area Criteria", *The Economic Journal*, Vol. 108, No. 449, pp. 1009-1025.

FUNKE, N. and M. Kennedy (1997)
"International Implications of European Economic and Monetary Union", OECD *Economics Department Working Papers* No. 174.

GERLACH, S. and F. Smets (1995)
"The Monetary Transmission: Evidence from G-7 Countries", in BIS, *Financial Structure and the Monetary Transmission Mechanism*.

GILDEA, J. (1992)
"The Regional Representation of Federal Reserve Bank Presidents", *Journal of Money, Credit and Banking* 24(2), May, pp. 215-25.

GROS, D., G. Tabellini and N. Thygersen (1998)
"The European Central Bank: Problems and Perspectives", EMU Net/Politics and Economics (www.euro-emu.co.uk/pubs/), September.

HAVRILESKY, T. and J. Gildea (1992)
"Reliable and Unreliable Partisan Appointees to the Board of Governors", *Public Choice* 73(4), June, pp. 397-417.

HAVRILESKY, T. and J. Gildea (1995)
"The Biases of Federal Reserve Bank Presidents", *Economic Inquiry* 33(2), April, pp. 274-84.

HOELLER, P., M.-O. Louppe and P. Vergriete (1996)
"Fiscal Relations Within the European Union", OECD *Economics Department Working Paper* No. 163.

INTERNATIONAL MONETARY FUND (1998*a*)
Code of Conduct on Fiscal Transparency, Washington, March.

INTERNATIONAL MONETARY FUND (1998*b*)
"Economic Policy Challenges Facing the Euro Area and the External Implications of the Euro", *Background Annex for the World Economic Outlook*, Autumn.

ISSING, O. (1992)
"Theoretical and Empirical Foundations of the Bundesbank's Monetary Targeting", *Intereconomics*, November/December, pp. 289-300.

ISSING, O. (1997)
"Monetary Targeting in Germany: The Stability of Monetary Policy and of the Monetary System", *Journal of Monetary Economics* 39, pp. 67-79.

KIELER, M. and T. Saarenheimo (1998)
"Differences in Monetary Policy Transmission? A Case not Closed", Paper presented at the *Conference on Monetary Policy of the ESCB*, Università Bocconi, Milano.

KIM, S. (1997)
"Economic Integration and Convergences: US Regions, 1840-1987", NBER *Working Paper* No. 6335.

KRUGMAN, P. (1991)
"Increasing Returns and Economic Geography", *Journal of Political Economy*, Vol. 99, No. 3, pp. 483-499.

LEIBFRITZ, W., D. Roseveare, D. Fore and E. Wurzel (1995)
"Ageing Populations, Pension Systems and Government Budgets: How do They Affect Savings", OECD *Economics Department Working Paper* No. 156.

MASSON, P.R. and B.G. Turtelboom (1997)
"Characteristics of the Euro, the Demand for Reserves, and Policy Co-ordination Under EMU", IMF *Working Paper* No. 97/58, May.

MCGREGOR, R. (1996)
"FOMC Voting Behavior and Electoral Cycles: Partisan Ideology and Partisan Loyalty", *Economics and Politics* 8(1), March, pp. 17-32.

MINISTRY OF FINANCE OF DENMARK (1995)
"Policy Implications of the Ageing Population in Denmark", *Working Paper* No. 4.

MONTICELLI, C. (1998)
"Voting on European Monetary Policy", Banca d'Italia, Research Department, October.

JP MORGAN (1998)
EMU and Euro-Central Bank Assets, May.

MUNDELL, R. (1998)
"International Consequences of the Euro", *Wirtschaftspolitik 2000 – Die Rolle der Wirtschaftspolitik und nationaler Notenbanken in der WWU*, 26 Volkswirtschaftliche Tagung 1998 der Öesterreichische Nationalbank, Vienna.

OECD (1997)
Economic Outlook 62, Paris, December.

OECD (1998*a*)
Harmful Tax Competition, Paris.

OECD (1998*b*)
Maintaining Prosperity in an Ageing Society, Paris.

PIGOTT, C. and H. Christiansen (1998)
"Monetary Policy When Inflation is Low", OECD *Economics Department Working Papers* No. 191.

RICH, G. (1998)
Inflation and Money Stock Targets: Is There Really a Difference?", Paper presented at the International Conference on *The Conduct of Monetary Policy*, China, June.

SIVIERO, S., D. Terlizzese and I. Visco (1997)
"Are Model-Based Inflation Forecasts Used in Monetary Policy Making? A Case Study", Paper prepared for the Congress *Empirical Models and Policy Making*, Tinbergen Institute, Amsterdam, May.

STÖSS, E. (1996)
"Die Finanzierungsstruktur der Unternehmen und deren Reaktion auf monetäre Impulse", Deutsche Bundesbank *Diskussionspapier* 9/96.

SVENSSON, L.E.O. (1998)
"Inflation Targeting as a Monetary Policy Rule", Paper presented at the *Conference on Monetary Policy Rules* in Stockholm, 12-13 June, organised by the Sveriges Riksbank and the Institute for International Economic Studies, Stockholm University.

TOOTELL, G.M.B. (1991)
"Regional Economic Conditions and the FOMC Votes of District Presidents", *New England Economic Review,* March-April, pp. 3-16.

TOOTELL, G.M.B. (1996)
"Appointment Procedures and FOMC Voting Behaviour", *Southern Economic Journal* 63(1), July, pp. 191-204.

VAN DER PLOEG, F. (1989)
"Fiscal Aspects of Monetary Integration in Europe", CEPR *Discussion Paper* No. 340.

VISCO, I. (1995)
"Inflation, Inflation Targeting and Monetary Policy: Notes for Discussion on the Italian Experience", in L. Leiderman and L.E.O. Svensson (eds.), *Inflation Targeting*, Centre for Economic Policy Research.

VON HAGEN, J. (1998)
"Money Growth Targeting", Paper presented at Conference on *Monetary Policy Rules*, Stockholm, June.

WHITE, W.R. (1998)
"The Coming Transformation of Continental European Banking?", BIS *Working Papers* No. 54.

V. RECENT EQUITY MARKET DEVELOPMENTS AND IMPLICATIONS

Starting in mid-July of this year, the equity markets of most OECD economies began to turn down and by early October had fallen by 20 to 35 per cent. The drops generally followed, or were close to, recent peaks; the major exception among the larger OECD economies was Japan where prices were already low following the prolonged adjustment in the aftermath of the bubble economy. The declines that happened stood out both by their size and by their simultaneous occurrence in all major economies. Since then, these markets have recovered a large part of those losses and once again appear over-valued on a number of measures. This chapter addresses, in turn, the nature of the third quarter drop compared with previous such episodes, outlines some benchmarks against which current levels of equity prices can be measured and assesses the implications of declines in equity prices in general for economic activity in the OECD area.

Some features of the third quarter market declines

Share prices fell…

The peaks that were reached in various equity markets by mid-July followed a sequence of gains dating back to the early 1980s, in most cases broken only by short-lived setbacks. While there were sound reasons to believe that these longer-term trends in various markets represented a response to improved fundamentals, for example, the drop in inflation (Blanchard, 1993), by the late 1990s many of these markets appeared to have reached levels that were difficult to rationalise. Part of this process seems to have been driven by extrapolation of then favourable trends in earnings as well as increased investor complacency regarding risk. The declines that occurred in the third quarter appeared to be the result of a downgrading of earnings projections and a reappraisal by investors of the risks inherent in these markets. Much of this seems to have been triggered by the spreading and deepening financial problems in emerging economies.

… in all major economies

Equity market corrections are a periodic feature of all major economies but their simultaneous occurrence across a majority of G-7 economies is relatively uncommon. Using three *ad hoc* definitions,[1] based on quarterly changes in major stock indices, only four such episodes since the 1970s can be identified: *i)* the downturn following the first oil-price shock; *ii)* the "stagflation" period around 1981; *iii)* the crash in October 1987; and *iv)* in 1990, the German post-unification crisis and the collapse of the Japanese asset bubble which affected equity markets within the same quarter. In terms of the number of economies affected, the current period compares best with the first and third episodes.

The drop in equity prices that happened also departed from past experience in two other important respects:

Shares of financial institutions were hard hit…

– There was a sharp downgrading of bank and financial shares almost everywhere. While it is common for bank share prices to be more cyclical than total equity prices on average – due to the sensitivity of their loan portfolios

1. These were: quarterly drops greater than 2 standard deviations; half-yearly ones, larger than 3 standard deviations; and declines in real prices by more than 2 standard deviations over 4 quarters.

to business activity as well as to their equity holdings in most countries – additional factors would seem to have been at play. These included: *i)* uncertainties regarding bank exposure to emerging markets; *ii)* the recently disclosed large positions of some banks with highly-leveraged borrowers, like Long-Term Capital Management and others; and *iii)* the unresolved financial crisis in Japan.

… and overall volatility rose and remains high

– Major equity markets have become unusually volatile. The magnitude of day-to-day percentage changes of equity prices since early July – a rough measure of overall stock market volatility – has been high by the standards of the past three decades and the intra-month variability is second only to that at the time of the crash in 1987. Furthermore, their implied volatility (based on option prices) shot up in the third quarter of 1998 to levels seen only in Japan in recent years (Figure V.1). In response, investors moved substantial funds into various government bond markets, which drove longer-term yields to record lows in some cases (the safe-haven effect).

Taken together, the rise in the pricing of risk (implied by the increase in interest rate spreads between corporate and government bonds), the increase in volatility and signs of weakness in national banking sectors represent additional negative facets surrounding the economic outlook. A renewal of the downward pressures on equity prices seen in the third quarter could exacerbate these factors.

Equity prices in perspective

Valuation measures are out of line with past norms

It is very difficult to determine what is the "appropriate" price level for equity. At best, only a range of such estimates can be provided. As a first approximation, the levels of the dividend-price and price-earnings ratios (commonly used market valuation measures) can be compared with their historical norms (Table V.1). On this basis, the dividend-price ratios as of early October were still below the norms of the past three-and-a-half decades for most economies, with the exception of the United Kingdom despite the declines in prices that had been registered. This was true even when the October dividend yields were compared with those in the 1960s, a time when inflation was similarly low. Price-earnings ratios, on the other hand, although high, were less out of line, in part because of the previous very strong earnings growth in a number of countries.

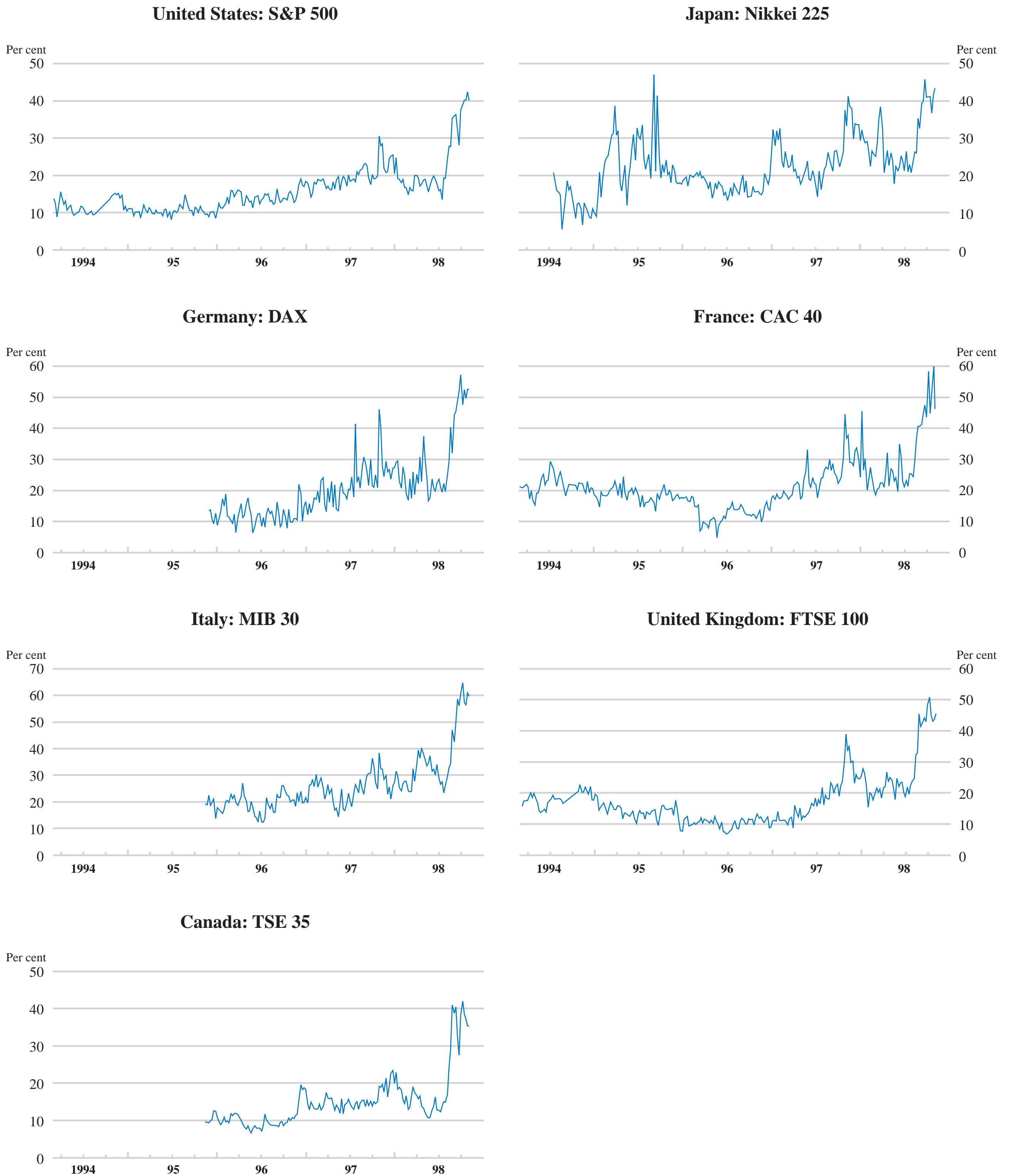
Over the past half decade there has been a fall in the dividend-pay-out ratio in a number of countries. One reason could be that corporations have changed how they distribute earnings – preferring to generate lower-taxed capital gains by re-investing earnings as opposed to paying dividends.[2] This could help justify some part of the unusually high prices as long as earnings growth is sustained. Another interpretation is that firms may not be raising dividend payments because current earnings are believed to be cyclically high and not sustainable.

Measures that emphasise the role of risk and earnings growth…

An alternative approach to assessing share prices that puts more focus on earnings sustainability, as well as investor perceptions of risk, starts from the premise that, in long-run equilibrium, the dividend-price ratio is directly related to equilibrium levels of the risk-free real interest rate and the equity risk premium less the growth in real

2. However, Cole *et al.* (1996) have adjusted the US data for this effect and they still find that the dividend yield is low.

Figure V.1. **Implied volatility of stock prices**[1]



1. Implied volatility could be interpreted as the market's prediction of future volatility and is calculated from call option prices using the Black-Sholes formula. The scale differs from country to country.

Source: Bloomberg.

Table V.1. **Some stylised facts in G-7 equity markets**[a]

	Whole period	1960-69	1970-79	1980-89	1990-97	1998 Q2	Oct. 1998	Nov. 1998
United States								
D/P	3.6	3.2	4.0	4.2	2.8	1.4	1.6	1.4
P/E	15.2	17.8	12.3	12.2	19.6	26.6	24.0	28.6
Japan								
D/P	2.2	4.4	2.3	1.1	0.8	1.2	1.2	1.0
P/E[b]	27.6	n.a.	13.9	22.7	41.4	115.5	n.a.	220.6
Germany								
D/P	3.0	n.a.	4.0	3.0	2.1	1.3	1.7	1.9
P/E[c]	14.0	n.a.	12.7	13.2	16.1	22.9	17.7	26.8
France								
D/P	4.2	n.a.	4.9	4.5	3.3	2.2	3.0	2.3
P/E[c]	11.8	n.a.	12.5	10.4	13.1	19.8	14.7	21.0
Italy								
D/P	3.0	n.a.	4.0	2.3	2.9	1.3	2.3	1.3
P/E[c]	16.9	n.a.	n.a.	15.6	17.4	30.6	19.6	43.6
United Kingdom								
D/P[c]	4.8	4.7	5.3	4.7	4.2	2.8	3.8	3.4
P/E[c]	11.4	14.6	9.8	9.4	13.2	18.4	21.9	23.9
Canada								
D/P	3.4	3.2	3.9	3.6	2.7	1.4	1.9	1.7
P/E	20.3	17.4	11.6	14.3	42.9	33.6	22.3	23.5

a) D/P denotes the dividend-price ratio and P/E the price-earnings ratio.
b) Price-earnings ratios have been adjusted for cross holdings between firms. Data start from 1976.
c) For Germany and France, data start from 1974; for Italy, data start from 1986; and for the United Kingdom, data start from 1963.
Source: OECD, Bloomberg and Salomon Smith Barney.

dividends.[3] Assuming that dividends are a constant fraction of earnings in equilibrium, the long-run growth rate of real earnings and dividends would be the same. The equity premium is the extra return (above the riskless real interest rate) required by investors to purchase stocks in recognition of their riskiness.

This approach can be used to make illustrative calculations of consistent sets of observations for the dividend yield, the real interest rate, the risk premium and growth. The first column in the lower panel of Table V.2, for example, shows the dividend yield consistent with October levels of the real rate of interest and average values of the risk premium and real growth over the past 18 years.[4] In a similar manner, the other columns show the implied level of the real interest rate, the risk premium or the real growth rate which could validate the October dividend yield with the other assumed determinants of share prices taking on the current (the real interest rate) or more recent historical average (the risk premium and real growth) levels. Comparing these implied values with their actual counterparts in the top panel of Table V.2, and bearing in mind the judgmental nature of this type of exercise, the following may be said:

… give mixed results across economies

– In October, the dividend yield consistent with average values of its determinants was still above current values for the United States and Canada despite

3. Formally, the expression is $D/P = r + \sigma - g$, where D/P is the dividend-price ratio; r the real interest rate; σ the risk premium; and g the growth rate of real dividends. This is a variant of the Gordon formula (see Myron Gordon (1962), *Investment, Financing and Valuation of the Corporation*, Homewood, Ill.). This expression can be re-written to show the determinants of the price-earnings ratio (P/E) by assuming a constant dividend-pay-out ratio (ν). Then the price-earnings ratio is: $P/E = \nu/(r + \sigma - g)$.
4. It is worth pointing out that judgement is required in deriving the historical risk premium which can only be inferred from the data. Concretely, the Gordon formula was used to derive a measure of the risk premium using average values of dividend yields, real interest rates and real growth over the past 18 years in most cases. A description of the method used is contained in Kennedy *et al.* (1998).

Table V.2. **Evaluations of current dividend yields**

Recent and historical data

	Dividend yield October 1998	Real interest rates	Average value of premium 1980-97[a]	Average potential growth 1980-97[b]
United States	1.60	3.90	1.70	2.50
Japan	1.18	2.75	0.34	2.00
Germany	1.71	4.00	0.36	2.25
France	3.01	4.00	0.86	2.15
Italy	2.28	4.00	1.19	2.20
United Kingdom	3.81	4.00	2.35	2.25
Canada	1.92	4.00	1.29	2.60

Measures of potential overvaluation

	Implied dividend yield[c]	Implied real interest rates[d]	Implied premium[d]	Implied growth of dividends[d]
United States	3.10	2.40	0.20	4.00
Japan	1.09	2.84	0.43	1.91
Germany	2.11	3.60	–0.04	2.65
France	2.71	4.30	1.16	1.85
Italy	2.99	3.29	0.48	2.91
United Kingdom	4.10	3.71	2.06	2.54
Canada	2.69	3.23	0.52	3.37

Note: The columns in the bottom panel are each calculated on the basis of the data in the top panel (see footnotes for details) and have no relationship to each other. Indications of overvaluation can be obtained by comparing similar columns in each panel, for example the current dividend yield (top panel) with that implied if the dividend yield were in line with fundamentals (bottom panel).

a) For Japan, Italy and Canada the 1980-89 average was used because of extreme values in the data in the 1990s.

b) Potential growth of the economy is used as a proxy for real dividends or earnings growth to put the calculations on a comparable basis across countries. For Japan, the historical average was not used. The potential growth rate for Japan was lowered in view of the mounting evidence that the slowdown in productivity seen in the first half of the 1990s reflected a permanent rather than a cyclical phenomenon.

c) Implied dividend yield is the sum of columns two and three, less column four in the top panel. It is meant to represent a proxy for the equilibrium level of the dividend yield.

d) Implicit values of the real interest rate, the premium and the growth rate are derived from the formula in footnote 3 of the text using the current dividend yield and various combinations of two of the other measures from columns two to four in the top panel.

the declines in prices that have occurred. The same was true for Germany and Italy although to a lesser extent.

– Similar patterns for these economies emerge when the other variables are examined. For example, the implied real earnings growth seems high while implied risk premia look low.
– On the other hand, based on the various calculations used, valuation measures in Japan, the United Kingdom and France all appear close to levels consistent with fundamentals as defined here.
– The bounce back in equity prices that has generally occurred in major markets has not appreciably changed these conclusions.

Possible effects on economic activity of a stock market decline

Share price declines directly affect consumption…

Changes in equity prices can have large and direct effects on economic activity through changes in household wealth. The impact will depend on how households view the decline (permanent versus temporary) as well as on their exposure to asset prices in combination with their marginal propensity to consume out of financial wealth. For the United States, an extensive empirical literature points to a relatively narrow

Table V.3. **Macroeconomic effects of an equity market correction**[a]

Consumption effect only, changes compared with baseline

Effects of a 20 per cent fall in real equity prices in each individual country

	Real private consumption (percentage points)		Real GDP (percentage points)	
	1st year	2nd year	1st year	2nd year
United States	–1.2	–1.1	–0.8	–0.8
Japan	–0.6	–0.7	–0.5	–0.4
Germany	–0.2	–0.4	–0.1	–0.2
France	–0.3	–0.2	–0.1	–0.1
Italy	–0.1	–0.2	0.0	–0.1
United Kingdom	–0.2	–1.0	0.0	–0.4
Canada	–0.3	–0.4	–0.1	–0.1

Effects of a 20 per cent simultaneous fall in real equity prices in G-7 countries

	Real private consumption (percentage points)		Real GDP (percentage points)	
	1st year	2nd year	1st year	2nd year
United States	–1.2	–1.2	–1.0	–1.0
Japan	–0.7	–0.8	–0.7	–0.8
Germany	–0.3	–0.5	–0.4	–0.5
France	–0.3	–0.3	–0.3	–0.4
Italy	–0.1	–0.2	–0.2	–0.4
United Kingdom	0.0	–1.0	–0.1	–0.7
Canada	–0.3	–0.4	–0.5	–0.5
OECD total[b]			–0.6	–0.7

a) Simulations based on fixed exchange rates and unchanged policies.
b) Weighted averages.

range for the estimated marginal propensity to consume out of equity market wealth of 4 to 7 per cent. Accordingly, the potential impact of a 10 per cent stock market correction on the level of private consumption, after one year, is calculated to be about 0.5 per cent for this economy. Because of a lack of similar studies and data for other economies, direct effects of real equity prices on household consumption in the G-7 economies were estimated by the Secretariat (Boone *et al.*, 1998). This work suggests similar orders of magnitude for the United States, but smaller impacts for the other economies.[5] These differences likely reflect, among other things, variations in the size of household equity holdings across countries. Based on the estimated effects on consumption, simulations carried out with the INTERLINK model, which allow for economy-wide ramifications of lower consumption, suggest that a 20 per cent simultaneous fall in equity prices in all the major countries could lead to a reduction in the level of output for the OECD area of around 0.7 per cent over the coming two years (Table V.3).

… and investment

Lower equity prices are also likely to have a direct negative impact on investment. Estimating this influence is, however, difficult as the effects come through channels – the real user cost of capital, the level of indebtedness of the corporate sector, the availability of internal finance, the uncertainty about demand and capacity utilisation – difficult to identify empirically (Whitaker, 1998). The effects on capital investment, moreover, would only materialise to the extent that stock market corrections were associated with a fundamental change in business conditions (Fama and French, 1989).

5. According to these results, a 10 per cent fall in real equity prices reduces US consumption by 0.5 per cent after one year. The effects are 0.4 per cent for the United Kingdom, 0.3 per cent for Japan and 0.2 per cent for Canada within 2 years. For continental European countries the estimated effect is less than 0.2 per cent within 2 years.

A recent study estimated that the potential impact of real equity prices on business investment could be four times as large as that on private consumption (Meredith, 1997). Since the level of investment in the major OECD countries is about one-fourth as large as that of consumption, based on this estimate the adjustment of investment and consumption following a fall in equity prices could contribute roughly equally to the decline in output.

Additional negative effects could be felt if the financial sector retrenches

The estimated ex ante declines in total demand provided above could well prove to be on the low side. During a major correction, increasing crisis awareness is likely to lead to a rise in the pricing of risk-taking (or an outright refusal to accept additional risks). In the event, financial institutions will have to adjust their balance sheets, inter alia by reducing the amount of credit they extend. In the worst case, this can lead to a "credit crunch" – such as happened in the wake of the US Savings & Loans and more recently the Japanese banking crisis – with strong additional impacts on consumption and investment. The effects here could be uneven across economies since the size of equity holdings in banks' portfolios and the sensitivity to a fall in equity prices varies. Even where bank equity holdings are low, however, there are additional sources of financial fragility. For example, as noted above, some banks are exposed to highly-leveraged investors. Finally, in most economies, institutional investors are important holders of equities; given a large correction, they too could come under pressure to reduce their exposure.

BIBLIOGRAPHY

BLANCHARD, O. (1993)
"Movements in the Equity Premium", *Brookings Papers on Economic Activity* 2, pp. 75-138.

BOONE, L., C. Giorno and P. Richardson (1998)
"Stock Market Fluctuations and Consumption Behaviour: some Recent Evidence", *OECD Economics Department Working Paper* (forthcoming).

COLE K., J. Helwege and D. Laster (1996)
"Stock Market Valuation Indicators: Is This Time Different?", *Financial Analysts Journal*, May/June, pp. 56-64.

FAMA, E. and K.R. French (1989)
"Business Conditions and Expected Returns on Stocks", *Journal of Financial Economics* 25, pp. 23-49.

GORDON, M. (1962)
Investment, Financing and Valuation of the Corporation, Homewood, Ill.

KENNEDY, M., A. Palerm, C. Pigott and F. Terribile (1998)
"Asset Prices and Monetary Policy", *OECD Economics Department Working Paper* No. 188, February.

MEREDITH, G. (1997)
"Effect of Equity Prices on Aggregate Demand", IMF Research Department memo, October.

WHITAKER, S. (1998)
"Investment in This Recovery: An Assessment", Bank of England *Quarterly Bulletin*, Volume 28, No. 1, February, pp. 38-47.

VI. LOW-INCOME DYNAMICS IN FOUR OECD COUNTRIES

Introduction

Information on low-income dynamics can help improve anti-poverty policies

In many OECD countries, policies concerning income distribution pay particular attention to poverty alleviation. However, poverty or low-income rates – which are the most commonly used policy indicators in this area – do not provide much information to help improve policies aimed at reducing the share of individuals facing low incomes. This chapter seeks to help fill this analytical gap by examining the dynamics of individuals around a low-income threshold for four OECD countries (Canada, Germany, the United Kingdom and the United States), supplementing earlier work on income distribution and poverty in *OECD Economic Outlook 62*. This study uses longitudinal data sets which follow individuals over time and enable flows into and out of low income and the length of stay below the low-income threshold to be estimated. Since these data sets also contain information on individual and household characteristics, they can also provide information about which types of individual stay longest below the low-income threshold and whether certain changes in household status – such as getting or losing a job or experiencing divorce – are associated with transitions into or out of low-income status.

This chapter is made up of five sections. Main conclusions are briefly outlined first. Data and definition issues are then addressed. This is followed by an overview of low-income dynamics for the most recent available six-year period for the four countries. The characteristics associated with those who are on low incomes for a longer period are then examined. Subsequently, the chapter looks more closely at changes in households when they move into or out of low-income status. A final section raises some policy issues that arise directly from the analysis in this chapter.

Main conclusions

There are a number of common features about low incomes and low-income rates across the four countries covered:

- Between 20 and just under 40 per cent of the population lived on low income at least one year over a six-year period. Within this group, however, the majority had short spells.
- People experiencing longer spells have a lower probability of exit and the chances of exiting also fall with previous experiences in low income. At the same time, there is a high probability of falling back below the low-income threshold. Thus, for those remaining on low incomes over a longer period, low probability of exit and high probability of re-entry tend to reinforce each other.
- A small group of the population remains on low income for longer periods of time with, apparently, very low chances of exit: people with low incomes for six or more years typically make up 2 to 6 per cent of the population. However, because of their long stays below the threshold, they represent from

around one quarter to just over a third of the total time all individuals spend below the low-income threshold (from 30 to just over 50 per cent if five+ years are considered).

- The tax-and-transfer system sharply reduces the share of individuals on low income, particularly among those on low incomes over longer periods and shortens the length of low-income spells.
- For three of the four countries, the characteristics of households experiencing shorter spells on low income tend to be different from those with longer-term spells. Some groups appear to be over-represented among those experiencing long periods on low income, in particular women, lone parents and elderly single individuals, and the sick and disabled. A significant share of these have jobs.
- Obtaining or losing employment and improving earnings is particularly important for transitions across the low-income threshold and also affect the length of time people spend on low incomes. Some aspects of this are:

  - A large share of transitions occur when there are employment/earnings-related "events" (*e.g.* getting or losing a job), particularly in the case of exits from low income. The probability of falling below the threshold is generally higher for employment-related "events" than for family-related "events" such as divorce or separation.
  - Households with more than one worker are better protected from falling below the low-income threshold and have shorter stays on low income when they do. Increased employment or hours worked by other household members is an important source of exit from low incomes and households which get a second job appear to shorten their spells by more than households which obtain a first job.
  - Employment is the main channel of exit for lone-parent households from low-income status and acts to reduce the average length of stay significantly.

Definition of income and the low-income threshold

Low-income transitions are defined in terms of a threshold equal to 50 per cent of median income

Following the methodology in *OECD Economic Outlook 62,* low-income status is defined as incomes falling below 50 per cent of the median of household disposable income adjusted for household size – a concept referred to below as equivalent household disposable income (see Box VI.1 for details on the data sets used and precise definitions). Data are annual. To assess the direct impact of the tax-and-transfer system, low-income rates and transitions have also been calculated, in some cases, using market income – *i.e.* disposable income plus taxes paid to and less transfers received from government – but using the same 50 per cent low-income threshold.[1] Thus, those with low incomes before taxes and transfers include those individuals who have been kept above the low-income threshold by the tax and transfer system.

In reviewing the results presented, two important caveats should be emphasised. First, this study is based on only a handful of OECD countries and, although these possess a range of institutions that might affect the extent of low incomes and low-income dynamics, there is no compelling reason to expect that they are representative.[2] Second, given the differences in data sources and time periods covered, one should be cautious about drawing too strong conclusions from cross-country differences.

1. Taxes and transfers have important indirect effects on low-income dynamics through work incentives. These effects are not considered here.
2. On the other hand, the results agree broadly with other studies that have used different definitions of low income or poverty, and they are likely to be robust in this sense.

Box VI.1. **Data issues and definitions**

Relatively few OECD countries have accessible and sufficiently developed longitudinal data sets and this study has been limited to four countries.[1] The data for the United Kingdom covers only six years, and to preserve comparability with other countries, the data presented here were restricted to the last available six years of data for the four countries.[2] The data sources are: *a)* the Canadian Longitudinal Administrative Database (LAD), a large file based on tax records and this information is used to attach family-based information to individuals; *b)* the German Socio-Economic Panel (GSOEP) which is a longitudinal data set containing information on around 28 000 individuals (although only the West German sub-sample was used); *c)* the British Household Panel Survey (BHPS), a nationally representative sample of private households in Great Britain containing about 17 000 individuals; *d)* the US Panel Survey of Income Dynamics (PSID) is a longitudinal survey based on a representative sample of 33 000 individuals.[3]

There are some important differences in the data across countries. Sample size is smaller for Germany, the United Kingdom[4] and the United States than for Canada but, for this country, information on individual and household characteristics is more limited, a factor which may partly explain some of the differences in results when compared to the other three countries.[5] Small sample sizes can increase the size of sampling error when the data for those on low incomes are broken down by characteristic (particularly for Germany where low-income rates are low). Canadian data are not fully consistent over time as social assistance benefits were underestimated before 1992. Thus, changes in low-income rates and in exits out of low income between 1991 and 1992 are likely to be overstated. Tax models have been used by national research teams to estimate taxes for Germany and the United States. Tax estimates were unavailable for the last two years for the United Kingdom, necessitating the use of pre-tax data for the entire period.[6] For these reasons, comparisons of the number of individuals below the low-income threshold across countries should be avoided.

For all countries the time unit is the year, which may not be the most appropriate period for policy purposes (Blank, 1989; Ruggles, 1990; Census Bureau, 1998).[7] Rates of entry into and out of low-income status are cyclically sensitive (Huff Stevens, 1994; Gottschalk and Moffitt, 1994) and cyclical effects have generally not been allowed for here.

The low-income threshold is defined relative to median equivalent household disposable income. This was calculated in the following manner:

- Household disposable income – defined as the sum of earnings, self-employment and capital income and private transfers plus income transfers received from general government less direct taxes and social security contributions paid – is summed across all individuals in the household.
- This value is then divided by the square-root of the number of household members to achieve equivalent household disposable income and this amount is attributed to each individual in the household, even though they may not earn income in their own right.[8]
- Individuals are ranked in terms of their income to create the distribution and the income of the median person is determined. The low-income threshold is defined in relative terms as 50 per cent of the median income in each year.

Other low income thresholds – for example, thresholds fixed at the beginning of the period in real terms – were not estimated.

1. This gap is being rapidly filled in many countries – for example, in Europe through the Eurostat European panel – but available time spans are generally too short for the kind of analysis carried out here. In some existing data sets, the sample proved too small (Italy), the data contained in them were not sufficiently detailed through time (Belgium, Sweden, Italy) or access could not be arranged (the Netherlands).
2. The periods are: Canada, 1990-95; Germany, 1991-96; the United Kingdom, 1991-1996; and the United States, 1988-1993. Thus for the United States, the effects of recent policy initiatives such as the Earned Income Tax Credit cannot be picked up. Some econometric estimates reported in this report used longer time periods.
3. Data for Germany and the United States were drawn from the Equivalent File prepared by Syracuse University, which attempts to create a common set of variables for both countries.
4. Data for the United Kingdom cover, in fact, only Great Britain and, thus, exclude Northern Ireland.
5. For example, it is not possible to trace children over time, as they formed new households. The head of household was also defined differently from the other countries in certain cases.
6. Given that the tax schedule is linear over the range where the low-income threshold appears, experts in the United Kingdom have suggested that the differences between pre- and post-tax results are likely to be small.
7. Indeed, many countries base access to social assistance benefits on previous monthly income. Thus, the spells of those individuals on low incomes for a month or two, but with high enough income in the rest of the year to bring annual income above the low-income threshold, would be missed (although one might be less concerned about such households). Ruggles (1990) estimates that using annual rather than monthly data could reduce the number of low-income spells by 20 to 25 per cent in the United States.
8. This allows for greater needs in larger families and for the fact that needs tend to rise less than proportionately with household size.

Low-income dynamics over a six-year period

Broad patterns of low-income dynamics

Three different dimensions of low income are shown in Figure VI.1 for the most recent available six-year period for the four countries (Box VI.1):

- The "static" low-income rate – calculated as the share of people on low incomes in the total population in each year and then averaged over the period. (This is conceptually equivalent to poverty rates calculated from static income distribution data and shown in *OECD Economic Outlook 62*.)
- The longer-term low-income rate – calculated as the share of individuals in the total population who had low income in every year through the six-year period.
- The rate of those with low incomes at least once – calculated as the share of individuals in the total population who had low incomes at least once through the period.

Many people experience low income over a six-year period

Looking first at the data on a post-tax-and-transfer basis, Figure VI.1 shows that the low-income situation is both better and worse than the "static" low-income rates suggest. On the one hand, the share of individuals who have low incomes throughout the period is small (in the range of 2 to 6 per cent of the population); on the other, the share of the population which fell below the low-income threshold at least once over the six-year period is large (between 19.5 and 38.4 per cent of the population). Indeed, the latter indicator is much higher than the "static" low-income rate, reflecting considerable turnover among those below the threshold.

Transfers reduce the degree of low income

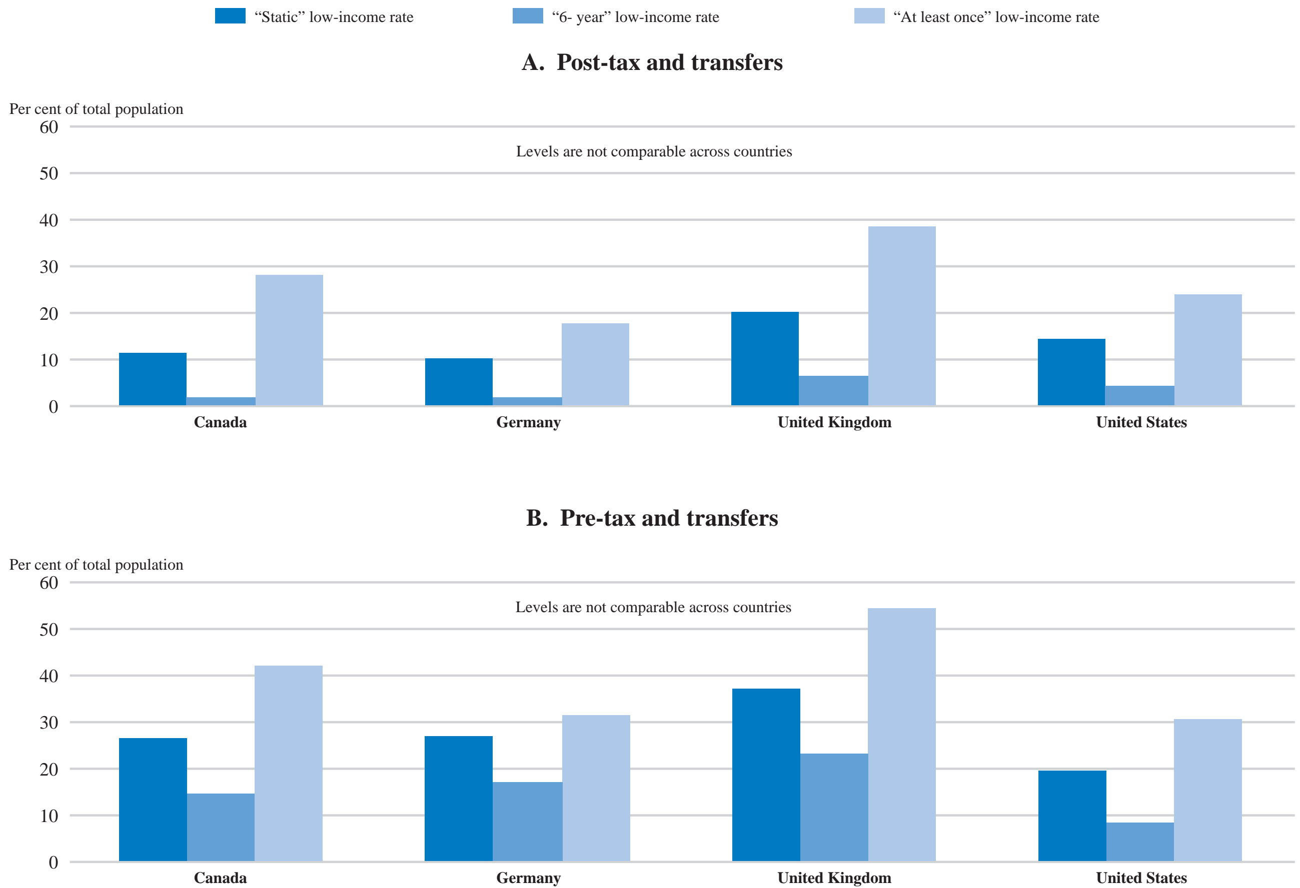
A key question concerns the impact of taxes-and-transfer systems on low income. A comparison of the top and bottom panels of Figure VI.1 suggests possible magnitudes for these effects[3] and confirms the results of *OECD Economic Outlook 62* (for five OECD countries) that taxes and transfers sharply reduce the number of those on low incomes in all four countries. Not surprisingly, the effect is smallest in the United States while, in the remaining three countries, the low-income rates before taxes and transfers are roughly two to three times as large as after taxes and transfers. The difference is particularly marked for the share of individuals below the low-income threshold over a longer period in Canada, Germany and the United Kingdom – in the first two countries the rate falls from around 14 per cent to around 2 per cent.

Against this background, Table VI.1 shows the distribution of the time individuals remained on low income. The top panel breaks down the share of individuals touched by low income over the six-year period on the basis of the number of years spent on low income, including repeat spells.[4] In Germany, just over 46 per cent experienced low incomes only one year, which is higher than for Canada, the United Kingdom and the United States (25 to 35 per cent). The opposite is the case for those on low incomes for five+ periods which make up 25 to 30 per cent of those touched by low income for the latter two countries compared with only around 15 per cent for Canada and Germany.

---

3. As shown by Figure VI.1, the pre-tax-and-transfer, low-income population is larger than the post-tax-and-transfer population, and includes: *a)* all those with low incomes on a post-tax-and-transfer basis (but most of whom will now have a lower pre-tax-and-transfer income); and *b)* all those who are kept off of low incomes by the tax-and-transfer system. They are, thus, not the same sample. Transitions are judged against the same low-income threshold.
4. In the table, 5+ is the sum of five and six years or more spent on low income.

Figure VI.1 **The share of the population on low income**



Note: The "static" low-income rate is the share of those below the low-income threshold in the total population in each year averaged over the period. The "6-year" low-income rate is the share of individuals who are on low incomes for 6 years as a share of the total population. The "at least once" low income rates is the share of those who have experienced at least one year of poverty over the six year period as a share of the total population.
Source: OECD.

The low-income problem is concentrated among those on low income for longer periods

To obtain an estimate of the share of the total time each group spends below the threshold (Table VI.1, top panel), the shares in the columns of the top panel are weighted by the length of time each spends below the low-income threshold (one to six years) and, then, divided by the total number of years spent on low income by the whole population (the sum of the weighed values). The results in the bottom panel indicate why those with longer periods on low income are central to policy: semi-permanent low income is a more pressing social concern than transitory low income because these groups account for a large share of the total time spent in poverty. Those with five+ years spent as much as 50 per cent (the United Kingdom and the United States) of the total time spent on low incomes by the entire population over the six-year period. This group tends to suffer relatively more from being on low incomes and – where they are entitled to benefits – may potentially absorb a large share of the total spending for income support.

Table VI.2 shows "hazard" rates for low-income exit and re-entry for the same six-year window. These are defined as, respectively: *i)* the likelihood that people exit as a function of the time spent in low income (top panel); and *ii)* the likelihood that

Table VI.1. **Time spent in low income over a six-year period**[a]

		Share of individuals with low income for 1 to 5+ years[b] (%)					
		1 year	2 years	3 years	4 years	5+ years	Average number of years in low income
Post-tax and transfers							
Canada	1990-95	35.9	27.0	14.4	9.2	13.5	2.4
Germany	1991-96	45.6	19.4	12.0	7.6	15.5	2.4
United Kingdom	1991-96	26.0	19.3	13.6	13.2	27.9	3.1
United States	1989-93	33.0	18.5	11.2	10.1	27.3	3.0
Pre-tax and transfers							
Canada	1990-95	21.5	13.6	10.6	9.8	44.6	3.8
Germany	1991-96	20.6	14.3	9.9	9.2	45.9	3.8
United Kingdom	1991-96	14.8	12.4	9.7	9.5	53.7	4.2
United States	1989-93	27.9	15.1	11.5	8.8	36.7	3.4
		Share of total time spent in low income[c] (%)					
Post-tax and transfers							
Canada	1990-95	14.8	22.1	17.7	15.2	30.3	. .
Germany	1991-96	19.2	16.3	15.2	12.8	36.4	. .
United Kingdom	1991-96	8.3	12.3	13.0	16.9	49.6	. .
United States	1989-93	11.1	12.4	11.2	13.5	51.8	. .
Pre-tax and transfers							
Canada	1990-95	5.7	7.2	8.5	10.4	68.2	. .
Germany	1991-96	5.4	7.5	7.8	9.6	69.8	. .
United Kingdom	1991-96	3.5	5.9	7.0	9.1	74.5	. .
United States	1989-93	8.3	8.9	10.2	10.5	62.1	. .

a) The sample used includes all those individuals interviewed in each of the six years who have experienced at least one year in low income.

b) The share of individuals spending one to five+ years in low income as a share of all individuals touched by low income over the period. For example, 35.9 per cent of those experiencing low income over the six-year period in Canada faced low incomes for one year and 13.5 per cent for five years or more.

c) The following steps were used to calculate the values in each column. First, the values in each of the columns of the top panel were multiplied (weighted) by the number of years spent in low income shown in the heading (distinguishing between five years and six+ years). A weight of six was given to groups which have six or more years in low income, thus biasing downward the last column in the bottom panel. Second, these weighted values were then summed to estimate the total number of years spent in low income by the total population. Finally, the values in the columns of the bottom panel are the results of the first step divided by the total calculated in the second step.

Source: OECD.

individuals re-enter as a function of the time spent above the threshold (bottom panel).[5] Taking Canada as an example, 55.7 per cent of those falling below the low-income threshold leave in the first year and, of the 44.3 per cent remaining, 41.3 per cent leave during the second year. A fall in these "hazard" rates through the period indicates that people who remain on low incomes have progressively a more difficult time exiting low income, the longer the stay in low income lasts.[6]

Spells of low income are mainly short term, but there are many repeat spells…

Looking first at the post-tax-and-transfer data, Table VI.2 indicates rapid exit for most of those below the low-income threshold (top panel). Between 46 and 56 per cent of those falling below the threshold exit before one year and, by the end of the second, between two-thirds and three-quarters will have left. However, the bottom panel shows that there is considerable re-entry into low-income status. This

5. More specifically, the rate of exit is calculated as the number of individuals exiting low incomes in a period *t* as a ratio of the number of people still having low incomes at the end of the preceding period. The sample used in this table includes individuals where the start of a low-income spell (top panel) or the exit from low-income status (bottom panel) can be observed.

6. This can reflect either a declining probability of exit, because of feedback effects (such as the wastage of their human capital) or a sorting process in which those with the best chances of exiting leave first.

Table VI.2. **Low-income dynamics: "hazard rates"**[a]

		Probability of exiting from low income before:[b] *(rate x 100)*			
		1 year	**2 years**	**3 years**	**4 years**
Post-tax and transfers					
Canada	1990-95	55.7	41.3	38.8	35.4
Germany	1991-96	52.7	42.7	32.0	19.1
United Kingdom	1991-96	45.4	37.0	32.3	25.8
United States	1989-93	45.6	31.9	23.1	20.2
Pre-tax and transfers					
Canada	1990-95	41.0	25.3	18.7	14.3
Germany	1991-96	36.4	23.8	18.4	16.7
United Kingdom	1991-96	31.6	23.6	16.9	14.7
United States	1989-93	42.8	28.3	11.8	19.8
		Probability of re-entering into low income before:[c] *(rate x 100)*			
Post-tax and transfers					
Canada	1990-95	16.7	9.7	7.9	7.1
Germany	1991-96	25.6	13.0	17.5	15.5
United Kingdom	1991-96	32.8	18.2	11.0	10.0
United States	1989-93	31.8	21.5	18.3	18.6
Pre-tax and transfers					
Canada	1990-95	27.4	16.1	12.2	9.5
Germany	1991-96	29.3	10.2	6.4	3.9
United Kingdom	1991-96	28.7	13.1	13.1	7.5
United States	1989-93	35.1	23.5	17.0	20.7

a) Latest available six-year period. Includes all low-income spells or spells above the threshold where the beginning of the spell can be observed.

b) This is calculated as the ratio of those individuals, having just fallen below the threshold, who exit before the end of one, two, three or four years in low income relative to those still on low incomes at the beginning of each successive period. For example, in Canada, 55.7 per cent leave before the end of the first year and, of the 44.3 per cent who remain, 41.3 per cent leave between the first and second year.

c) The sample includes all those spells above the low-income threshold conditional on the individual having exited low income immediately before. The re-entry hazard is calculated as the ratio of those individuals observed to fall back below the threshold before one, two, three or four years above the low-income line over the population at risk. For example, of those who moved above the threshold and are still above the low-income line after one year, 9.7 per cent will fall back below the threshold in Canada between first and second years.

Source: OECD.

result confirms recent research (Gottschalk and Moffitt, 1994; Jarvis and Jenkins, 1997; Huff Stevens, 1995; and Laroche, 1997) and signals considerable recycling onto and off of low-incomes. A broad measure of the importance can be seen by combining the information in the top and bottom panels. As noted, between 46 per cent (the United States) and 56 per cent (Canada) of those entering low incomes would have left by the end of the first year. On the basis of information in the bottom panel, between 36 per cent (Canada) and 64 per cent (the United States) of these individuals would have fallen back to below the threshold for at least one year in the following four years.[7]

... and the chances of exiting low income decline with the length of spell

Table VI.2 also illustrates the declining probability of exit and of re-entry as the period lengthens. People who remain on low incomes have a progressively more difficult time exiting. On the other side of the coin, the longer the time since exit from low income, the smaller the likelihood of falling back in.

7. While the two tables are not strictly comparable, the difference in the importance of repeat spells can also be seen by comparing: *i)* the shares of individuals who have been on low incomes for one and two years over the six-year period (Table VI.1); and *ii)* those who escape low income after one and two years (Table VI.2).

Low-income dynamics before and after taxes and transfers

Taxes and transfers increase the rate of exit and shorten the spells…

The tax-and-transfer system has a substantial impact on the time spent in low income (Table VI.1) and on the rate of exit from individual spells (Table VI.2). This probably reflects the role of transfers on delaying entry or accelerating exit where a person moves onto a higher benefit – for example, on reaching retirement age. Comparing the pre- and post-tax-and-transfer data in the top panel of Table VI.1 shows that, in all countries, the tax/transfer system is associated with a rise in the share of those remaining on low incomes over the longer term. On a pre-tax-and-transfer basis, the share of total time spent below the threshold by those on low incomes over a longer period rises to between two-thirds and three-quarters of the total time all individuals spend on low incomes (Table VI.1, bottom panel).

... although they affect repeat spells less

The rate at which individuals exit from below the low-income threshold falls more sharply when moving from a post-tax-and-transfers to a pre-tax-and-transfer basis (although, once again, this is less the case for the United States) (Table VI.2, bottom panel). The difference pre- and post-tax-and-transfers is less marked for re-entry rates, possibly because those above the threshold (and at risk of re-entry) tend to receive less in the way of transfers than those below the threshold (and who may exit).[8]

The characteristics of those on low incomes by length of spell

Variation in the family and labour-market characteristics as the time spent below the low-income threshold lengthens can suggest which groups require more policy attention. Table VI.3 compares, for all four countries, the share of individuals with specific characteristics within four groups: the total population, the population remaining above the low-income threshold through the six-year period, those on low incomes only one year over the period and individuals who have low incomes for at least six years.[9]

Several broad patterns appear from Table VI.3, although they do not apply to all countries in all cases. Indeed, Canada appears to be quite different from the other three countries.[10]

Those with low incomes over a longer period tend to be concentrated in certain household types…

– First, with the exception of Canada, the following groups tend to be over-represented among individuals below the threshold for six years or more (particularly when compared to their share in the total population): those living in female-headed households, in lone-parent households, in single-adult households of retirement age,[11] in households where the head has lower education (Germany excluded),[12] and where there is no worker (one worker

8. For example, those exiting low income on getting a job will have more market income, less transfer income and pay more tax than those falling below the threshold on losing a job. Thus, the fall in income when moving from a pre- to post-tax-and-transfer basis will be smaller for those who have exited and are "at risk" of re-entry than for those who have fallen below the line and are "at risk" of exit.
9. While the data cover only a six-year period, some of those who were in low-income status in all of the six years will have been so before the period began and will continue to be so after the period ends. The characteristics are defined at the beginning of the period except for those on low income for one year. The broad results do not change if characteristics are defined in other years.
10. For Canada, there appears to be less difference both between individuals with short and longer-term, low-income status and, aside from employment status, between those above the threshold through the period and those on short and on longer-term low incomes. Part of the differences between Canada and the other three countries may reflect the differences in the nature of the data set (Box VI.1), but it may also reflect the impact of the transfer system on "high-risk" groups.
11. Result based on supplementary information.
12. This may reflect the fact that the education attainment variables (which refer to the head of household) may be a poor measure of total human capital. This may be particularly the case in Germany, where on-the-job training and apprenticeships may make up a larger share of total investment in skills than elsewhere. This can lead to an underestimate of the share of individuals with skills corresponding to "higher education".

Table VI.3. Characteristics of individuals above and below the low-income threshold

Per cent share of persons with a specified characteristic in each group

Household characteristics	Total population[a]	Above threshold[a]	Low income for 1 year[b]	Always in low income[a]	Total population[a]	Above threshold[a]	Low income for 1 year[b]	Always in low income[a]
	Canada				**United Kingdom**			
Head gender								
Head male	83.7	87.9	70.6	72.4	69.2	74.6	54.8	39.6
Head female	16.3	12.1	29.4	27.6	30.9	25.5	45.2	60.5
Employment status								
No worker	18.3	13.6	45.3	36.4	23.9	11.3	48.4	91.8
One worker	31.2	27.9	42.3	43.9	25.7	25.0	31.8	8.2
Two workers	39.0	44.3	11.3	17.9	36.3	45.0	16.0	..
More than two workers	11.5	14.2	1.1	1.8	14.1	18.7	3.8	..
Family type								
Single adult, no children	19.4	16.1	34.3	24.9	13.8	8.0	24.0	54.8
Two adults, no children	30.1	32.4	15.5	26.7	61.4	68.3	56.6	20.5
Single adult, children	4.4	2.1	11.3	11.6	2.4	0.6	4.5	11.2
Two adults, children	31.5	32.4	33.2	29.2	21.5	22.5	13.4	13.6
Large families	14.6	16.9	5.7	7.6	0.8	0.6	1.5	..
Age of household head[c]								
Young-age head	28.3	25.0	38.2	28.6	13.5	12.8	18.8	15.9
Prime-age head	34.0	35.7	34.8	33.4	43.8	49.9	33.6	15.9
Older-working-age head	21.8	22.6	21.6	22.0	24.9	25.5	26.4	15.5
Retirement-age head	15.9	16.7	5.4	16.0	17.8	11.8	21.2	52.7
Education level[d]								
Low education	..	..	..	..	3.1	25.3	36.9	68.2
Middle education	..	..	..	..	37.3	38.6	39.8	25.8
Higher education	..	..	..	..	29.6	36.1	23.4	6.0
	Germany				**United States**			
Head gender								
Head male	76.3	80.1	53.2	16.6	80.1	87.0	70.5	27.4
Head female	23.7	19.9	46.8	83.4	19.9	13.0	29.5	72.7
Employment status								
No worker	18.0	14.4	48.9	71.7	11.7	7.7	19.8	53.3
One worker	39.1	37.6	44.9	28.3	31.8	28.8	51.3	38.8
Two workers	35.6	39.8	2.5	..	42.0	46.9	25.0	6.6
More than two workers	7.3	8.3	3.7	..	14.5	16.5	3.9	1.4
Family type								
Single adult, no children	16.0	13.8	28.5	35.0	15.6	13.2	25.2	28.5
Two adults, no children	48.4	51.5	32.6	15.0	38.6	44.0	27.4	10.3
Single adult, children	3.1	1.6	14.3	32.6	9.1	4.4	14.5	48.1
Two adults, children	31.2	31.9	24.6	17.5	34.9	37.3	29.8	11.4
Large families	1.3	1.2	0.1	..	1.9	1.1	3.0	1.7
Age of household head[c]								
Young-age head	12.1	9.7	22.8	30.0	18.6	15.2	32.2	34.9
Prime-age head	46.5	48.4	41.7	31.2	50.6	53.9	40.6	33.4
Older-working-age head	27.1	28.1	17.6	10.8	19.8	21.3	16.0	12.7
Retirement-age head	14.3	13.8	17.9	28.1	11.0	9.7	11.3	19.1
Education level[d]								
Low education	28.2	26.2	31.0	29.5	18.8	12.4	25.5	58.5
Middle education	52.8	53.0	58.7	65.9	36.6	35.3	43.1	30.3
Higher education	19.1	20.9	10.3	4.6	44.6	52.2	31.5	11.2

Note: For definitions see Oxley, Antolin and Dang (forthcoming). Characteristics refer to the household head.

a) Characteristics defined at the beginning of the period.

b) Individuals who are in low income in only one year over the period, excluding spells occurring in the first and last year of the six-year period.

c) Young, prime-age, older-working-age, and retirement-age refer, respectively, to households with a head below 30, between 30 and below 50, between 50 and 65, and above 65 years old.

d) Low education is less than high-school; middle is completed high-school and higher is more than high-school education.

Source: OECD.

in the case of the United States). The concentration of those on low incomes over a longer period among these groups probably reflects the fact that many of these conditions, when they occur, tend to persist: for example, in the United Kingdom, lone-parenthood lasts, on average, for around six years (McKay, 1998) and, for older people, incomes change little, such that those on low incomes stay there for a long time (Census Bureau, 1998).

... which differ from the household types of those who remain on low incomes for only one year

– Again excepting Canada, there are significant differences in many of the characteristics between those on low incomes for one year only and for six or more years; those on low incomes only one year appear, in some dimensions, to be closer to those remaining above the threshold over the entire period. Compared to those with longer-term low incomes, individuals on low income for only one year live, to a greater extent, in households with at least one earner and are less concentrated among households which are headed by women, single adults, lone parents and the less educated. Thus, they appear to come from a wider span of the population.

Household employment is lower for those on low incomes over a longer-term period but many still work

– Aside from Canada, the number of workers in the household is a key factor distinguishing individuals with different lengths of time below the threshold. The share of non-working households is much lower among those always above the threshold than among those on low incomes only one year, and the share is highest among those with low incomes over the entire period. The share of longer-term low-income individuals living in households which have two or more workers is also small. However aside from United Kingdom, a significant share of those with low incomes for a longer period live in households that work, suggesting that the problems of low earnings also need to be addressed.[13]

Econometric tests find similar results for the role of employment and lone-parent households

These results are supported and enlarged by econometric tests of the factors affecting the length of stay on low incomes (Oxley, Antolin and Dang, forthcoming):

– Employment by the head of household reduces the stay below the low-income threshold with substantial effects also occurring when there is a second earner.[14]
– Lone-parent households (particularly where female-headed) appear to have significantly longer spells than the average.[15] However, when the head in lone-parent households is employed, the share experiencing low incomes over a longer-term period falls sharply, again emphasising the importance of employment.
– Individuals in poor health or disabled, or having experienced previous spells of low income have longer spells of low income, and, in the United States, this is also the case for non-whites and individuals with lower education levels.[16]

13. The problem of the working, low-income households appears more severe in Canada and the United States where there is a non-negligible share of two-earner households who were below the low-income threshold through the period.
14. The percentage of people remaining on low incomes after one year falls by 5 percentage points in Germany and the United States and by about 15 percentage points in the United Kingdom if the household head becomes employed. The additional fall when there is a second earner is 12 percentage points in Germany, 10 points in the United Kingdom and 9 points in the United States.
15. The tests also suggest that the share of women who are on low incomes for a longer-term period reflects the fact that lone-parent households are almost always headed by women. The results provide little support for the hypothesis that children, as a group, have longer spells of low income, although children in lone-parent households clearly do.
16. Some of these effects, particularly previous spells on low income, may be picking up the effects of unobserved personal or household characteristics.

Factors associated with low-income transitions

"Events" and transitions

Household characteristics often change when transitions occur

This section examines whether transitions might be linked to certain "events" which can propel households to below the low-income threshold or permit them to rise above it. Low-income transitions can result from changes in income and in household demography and, very often, such "events" occur at the same time. For example, changes in household size (such as the arrival of a child) means spreading income over a larger number of household members. Alternatively, in the case of separations or divorce, economies of scale are lost as two new households are set up even if the two adults do not change their labour-market status; and, in cases where one parent (typically the mother) takes legal responsibility for the children, the income of the original household is not always reallocated in line with the respective needs of the two new households. While the material presented in this section provides a clearer picture of factors correlated with transitions, these results do not purport to "explain" transitions across the low-income threshold. Changes in both income and household size are, themselves, driven by a number of inter-related decisions about household labour supply, household formation and fertility, as well as government tax-and-transfer policies.

Which "events" have households experienced when they enter and exit low income

Table VI.4 explores in more detail which family-structure and labour-market changes (or "events") have occurred most frequently when individuals have entered or left low-income status. Although it is conceptually difficult to categorise "events" cleanly into one category or another – because family-related and employment-related "events" are often intertwined – the total number of transitions is broken down into three broad categories:

- Transitions which occurred when there were employment/earnings-related "events" including changes in employment status, hours and wage rates.[17]
- Transitions associated with family-structure-related "events"– mainly cases related to separation/divorce, partnerships/marriage, as well as children or other family members forming new households.
- Transitions with "other events" – which covers all transitions where there were no changes in either employment/earnings or family structure. These were mainly cases where there were large changes in transfer payments.

Changes in employment or earnings are the most frequent "event" when transitions occur

Table VI.4 indicates that transitions which were concomitant with employment/earnings-related "events" made up the largest group, with the exception of entries into low-income status for Canada and the United Kingdom, where changes in family structure and the "other events" weigh heavily. A comparison of the two columns indicates that the role of employment/earnings is more marked at the level of the population living in households with a working-age head, as this group excludes a large number of the retired and this difference is particularly marked for the United Kingdom. Further, the importance of employment/earnings-related "events" is even more marked

17. Certain cases where employment changes occurred at the same time as changes in household needs are also included in this sub-category. These tend to be small in number and reallocating them to another category does not change the conclusions.

— Table VI.4. **Frequency of "events" associated with low-income transitions** —

Per cent share of total transitions

	Entries		Exits	
	Total population	**Household with working-age head**[a]	**Total population**	**Household with working-age head**[a]
	Canada			
Transitions by type:[b]				
Employment/earnings-related	26.1	28.1	38.4	44.4
Family-structure-related	19.0	20.4	16.1	28.1
Other factors[c]	37.9	33.7	28.2	19.7
	Germany			
Transitions by type:[b]				
Employment/earnings-related	47.1	51.5	50.1	55.0
Family structure-related	24.7	25.2	8.9	9.5
Other factors[c]	23.4	17.9	33.3	27.1
	United Kingdom			
Transitions by type:[b]				
Employment/earnings-related	27.5	34.2	41.2	51.6
Family structure-related	26.4	28.5	9.1	10.2
Other factors[c]	35.4	23.4	40.5	26.6
	United States			
Transitions by type:[b]				
Employment/earnings-related	57.4	61.5	62.1	64.9
Family structure-related	19.0	20.1	12.8	13.9
Other factors[c]	13.8	8.2	11.2	7.5

Note: See Oxley, Antolin and Dang (forthcoming) for description. Covers most recent six-year period of available data.
a) Refers to individuals in households with a working-age head.
b) The per cent shares do not sum to 100 per cent. The remainder includes cases which could not be classified.
c) Households which were either employed or unemployed in both periods and where income changes were not dominated by movements in earnings. Largely transfer-related.
Source: OECD.

for exits where they make up around 45 to 55 per cent (Canada, Germany, the United Kingdom) to over 60 per cent (the United States) of all exits for those in households with a working-age head. In contrast, family-status-related "events" – which supplementary analysis shows are relatively more concentrated among low-income single-adult and lone-parent households – are more important for entries than for exits.[18]

Separations or divorce are more important for entry than for exit

The frequencies shown in Table VI.4 do not show whether those experiencing an "event" are more likely to enter or exit low incomes. For example, a household separation may not lead to low-income status if both spouses are high earners. To clarify this, further tests were carried out to see the effects of certain "events" on the *chances* of entry and exit. To this end, Table VI.5 indicates by how much the probability of falling below or rising above the threshold changes if selected "events" occur.[19]

18. Most of those suffering a household breakdown tend to exit from low income by finding jobs and relatively few exit through finding another partner, although the latter occurs somewhat more frequently in Canada and the United States than in the other two countries.
19. Not all of the "events" included in Table VI.4 were listed in Table VI.5. For example, the first line of the first four columns shows only how much the probability of entry or exit from low income would increase if there were loss of jobs.

Table VI.5. Changes in probability of entry and exit when an "event" occurs

Changes in probability points

	Canada[a]	Germany	United Kingdom	United States
	Low-income entry[b]			
Change in employment status only				
Loss of all workers	0.45	0.41	0.28	0.37
Loss of some but not all workers	0.10	0.04	–0.01	0.08
One worker, fall in hours	. .	0.15	0.12	0.22
More than one worker, fall in hours	. .	0.00	–0.04	0.01
Change in family structure only				
Separations/divorce (spouse becomes head)	0.19	0.14	0.06	0.08
Child becomes head	. .	0.09	0.09	0.16
Concomitant changes in employment and family status				
Separations/divorce (spouse becomes head)				
Loss of all workers	0.73	0.82	0.49	0.62
Loss of some but not all workers	0.39	0.31	0.05	0.25
One worker, fall in hours	. .	0.58	0.28	0.45
Child becomes head				
Loss of all workers	. .	0.75	0.55	0.73
Loss of some but not all workers	. .	0.23	0.07	0.38
One worker, fall in hours	. .	0.48	0.34	0.59
	Low-income exit[b]			
Change in employment status only				
From zero to at least one worker	0.20	0.20	0.19	0.08
Additional workers in working households	0.27	0.40	0.36	0.37
One worker, increase in hours	. .	0.43	0.08	0.34
More than one worker, increase in hours	. .	. .	0.30	0.47
Change in family structure only				
Marriage/partnership (head becomes spouse)	0.30	0.11	0.00	0.39
Child becomes spouse	. .	. .	0.12	0.37
Concomitant changes in employment and family status				
Marriage/partnership (head becomes spouse)				
From zero to at least one worker	0.43	0.30	0.19	0.46
Additional workers in working households	0.46	0.46	0.36	0.63
One worker, increase in hours	. .	0.49	0.08	0.62
Child becomes head				
From zero to at least one worker	. .	. .	0.30	0.45
Additional workers in working households	. .	. .	0.45	0.62
One worker, increase in hours	. .	. .	0.20	0.61

a) Results for the Canadian data are less comparable to the other countries because information on labour-market and family status is more limited and some results may be affected by breaks in the data.
b) Changes in probability points are defined relative to a baseline which is, essentially, the probability of transiting when there is no change either in family or employment status.
Source: OECD.

Such tests of the correlation between "events" and transitions suggest that:

The chances of entry when an "event" occurs is high for loss of employment while second jobs have a large impact on exit

– For employment-related "events", the probability of falling below the threshold increases the most in the case of households losing all jobs or experiencing a fall in hours, family situation held constant. In contrast, it is second workers (or an increase in hours in a household with only one worker) which increase the probability of exit from low-income status the most. Further, the impact of the loss of jobs on the chance of falling below the threshold is higher than getting a job is for the probability of rising above the threshold. Thus, while

finding a first job in an unemployed household is an important first step in exiting low-income status, it is not a sure ticket. In many cases, a second earner or increased hours worked may be necessary: the results indicate that arrival of a second worker generally increases the probability of exit by more than for obtaining first jobs.[20]

– The increased probability of entry from separations and divorce or from children setting up on their own (employment held constant) is generally smaller than for a change in employment status.[21] However, the probability of entry increases sharply for all categories of family-structure-related "events" where they occur at the same time as employment-related changes. Put another way, the risk of falling below the threshold when an employment-related "event" occurs is lower if there is a stable household environment.

Selected policy lessons

Multi-earner households may reduce the risk of falling below the threshold…

In considering ways to reduce the number of individuals on low incomes, governments may need to pay greater attention to the distribution of earnings across households. Thus, multi-worker households reduce the risk of falling below the threshold if one worker loses a job. At the same time, the number of no-earner households appears to be an area of considerable concern, and the growing dichotomy between "work rich" and "work poor" households may have contributed to the widening in the distribution of income in many OECD countries (Oxley *et al.,* forthcoming). The present study (and *OECD Economic Outlook 62*) suggests that households with two earners are less likely to have incomes below the threshold, more likely to have shorter spells of low income and more apt to rise above the threshold – either because other household members enter the labour market or because remaining workers can increase hours worked more easily.

... and policies can encourage two-earner households

A number of policies can encourage two-earner households. Tax systems and labour-market legislation often discriminate against second earners and part-time work. In addition, more extensive systems of subsidised child-care can also facilitate second earners in households with children. Such policies also encourage single parents – where child-care expenses can reduce the net gains from employment substantially – to re-enter the labour market. All of these factors may partly explain why women's labour-market participation is so high and low-income rates so low in certain Nordic countries. But again there are difficult trade-offs. The budgetary costs of such measures when made available to the whole population can be high. Moreover, targeting such policies towards those on low incomes to keep costs down can lead to high effective tax rates over certain income ranges.

More attention to the specific difficulties of those in low income may be essential…

General policy changes are unlikely to be sufficient, however, and helping those on low incomes over a longer period could require policies tailored to problems specific to individuals in this group. A key problem is that, for many individuals on benefit programmes, the expected earnings from working are not seen to be very different from

20. It should be noted, however, that a significant share of all employment/earnings-related "events" shown in Table VI.4 concern workers who transit because their earnings increase. This indicates that upward earnings mobility of those in jobs is also an important channel for exit.

21. There are significant cross-country differences in the coefficients associated with specific family-related "events". Probabilities of entry on divorce, separations or children setting up households appear higher in Germany and the United States relative to other family-related "events" than they do in the United Kingdom. The arrival of children appears more important in the United Kingdom, while additional adults in the household appear more important in the other two countries. For Canada and the United States, the change in the probability of exit is higher for separations/marriage than for employment-related "events".

current transfer income – once the costs of working (such as child-care) are taken into account – and their prospects for enjoying subsequent upward earning mobility may be limited. But there may be additional impediments: lack of basic work skills; difficulties obtaining assistance in job search; uncertainty about their income in the transition period; loss of collateral benefits such as medical coverage or free school meals for children and loss of protection from creditors. Better policy co-ordination across the various agencies affecting those on low incomes may be required along with measures tailored to individual needs and better monitoring to ensure that individuals receiving assistance shoulder their part of the responsibility for a return to work and increased self-sufficiency. Unfortunately, there is not much evidence about which policies are most effective.

... and work-conditional income support may also be needed

The fact that a substantial share of low-income households have at least one worker indicates that getting people into jobs is not always sufficient to move households off low incomes. A number of countries use in-work benefits of different sorts to address this issue. A number of English-speaking countries have introduced employment-conditional transfers such as the Earned Income Tax Credit (EITC) in the United States, which was set to bring families with at least one full-time, year-round worker on the minimum wage above the (official US) poverty line, and Family Credit in the United Kingdom. Continental European countries have been focusing more on employment subsidies, often in the form of reduced social charges for the low paid. The various programme designs respond to the particular policy objectives given priority in the countries concerned, *e.g.* household poverty alleviation, compensating people for low earnings capacity, strengthening incentives for secondary workers to accept jobs, etc. Programme designs also reflect existing tax and benefit structures which in-work benefits have to be welded into. And they also have to take into account the existing situation as regards marginal tax rates, marginal rates of benefit withdrawal, as well as the distribution of wage rates. For these reasons, the most appropriate choice of instruments will depend on the circumstances in each country. But whatever the approach, measures need to be carefully designed so as maximise the overall impact on low incomes and minimise distorting effects on labour markets.

BIBLIOGRAPHY

BLANK, R. (1989)
"Analysing the length of welfare spells", *Journal of Public Economics*, pp. 245-273.

CENSUS BUREAU (1998)
"Dynamics of economic well-being, poverty 1993-94: Trap door? Revolving door? Or both?", *Current Population Reports*, US Department of Commerce, July.

GOTTSCHALK, P. and R. MOFFITT (1994)
"Welfare dependence: concepts measures and trends", *American Economic Review*, Vol. 84, No. 2, pp. 38-42.

HUFF STEVENS, A. (1994)
"The dynamics of poverty spells; updating Bane and Ellwood", *American Economic Review*, Vol. 84, No. 2, pp. 34-37.

HUFF STEVENS, A. (1995)
"Climbing out of poverty, falling back in: measuring the persistence of poverty over multiple spells", *National Bureau of Economic Research Working Paper*, No. 5390.

JARVIS, S. and S. JENKINS (1997)
"Low income dynamics in 1990s Britain", *Fiscal Studies*, Vol. 18, No. 2, pp. 123-142.

LAROCHE, M. (1997)
"The persistence of low income spells in Canada, 1982-1993", *Department of Finance, Economic and Fiscal Policy Branch Working Paper*, No. 98.

McKAY, S. (1998)
"Exploring the dynamics of family change: lone parenthood in Great Britain", in L. Leisering and R. Walker (eds.), *The Dynamics of Modern Society*, The Policy Press, University of Bristol.

OECD (1997)
Making Work Pay, Paris.

OXLEY, H., P. ANTOLIN and T-T. DANG (forthcoming)
"Poverty dynamics in selected OECD countries", *OECD Economics Department Working Papers.*

OXLEY, H. *et al.* (forthcoming)
"Income distribution and poverty in selected OECD countries, *OECD Economic Studies,* No. 29.

RUGGLES, P. (1990)
Drawing the Line, Urban Institute Press, Washington, DC.

Annex

This annex contains data on some main economic series which are intended to provide a background to the recent economic developments in the OECD area described in the main body of this report. Data for 1998-2000 are OECD estimates and projections. The data on some of the tables have been adjusted to internationally agreed concepts and definitions in order to make them more comparable as between countries, as well as consistent with historical data shown in other OECD publications. Regional totals and sub-totals are based on those countries in the table for which data are shown. Aggregate measures contained in the Annex, except the series for the euro area (see below) are computed on the basis of 1991 GDP weights expressed in 1991 purchasing power parities (see following page for weights). Aggregate measures for external trade and payments statistics, on the other hand, are based on current year exchange for values and base-year exchange rates for volumes.

The OECD projection methods and underlying statistical concepts and sources are described in detail in "Sources and Methods: OECD Economic Outlook" which can be downloaded from the OECD Internet site (http://www.OECD.org/eco/out/source.htm). A supplementary document, the "OECD Economic Outlook Database Inventory", can also be downloaded (http://www.oecd.org/eco/ data/eoinv.pdf). The construction of macroeconomic series of the euro area are described in another supplementary document (http://www.oecd.org/eco/data/euroset.htm).

NOTE ON STATISTICAL TREATMENT OF GERMANY,
THE CZECH REPUBLIC, HUNGARY AND POLAND

In this publication, data up to end-1990 are for western Germany only; unless, otherwise indicated, they are for the whole Germany from 1991 onwards. In tables showing percentage changes from previous year, data refer to the whole Germany from 1992 onwards. For technical reasons, data for the Czech Republic, Hungary and Poland are shown and included in aggregate measures for total OECD from 1993 onwards only. In tables showing percentage changes from previous year, data (for the Czech Republic, Hungary and Poland) are included from 1994 onwards.

Country classification

	OECD
Seven major OECD countries	United States, Japan, Germany, France, Italy, United Kingdom and Canada.
Smaller OECD countries	Australia, Austria, Belgium, the Czech Republic, Denmark, Finland, Greece, Hungary, Iceland, Ireland, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Sweden, Switzerland and Turkey.
European Union	Germany, France, Italy, United Kingdom, Austria, Belgium, Denmark, Finland, Greece, Ireland, Luxembourg, Netherlands, Portugal, Spain and Sweden.
	Non-OECD
Africa and the Middle East	Africa and the following countries (Middle East): Bahrain, Cyprus, Iran, Iraq, Jordan, Kuwait, Lebanon, Oman, Neutral Zone, Qatar, Saudi Arabia, Syrian Arab Republic, United Arab Emirates, Asia West and Yemen.
Dynamic Asian Economies (DAEs)	Chinese Taipei; Hong Kong, China; Indonesia; Malaysia; the Philippines; Singapore and Thailand.
Other Asia	Non-OECD Asia and Oceania, excluding China, the DAEs and the Middle East.
Latin America	Central and South America.
Central and Eastern Europe	Albania, Bulgaria, Romania, the Slovak Republic, the Newly Independent States of the former Soviet Union, and the Baltic States.

Weighting scheme for aggregate measures

Per cent

Country	Weight	Country	Weight
United States	32.14	Ireland	0.25
Japan	14.10	Korea	2.29
Germany	8.10	Luxembourg	0.06
France	6.18	Mexico	3.04
Italy	5.80	Netherlands	1.48
United Kingdom	5.45	New Zealand	0.27
Canada	3.15	Norway	0.47
Total of above countries	77.92	Poland	1.03
		Portugal	0.61
Australia	1.66	Spain	2.96
Austria	0.82	Sweden	0.86
Belgium	1.04	Switzerland	0.89
Czech Republic	0.62	Turkey	1.64
Denmark	0.55	Total of smaller countries	22.08
Finland	0.46	Total OECD	100.00
Greece	0.60	*Memorandum item*	
Hungary	0.45	European Union	35.22
Iceland	0.03		

Note: Based on 1991 GDP and purchasing power parities (PPPs). The benchmark year for the PPPs is 1990.

OECD PUBLICATIONS, 2, rue André-Pascal, 75775 PARIS CEDEX 16
PRINTED IN FRANCE
(12 98 64 1 P) ISBN 9264-15958-4 – No. 50415
ISSN 0304-3274