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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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FOREWORD

With this edition of the *OECD Economic Outlook*, a certain number of changes have been introduced to the presentation of the publication: the revamped cover, the more accessible layout and a more user-friendly book are among the most visible modifications. Nonetheless, the usual identity and contents of the *Outlook* have not been affected by this new format. The reader will find in this issue an analysis of prospective economic developments in the OECD area over the coming two years as well as recommendations on the economic policies needed to ensure sustainable economic growth in OECD Member countries. The detailed country notes provide an assessment of the economic situation and the outlook for each Member country and a certain number of non-member countries.

The policy assessment in this edition is based on a set of projections which were finalised on 25 March 1998 and published, in a preliminary edition, in early April. Thus, the consequences of the financial crisis which has affected Asia in the course of last year and the beginning of 1998 are incorporated here. On the other hand, the recent measures adopted by the Japanese authorities in order to deal with the current economic weakness and ensure sustainable economic growth in the longer term are not taken into account. However, an assessment of these measures is presented in a special box in the Editorial, which was finalised on 4 May 1998.

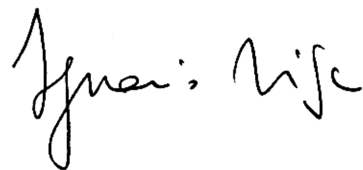
Beyond these issues which are covered in each edition of the *Outlook*, a number of other themes are dealt with in more depth in five special chapters:

- *Forces shaping fiscal policy*: in most OECD countries, public finances have been squeezed between rising transfers payments, largely intended to achieve equity objectives, and various forces acting to constrain taxation. Some possible reforms, and related problems, are assessed in this chapter.
- *Progress in implementing the OECD Jobs Strategy:* a vast array of measures have been taken in the past year in line with the recommendations embodied in the *OECD Jobs Strategy*. Nevertheless, progress has been uneven in different policy areas. On the whole, however, the analysis presented in this chapter confirms that the Strategy works, as illustrated by the growing number of countries which have taken comprehensive policy action and experienced falling structural unemployment.
- *The retirement decision:* changes in social security systems in most OECD countries have made it financially unattractive to work at older age: entitlement age to old-age pensions have fallen, pension benefits have been increased, and unemployment and disability schemes have been opened up to early retirees. This chapter evaluates the implications of recent pension scheme reforms in the context of ageing populations.
- *Potential advantages of economic instruments in dealing with climate changes:* the reduction of greenhouse gas emissions by OECD countries will reduce the growth of these emissions on a global scale. Nevertheless, to stabilize the level of gas emission and the atmospheric CO_2 concentration, the participation

of non-member countries is essential. This chapter analyses the potential importance of economic instruments, especially tradeable carbon emissions permits and carbon taxes.

– *The influence of emerging market economies on OECD countries' international competitiveness*: the large currency depreciations experienced by several emerging market economies have reinforced their competitive advantages. This chapter analyses changes in international competitiveness of OECD countries, and highlights the growing importance of Asian non-member countries in these changes and the implications for trade and international investment.

This publication is the joint work of all members of the Economics Department of the OECD. The analysis presented here has also benefited from discussions with colleagues throughout the Organisation. I hope that the new format will prove to be an easier, but no less informative, read.



Ignazio Visco

Head of Economics Department

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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
O	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

	1997	1998	1999	1997		1998		1999	
				I	II	I	II	I	II
	Percentage changes from previous period								
Real total domestic demand									
United States	4.1	3.9	2.7	4.4	4.0	4.5	2.6	2.6	3.0
Japan	–0.5	–1.0	0.7	0.7	–2.8	–0.7	0.4	0.6	1.3
Germany	1.2	2.1	2.7	1.5	0.4	2.8	2.3	2.9	2.8
European Union	2.2	2.7	2.8	2.6	2.7	2.8	2.7	2.8	2.8
Total OECD	2.8	2.6	2.6	3.2	2.3	2.8	2.4	2.5	2.8
Real GDP									
United States	3.8	2.7	2.1	4.3	3.3	3.1	1.4	2.1	2.6
Japan	0.9	–0.3	1.3	2.4	–1.4	–0.3	1.0	1.2	1.8
Germany	2.2	2.7	2.9	1.8	2.6	2.9	2.4	3.1	3.0
European Union	2.6	2.7	2.8	2.7	3.3	2.6	2.5	2.8	2.8
Total OECD	3.1	2.4	2.5	3.7	2.7	2.5	2.1	2.5	2.8
	Per cent								
Inflation[b]									
United States	2.0	1.6	1.8	2.1	1.5	1.6	1.7	1.8	1.8
Japan	0.6	0.5	0.0	0.9	1.0	0.7	–0.2	0.1	0.0
Germany	0.6	0.9	1.3	1.0	0.0	1.2	1.1	1.4	1.4
Total OECD *less* high inflation countries[c]	1.6	1.6	1.6	1.7	1.4	1.7	1.6	1.7	1.6
European Union	1.8	1.8	1.9	1.8	1.6	1.9	1.9	1.9	1.9
Total OECD	3.7	3.4	3.1	3.6	3.4	3.4	3.3	3.2	2.9
	Per cent of labour force								
Unemployment									
United States	4.9	4.8	5.0	5.1	4.8	4.7	4.9	5.0	5.0
Japan	3.4	3.5	3.6	3.4	3.4	3.5	3.5	3.6	3.6
Germany	11.4	11.5	11.1	11.2	11.6	11.7	11.4	11.3	11.0
European Union	11.2	10.9	10.5	11.3	11.1	11.0	10.8	10.6	10.4
Total OECD	7.2	7.1	7.0	7.3	7.1	7.1	7.1	7.1	7.0
	Per cent of GDP								
Current account balances									
United States	–2.1	–2.5	–2.8	–1.9	–2.2	–2.3	–2.7	–2.8	–2.9
Japan	2.3	3.2	3.7	1.9	2.6	3.0	3.3	3.6	3.9
Germany	0.0	0.4	0.7	–0.2	0.1	0.3	0.5	0.6	0.7
European Union	1.6	1.5	1.6	1.6	1.5	1.5	1.5	1.6	1.6
Total OECD	0.1	0.0	0.0	0.1	0.1	0.0	0.0	0.0	0.1
	Per cent								
Short-term interest rates[d]									
United States	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1
Japan	0.6	0.8	0.6	0.6	0.7	0.9	0.8	0.7	0.6
Germany	3.3	3.7	4.0	3.2	3.4	3.6	3.7	3.9	4.0
Major 4 European countries[e]	5.1	4.8	4.4	5.0	5.2	5.0	4.6	4.4	4.4
	Percentage changes from previous period								
World trade[f]	9.8	7.1	7.0	10.4	9.6	6.1	6.6	7.0	7.2

a) Assumptions underlying the projections include:
– no change in actual and announced fiscal policies,
– unchanged exchange rates from 18 March 1998; in particular $1 = ¥ 130.31 and DM 1.82;
– the cut-off date for other information used in the compilation of the projections was 25 March 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 rate; Japan: 3-6 month Certificate of Deposits rate; Germany, France, Italy and United Kingdom: 3-month interbank deposit rate.

e) Unweighted average of Germany, France, Italy and the United Kingdom.

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

EDITORIAL

Financial and exchange market tensions in Asia subsided during the first few months of this year. However, the situation in the region remains fragile. In the near term, all of the emerging countries affected by the crisis will have to undergo substantial adjustments in order to address the underlying problems exposed by the crisis. In the first instance, assuming that exchange rates in crisis countries and other emerging market economies remain unchanged, this will imply a large positive swing in the affected countries' current accounts – estimated at about $70 billion for 1998 and 1999 together – as well as a sharp slowdown in world trade growth.

The impact that such an adjustment will have on OECD countries' economies is likely to be significant. Nevertheless growth prospects for 1998-99 remain relatively favourable for the OECD area as a whole. Based on the projections presented in this issue of the *Outlook,* which do not take into account the latest developments in Japan (see box), economic activity in the area should expand at a rate around $2^1/_2$ per cent in 1998 and 1999, only slightly below the rates projected in the previous *OECD Economic Outlook*. However, unemployment will remain high in the area as a whole, while inflation is expected to be low nearly everywhere. The downward revision to the projections for activity is accounted for by a markedly weaker picture for Japan and Korea. In most OECD countries outside Asia, the underlying economic situation remains positive as policy responses and other forces acting on the economy, such as significantly lower long-term interest rates, are likely to mitigate the negative effects of the crisis.

In Japan, the already poor economic situation, as well as the existing weakness of the financial system, has been aggravated by the Asia crisis. The use of monetary policy to provide stimulus to the economy is severely constrained by the very low levels of short-term interest rates. Moreover, the fragility of the banking sector, by impeding intermediation, is contributing to the sluggishness of activity. Partly to respond to the current underlying weakness of the economy, the Government has announced a series of measures, culminating in a substantial and comprehensive package in late April which includes fiscal stimulus measures, structural reforms aimed at revitalising the business sector and measures to facilitate domestic financial flows.

These initiatives are welcome. The late April package, in particular, will boost domestic demand and activity in the near term. However, in order to promote a sustained recovery, the breathing space provided by better short-term performance should not be used to delay necessary adjustment, but rather to press ahead decisively with all the structural challenges that still lie ahead. One of these challenges is to deal rapidly with the extensive financial sector difficulties. An immediate priority is to address long-standing balance-sheet problems of the banking sector and improve the regulatory and supervisory framework. Important initiatives have already been announced by the Japanese authorities, but they will require careful implementation, in particular as regards the effective allocation and use of public funds, in order to restore private sector confidence and put the financial system on a sound basis.

Furthermore, product market competition should be enhanced through, in particular, an ambitious and sustained programme of regulatory reform. Structural reforms are fundamental to the improvement of Japanese medium- to longer-term prospects. Moreover, by raising the level of GDP, they would facilitate the achievement of the Government's medium-term objective of fiscal retrenchment, which remains a priority once the recovery becomes firmly established in view of the pressures that an ageing population will exert on public finances.

In Korea, recent signs are that the financial situation, though fragile, is stabilising, with some recovery of the won, stronger equity markets and a cautious revival of capital inflows. However, domestic demand will weaken sharply this year and, despite a strong contribution from net export growth, real output will stagnate at best. At the same time, unemployment and inflation are set to increase substantially. To address the fundamental problems of the economy, the Korean authorities have already initiated a wide range of structural measures. Their full and rapid implementation should strengthen confidence further and contribute to easing financial conditions that are currently very tight. This would provide scope for a reduction in interest rates and set the stage for a recovery of the economy next year.

In the United States, where the economy has been operating above potential for some time, the Asia crisis has reduced the risk of over-heating and hence eased the task of macroeconomic management in that respect. The weakening of US exports, together with the effects of the dollar appreciation on import prices, has delayed the need for increases in policy-controlled interest rates. The inherent uncertainty of the present situation has so far continued to favour a wait-and-see attitude on the part of US monetary authorities. Nevertheless, labour markets remain tight and wage growth is on a rising trend. Moreover, asset markets are buoyant and property prices have started to accelerate. Thus, inflation pressures could emerge as soon as the situation stabilises in Asia and temporary factors contributing to the present favourable outlook wear off. Partly reflecting the effects of the Asia crisis, the US external position is likely to deteriorate substantially over the next two years, with the current account reaching a deficit of almost 3 per cent of GDP in 1999. Given that the budget deficit has moved into balance, this widening in the external deficit mainly reflects an insufficient level of private saving. In view of the difficulty of designing effective policies

A brief update on the economic outlook

The projections contained in this volume were finalised on 25 March. Since then, the forces shaping the Japanese economic outlook have changed in two important ways. First, the underlying momentum in the economy has revealed itself to be weaker than had been expected. The Bank of Japan quarterly *Tankan* survey released in early April indicates that, based on capital spending intentions, there will probably be a substantial decline in business fixed investment over the next twelve months. Other incoming indicators on labour market and supply conditions also reveal stronger contractionary forces than had been projected.

Second, partly in response to that weakness, on 24 April the Japanese Government announced a comprehensive package of measures worth more than 16 trillion yen ($3^1/_4$ per cent of GDP) designed to shore up the economy. This package comprises a number of direct fiscal measures amounting to about 12 trillion yen, which consist of around 8 trillion yen in extra public works outlays and new infrastructure investment and further temporary tax cuts of about 4 trillion over the next two years. The package also contains a number of structural measures to promote more rapid deregulation, foster venture enterprises, help resolve the non-performing loan problem and enhance efficiency of land use.

The tax and spending part of the package responds in substantial manner to the economy's immediate need for stimulus and should have a significant positive impact on activity in the short term. There are however uncertainties as to its overall

to stimulate private saving, it might be desirable for the federal government to run budget surpluses in the years to come, especially as the surplus on social security will decline over time.

The situation has been improving in Europe. Growth has slowed to sustainable rates in some of the countries that risked overheating, while in most countries in the prospective euro area, the recovery seems to have become more broadly based, with domestic demand finally picking up. Even before the European Council decided, at the beginning of May, that eleven candidate countries would participate in the European Economic and Monetary Union (EMU) when it begins on 1 January 1999, financial markets clearly expected the convergence process to continue rather smoothly, as evidenced by the narrowing of intra-European long-term interest rate spreads. Nevertheless, it is important that countries in the future euro area do not satisfy themselves with the reductions in public deficits that have been achieved so far. Further progress is needed to ensure that fiscal positions are maintained on a sustainable path over the longer term.

The most pressing policy issue facing countries set to participate in the EMU still remains the implementation of reforms to reduce high levels of structural unemployment and increase the adjustment capacity of their economies. At this stage, it cannot be taken for granted that the advent of monetary union will create discipline and ensure a more rapid structural adjustment in the coming years. Consequently, authorities should take the opportunity offered by the current and projected favourable economic situation to make significant progress in the implementation of reforms that are essential to ensure the smooth functioning of EMU. Apart from labour market reform, it will be important that pension and fiscal reform, banking sector restructuring, competition policy and regulatory reform proceed at a faster pace and in a more uniform way across countries.

In sum, while the Asia crisis undoubtedly represents a shock for the world economy, its negative impact is likely to be limited for countries outside the Asian region. Countries directly affected should gradually recover, provided that policies currently being implemented proceed as effectively and rapidly as possible. Stable macroeconomic policies and sound financial structures, in particular as regards

and policy requirements in Japan

effect. Indeed, much depends on the speed of implementation of planned public spending and on the extent to which the proposed tax cuts translate into higher household consumption rather than extra saving. Depending on these two important conditions, the OECD Secretariat estimates that the overall effect of the fiscal part of the package on total demand might range from about 3/4 per cent to up to 1 1/4 per cent additional output in calendar year 1998.

These measures have thus the potential to head off the serious recession which would otherwise have occurred. If their implementation is rapid, the package may stabilise activity in calendar year 1998, and under favourable circumstances lead to real GDP growth of some 1 1/2 to 2 per cent over the fiscal year that has just begun. It will be important, however, to ensure that the recovery is sustained, in the first instance by taking care that the stimulus is not withdrawn prematurely. In particular, the expansionary impulse resulting from the temporary tax cuts should be maintained as part of an overhaul of the corporate and personal income taxes. The Government has already laid the foundations for such a strategy by announcing that it will present amendments to the Fiscal Structural Reform Law in the near future; these would, in particular, allow a two-year delay in the target for reaching the medium-term objective of 3 per cent of GDP for the deficit of central and local government. Ensuring a rebound in confidence and achieving a self-sustained recovery will also require that the momentum of structural reform be maintained.

supervisory and regulatory frameworks, are essential to the proper functioning of globalised financial markets. In order to overcome this crisis successfully, it is important that the foundations for liberalised financial markets be strengthened and that the adjustments in external positions that are taking place not be thwarted by a rise in protectionist pressures.

4 May 1998.

I. GENERAL ASSESSMENT OF THE MACROECONOMIC SITUATION

Main features of the outlook to 1999

Forces shaping the projections

Despite the Asia crisis the outlook outside Asia has not changed much

The financial crisis that began last summer in several emerging market countries in Asia intensified late in 1997, spreading to Korea and exacerbating a pronounced weakening in Japan which was already under way. Outside Asia, it has given rise to a number of compensating positive forces, notably lower long-term interest rates. Downward revisions for growth in the OECD area to around 2½ per cent during both 1998 and 1999 (Table I.1) almost entirely reflect poor outlooks for Japan and Korea. Indeed, in most OECD countries outside Asia little overall macroeconomic impact is so far apparent, although incoming trade reports are now showing steep declines in exports to affected Asian countries and the crisis has contributed to declines in oil and other primary commodity prices. In general, mature expansions should proceed at sustainable non-inflationary rates, although in some cases more slowly than in 1997, while recoveries in their relatively early stages should be strong enough to absorb spare capacity and lead to lower unemployment. (The projections reported in this edition of *OECD Economic Outlook* fully incorporate the OECD Secretariat's assessment of the effects of developments in Asia. More detailed analysis of the impact on OECD countries of the financial crisis that has affected a large part of the region is provided below. The outlook for non-member countries affected by the crisis is provided in Chapter III "Developments in Selected Non-Member Countries".)

Table I.1. **Growth projections for the OECD area**

	Real GDP			**Revision from *OECD Economic Outlook 62***		
	1997	**1998**	**1999**	**1998**	**1999**	**1998-99 (cumulative)**
	Per cent change from the previous year			***Percentage points***		
United States	3.8	2.7	2.1	0.0	0.2	0.2
Japan	0.9	–0.3	1.3	–2.0	–0.8	–2.8
European Union	2.6	2.7	2.8	–0.1	0.0	–0.1
OECD	3.1	2.4	2.5	–0.5	–0.1	–0.6

The crisis in emerging Asia will nevertheless have negative effects on world trade (Table I.2): as domestic demand slows in most of the region except for China, and contracts sharply in the most severely affected countries, imports will fall. As noted above, this is already becoming apparent from trade data. Given existing trade structures, Japan, and to a lesser extent Australia and New Zealand, would appear

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

	1997	1998	1999
	Percentage changes from previous period		
Merchandise trade volume			
World trade[a]	9.8	7.1	7.0
of which: Manufactures	11.4	7.7	7.4
OECD exports	11.3	7.6	6.9
OECD imports	10.0	8.9	7.5
Non-OECD exports	7.7	5.9	6.8
Non-OECD imports	7.7	2.0	5.7
Memorandum items:			
Intra-OECD trade[b]	11.7	9.6	7.5
OECD exports to non-OECD	7.2	2.1	5.7
OECD imports from non-OECD	7.8	6.1	6.7
Trade prices[c]			
OECD exports	0.8	0.8	1.5
OECD imports	1.3	–0.6	1.1
	Per cent of GDP		
Current account balances			
United States	–2.1	–2.5	–2.8
Japan	2.3	3.2	3.7
European Union	1.6	1.5	1.6

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 total OECD trade volumes and estimated trade flows between OECD and the non-OECD areas. Data are based on the 1991 structure of trade values, deflated by total OECD export prices.
c) Average unit values in local currency.

likely to bear most of the impact that this will have on export market growth (Table I.3). The current account deficit in the United States is projected to rise but, notwithstanding the crisis, surpluses will not change much in the European Union and will rise sharply in Japan.

Fiscal policies will continue to tighten, but less rapidly…

Fiscal policies have acted in recent years as a restraining force on economic activity, as Member countries have sought to bring their budget deficits down to more sustainable levels. In the case of European Union countries, this was made explicit in the Maastricht Treaty and it was reinforced by the need to respect the budget deficit criterion before decisions on participation in European Economic and Monetary Union (EMU) were taken in May 1998. During 1997, reductions in both actual and structural general government financial deficits were widespread and substantial (Table I.4). On current policy assumptions (Box I.1 on page 5), fiscal policies will continue to tighten somewhat in most of the OECD area, at least in 1998, but changes in stance should be considerably less important as a force shaping the outlook than in 1997. One important possible exception is Japan, where the supplementary budget package for the fiscal year 1997 and tax cuts incorporated in the fiscal year 1998 budget may only at best attenuate an overall underlying restrictiveness. Other countries where fiscal policies will continue to tighten include the United Kingdom and Korea.

… while monetary policies remain steady

Favourable inflation trends almost everywhere have allowed monetary policy over the past one to two years to provide an offset to fiscal retrenchment in most countries. Policy-controlled interest rates have remained low or stable in most countries where a large measure of price stability has been achieved (including the United States, Japan, Germany and France) and they have been reduced in countries where inflation has been on a sharp downward trend (Italy and smaller southern European countries). Against this background, and given the negative impact of the Asia crisis on trade, short-term interest rates are assumed

Table I.3. Merchandise trade between OECD countries and emerging Asian countries, 1996

Share in total exports and imports of OECD countries, per cent

	5 crisis countries[a]	China	Other emerging Asia[b]	Total emerging Asia
		Destination of exports		
United States	8.4	1.9	7.9	18.2
Japan	19.6	5.3	17.5	42.4
European Union[c]	6.5	2.3	6.4	15.2
Canada	1.9	1.1	1.2	4.2
Australia and New Zealand[c]	19.9	5.0	12.2	37.1
		Origin of imports		
United States	8.6	6.7	7.6	22.9
Japan	16.5	11.6	7.1	35.2
European Union[c]	6.5	4.5	6.1	17.1
Canada	2.8	2.1	2.2	7.1
Australia and New Zealand[c]	9.2	5.3	8.0	22.5

a) Korea, Indonesia, Malaysia, the Philippines and Thailand.
b) Chinese Taipei; Hong Kong, China; and Singapore.
c) Excluding intra-trade.
Sources: IMF, *Direction of Trade* (1997), OECD.

to remain fairly stable in the United States, Japan and the prospective euro area over the projection period (Figure I.1). In the prospective euro area, as the expansion becomes more firmly established, this is assumed to involve a modest increase in short-term interest rates in Germany, France and several smaller countries where they are now very low. It will also involve substantial declines during 1998 in some other countries, including Italy, Ireland, Portugal and Spain, as short-term interest rates converge during the run-up to the start of EMU on 1 January 1999. For the United Kingdom, short-term rates may ease later in 1998 as the economy slows, while in Canada rising money market rates have been built into the projections, mainly for 1998, in response to recent exchange rate weakness.

Table I.4. General government financial balances

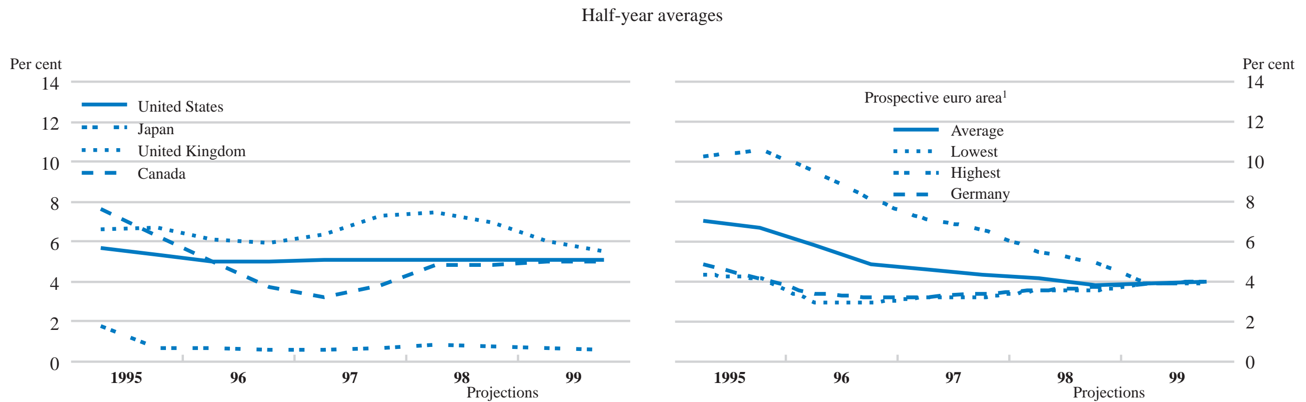
Per cent of GDP

	1996	1997	1998	1999	Change 1996-97	Change 1997-99
United States						
Actual balance	–1.1	0.0	0.4	0.1	+1.1	+0.1
Structural balance	–0.9	–0.3	0.0	–0.2	+0.6	+0.1
Japan						
Actual balance	–4.3	–3.1	–3.5[a]	–2.7	+1.2	+0.4
Structural balance	–4.0	–2.6	–2.2[a]	–1.3	+1.4	+1.3
European Union[b]						
Actual balance	–4.3	–2.4	–2.0	–1.8	+1.9	+0.6
Structural balance	–3.4	–1.7	–1.5	–1.5	+1.7	+0.2
Total OECD[b]						
Actual balance	–2.6	–1.3	–1.0	–0.9	+1.3	+0.4
Structural balance	–2.3	–1.1	–0.9	–0.8	+1.2	+0.3

a) Excludes the budgetary impact of the debt takeover of Japan National Railways and National Forest.
b) European Union figures exclude Luxembourg. Total OECD figures for the actual balance exclude, in addition, Mexico, Switzerland and Turkey. Total OECD figures for the structural balance further exclude the Czech Republic, Hungary, Iceland, Korea and Poland.

Figure I.1. Short-term interest rate developments and projections

Half-year averages



Note: Short-term interest rates are 3-month money market rates or interest rates on similar instruments.
1. Includes Germany, France, Italy, Austria, Belgium, Finland, Ireland, Luxembourg, Netherlands, Portugal and Spain.

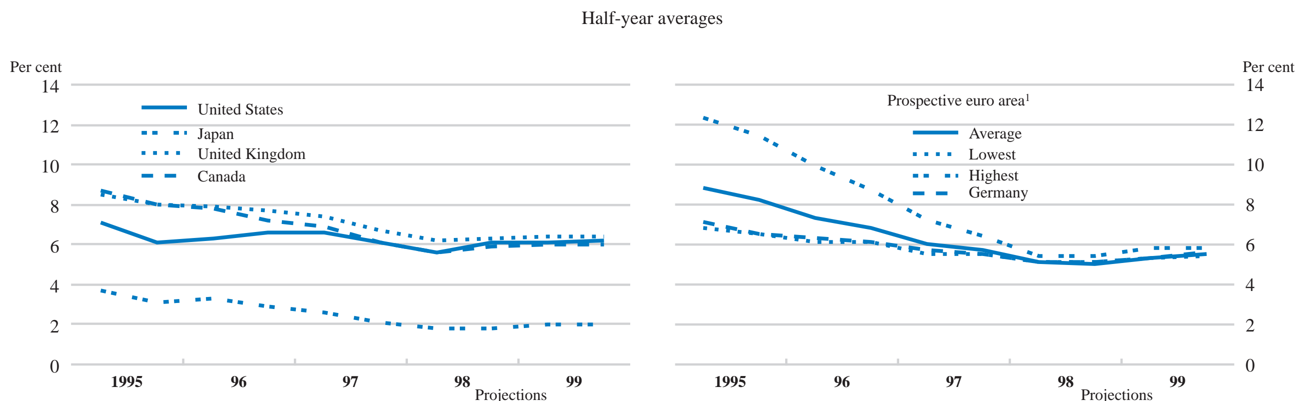
Following long declines, bond yields may start to firm

As inflation expectations have gradually adjusted to lower inflation outcomes and fiscal positions have improved, long-term interest rates have trended down in many countries (Figure I.2). The "flight to quality" in response to the crisis in emerging Asian countries has reinforced this trend in most OECD countries outside Asia. Given the favourable outlook for demand and activity in North America and Europe, and the extremely low level of government bond yields now prevailing in Japan, it appears likely that the declining trend in long-term interest rates of recent years will come to an end. These rates are generally projected to rise marginally during 1998 and 1999.

The most important change in the relationships between exchange rates of major OECD countries since early November, when the *OECD Economic Outlook* 62 projections were finalised, has been a continued strengthening of the US dollar, amounting to 7 per cent against the Japanese yen and around 4-5 per cent against the currencies of most European countries planning to participate in EMU in 1999. Most emerging economies in Asia, however, have experienced very sharp depreciations – in Korea,

Figure I.2. Long-term interest rate developments and projections

Half-year averages



Note: Long-term interest rates are 10-year government bond rates.
1. Includes Germany, France, Italy, Austria, Belgium, Finland, Ireland, Luxembourg, Netherlands, Portugal and Spain.

Box I.1. **Policy and other assumptions underlying the projections**

Fiscal policy assumptions are based on announced measures and stated policy intentions, where these are embodied in well-defined programmes. Details of assumptions for individual countries are provided in special boxes in the corresponding country notes. 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, although in some countries including Japan, the United Kingdom and Korea they remain restrictive throughout. With regard to monetary policy, 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 recoveries) or exchange rates. This is interpreted in the case of the United States to imply that short-term interest rates will be broadly stable over the projection period, while in Japan short-term interest rates should remain very low. European Economic and Monetary Union (EMU) is assumed to proceed from 1 January 1999 with eleven participating countries.[1] This leads to the elimination of differentials between comparable short-term interest rates across participating countries 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 lower end in the range of short-term interest rates in participating countries during 1998, and they are assumed to be 3¾ per cent when EMU begins.

The projections assume unchanged exchange rates from those prevailing on 18 March 1998; in particular, one US dollar equals ¥ 130 and DM 1.82. The fixed exchange rate assumption is modified for Hungary, Poland and Turkey to allow for continuous depreciation, reflecting the OECD Secretariat's interpretation of "official" exchange rate policies.

The average dollar price of OECD oil imports (cif) is estimated to average $14.35 in the first half of 1998, corresponding to an average price for Brent crude of around $14.10, and is projected to rise somewhat thereafter, averaging around $15.20 during the second half of 1999.

Non-oil commodity prices are projected to decline by 8½ per cent in dollar terms in 1998, on average, compared to 1997. They are projected subsequently to move in line with OECD manufactured export prices.

The cut-off date for information used in the projections was 25 March 1998.

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

even after the strong rebound since around mid-February as confidence in the won has improved, it amounts to nearly 35 per cent against the US dollar and to nearly as much on an effective basis.[1] This has caused many other OECD countries to experience overall losses in competitiveness. In the projections, nominal exchange rates are assumed to remain fixed at their 18 March 1998 levels.

Oil and commodity prices will remain weak

The weakness of oil and non-oil commodity prices embodied in the present projections will operate to restrain inflation in most countries. The steep decline in oil prices between November 1997 and mid-March 1998, when the price of North Sea Brent fell to a nine-year low of just below $12 per barrel, was due to several factors. These include the OPEC decision in November 1997 to increase production quotas and the return of Iraq to the market, which reinforced the effect of the crisis in Asia. Prices have, on balance, rebounded somewhat in response to cuts proposed in late March in production ceilings in OPEC and some non-OPEC oil producing countries, though they remain volatile. However, prices are still projected, on average, to remain lower than during the second half of 1997. The weakness of many non-oil commodity markets reflects a better outlook for crops (due to smaller "*El Niño*" effects than earlier discounted by markets) and a fall-off of Asian demand. The effects on most OECD countries, although not very large, should be favourable, strengthening real purchasing

1. The OECD Secretariat's calculations of nominal effective exchange rates and competitiveness indicators have been revised to take account of a larger number of trading partners outside the OECD area, and now include Argentina, Brazil, China, India, Indonesia, Malaysia, the Philippines, Russia and Thailand. The methodology and more details are provided in Chapter VIII "The Influence of Emerging Market Economies on OECD Countries' International Competitiveness".

power of households and reducing production costs. However, in important OECD oil and commodity producing countries, such as the United Kingdom, Canada, Australia, Mexico and Norway, losses of export revenue may be an important negative result.

The outlook for the main OECD regions

The outlook for Japan has significantly weakened…

The economic situation in Japan weakened sharply even before it was affected by the crisis in Asia and the outlook for the level of GDP in 1998 has now been revised down, cumulatively, by more than 4 1/2 percentage points since November 1996, when *OECD Economic Outlook* 60 was finalised. Japan is the most directly exposed to the Asia crisis of the industrial countries and will be the most affected. Export volumes to Asia were already falling in late 1997 and forward-looking data such as machinery orders point to further declines ahead. Other negative forces operating include continuing fiscal tightening which began in 1997 and the likelihood that a substantial part of the recently announced temporary tax cut will not be spent. With rising concerns about job insecurity, private consumption may remain weak throughout the projection period. Moreover, business spending will hardly rise as long as many enterprises continue to find bank credit difficult to obtain and inventory-to-sales ratios are high. Perhaps most importantly, a number of bankruptcies among financial and non-financial firms and a series of financial scandals have caused households and businesses to lose confidence and investors to retrench their positions. Provided that the financial sector situation does not deteriorate further and eventually begins to ease, confidence may gradually improve. However, on the assumption that there is no easing of the fiscal stance, in the form of a supplementary budget for the fiscal year 1998, no growth appears likely in 1998. Once the housing sector bottoms out, the economy may return to a modest growth path in 1999, with output rising by around 1 1/4 per cent.

… while growth will slow in many countries where expansions are mature…

Growth appears set to slow in several countries where it has been running above trend rates and spare capacity has largely been eliminated. In the United States, where growth and job creation continued to outpace expectations of many observers in early 1998, a number of forces should soon lead to a slowdown. The strength of the dollar and slower domestic demand in both Asia and Latin America will weaken exports. Business investment, which has been expanding very rapidly in recent years, should eventually slow, and the recent build-up of inventories should unwind (Table I.5). However, private consumption, buoyed by continuing real income gains of households and favourable wealth effects, should remain strong while stable monetary conditions and low long-term interest rates should attenuate the slowdown of aggregate demand. Overall, growth could slow to around 2 3/4 per cent in 1998 and 2 per cent in 1999, reducing the threat of overheating.

In the United Kingdom, following more than five years of expansion and a strong performance during most of 1997, growth has recently shown signs of faltering. This has largely been in response to tighter macroeconomic policies and a strong appreciation of sterling, and the impact of the crisis in Asia will reinforce this trend. As domestic demand gradually weakens, growth may average only 1 3/4 per cent during 1998 and 1999. Canada, where unused capacity still exists despite strong growth in 1997, should also experience some slowing as interest rates firm and the impact of the Asia crisis is felt. Among smaller European countries where expansions are now firmly rooted and spare capacity has been reduced to low levels or eliminated, Ireland, Denmark, Finland and Norway (mainland economy) may all experience some slowing of output growth to more sustainable rates.

Table I.5. **Contributions to changes in real GDP**

Per cent of GDP in previous period

	1996	1997	1998	1999
United States				
Final domestic demand	3.0	3.6	4.2	3.1
of which: Business investment	1.0	1.1	1.3	0.8
Stockbuilding	0.0	0.6	–0.2	–0.4
Net exports	–0.2	–0.5	–1.4	–0.9
GDP	2.8	3.8	2.7	2.1
Japan				
Final domestic demand	4.7	–0.5	–0.9	0.7
of which: Business investment	1.5	0.8	0.0	0.3
Stockbuilding	0.1	0.0	–0.1	0.0
Net exports	–0.8	1.4	0.7	0.6
GDP	3.9	0.9	–0.3	1.3
European Union				
Final domestic demand	1.7	1.8	2.5	2.7
of which: Business investment	0.4	0.5	0.7	0.7
Stockbuilding	–0.4	0.4	0.1	–0.1
Net exports	0.5	0.4	0.1	0.1
GDP	1.7	2.6	2.7	2.8
OECD				
Final domestic demand	3.1	2.5	2.6	2.7
of which: Business investment	0.9	0.8	0.7	0.7
Stockbuilding	0.1	0.4	0.4	0.1
Net exports	–0.3	0.2	–0.6	–0.3
GDP	2.8	3.1	2.4	2.5

… and domestic demand should increasingly sustain growth in most of continental Europe

Until recently the recovery of most countries in continental Europe has been underpinned mainly by exports, but the long-awaited revival of fixed capital formation now appears to be materialising. Given strong corporate earnings and rising business confidence, business investment spending should remain buoyant. If, as projected, long-term interest rates rise only slightly from the low levels reached in early 1998, they should provide at least a partial offset to the adverse impact of developments in Asia on exports. Real wage increases and improving household confidence may provide a moderate boost to private consumption which has been lagging the recovery in some countries – notably Germany and France. Growth in these countries should generally continue at a pace somewhat faster than in 1997.

Prospects are also good in most other OECD countries

Elsewhere outside Asia, Australia and New Zealand should benefit from relatively supportive macroeconomic policies as growth strengthens to slightly over 3 per cent during 1998 and 1999, notwithstanding their exposure to the Asia crisis. Among the emerging market Member countries, growth is expected to remain strong in Hungary, Mexico, Poland and Turkey. The Czech Republic is an exception to the generally buoyant picture in OECD countries outside Asia. With adjustment continuing after the currency crisis in May 1997, growth is projected to average little more than 1 per cent in 1998 and 1999.

The inflation outlook remains benign almost everywhere…

Inflation should remain low across nearly all of the OECD area (Table I.6). In the United States, the near-term inflation outlook should continue to benefit from the strength of the dollar and other restraining factors such as reduced health insurance costs. These effects are projected to diminish gradually and wage pressures to intensify, and inflation may return to a modest upward trend. In Japan, with the steep projected increase in the output gap over the next two years, upward pressure on prices should continue to be non-existent. While spare capacity will decline in most of

Table I.6. Inflation and labour market developments

	1996	1997	1998	1999
		Per cent		
Inflation[a]				
United States	2.3	2.0	1.6	1.8
Japan	–0.5	0.6	0.5	0.0
European Union	2.4	1.8	1.8	1.9
Total OECD less high inflation countries[b]	1.9	1.6	1.6	1.6
Total OECD	4.3	3.7	3.4	3.1
Employment growth				
United States	1.4	2.2	1.5	0.8
Japan	0.5	1.1	–0.1	0.2
European Union	0.3	0.6	0.9	0.9
Total OECD	1.1	1.7	0.9	0.9
		Percentage of labour force		
Unemployment rate				
United States	5.4	4.9	4.8	5.0
Japan	3.4	3.4	3.5	3.6
European Union	11.4	11.2	10.9	10.5
Total OECD	7.5	7.2	7.1	7.0
		Millions		
Unemployment levels				
United States	7.2	6.7	6.7	7.0
Japan	2.2	2.3	2.4	2.4
European Union	18.9	18.7	18.2	17.7
Total OECD	36.4	35.4	35.2	35.1

a) Per cent 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.

continental Europe, it is likely to remain sufficient to ensure that inflation stays low. However, "headline" inflation in Germany will be adversely, although temporarily, affected by the planned 1 percentage point increase in the value added tax, and in some smaller European countries where excess demand conditions are likely to prevail inflation may start to rise, albeit relatively moderately.

… while falling unemployment in the European Union will be matched by rises elsewhere

Following a decline in 1997, unemployment in the OECD area is projected to stabilize, remaining somewhat over 35 million persons or around 7 per cent of the labour force during 1998 and 1999. A substantial decline, amounting to around one million persons, should occur in the European Union (notwithstanding some rise in the United Kingdom), as employment rises by nearly 1 per cent per year – more strongly than at any time since 1990. In many continental European countries, unemployment has started to fall and it may come down further as the recovery spreads to the service and construction sectors, where employment responds relatively quickly to improving demand conditions. This downward trend in unemployment has already been observed in several small northern European countries for some time, and it is likely to continue there. Nevertheless, at close to 18 million persons by the end of the projection period, unemployment in the European Union will remain a serious economic and social problem.

Outside the European Union unemployment may rise in a number of countries, most importantly in Korea, where the crisis may entail a steep increase, of 800 000 persons, to more than 6 per cent of the labour force. Some rise is also projected in Japan, where the stagnation of output may lead to an increase in joblessness of more than

100 000 persons over two years, bringing the unemployment rate to a post-war high of 3.6 per cent. In the United States, the modest rise in the unemployment rate to 5 per cent, still low in historical terms and leaving no slack in the labour market, will imply a rise of around 300 000 persons.

The crisis in emerging Asia

Causes of the crisis

Long-standing structural weaknesses have amplified the crisis…

A number of factors have operated to generate the crisis in emerging Asian countries. (The main developments in the evolution of the crisis are set out in Box I.2 and more country-specific detail is provided in the country note on Korea in Chapter II "Developments in Individual OECD Countries" and in the section on Asia in Chapter III "Developments in Selected Non-Member Countries"). An important one, on which much attention has been focused, is the large number of structural weaknesses that exist in the affected countries, including: weaknesses in corporate governance arrangements; lack of transparency about business' financial situation and their relationship to government authorities; poor regulatory and supervisory arrangements in the financial sector; and tendencies to high indebtedness and over-leveraging in business sectors and to allowing financial institutions to continue operating with high levels of non-performing loans. While these structural deficiencies have played a major role in amplifying the crisis, and addressing them must be an important part of the solution, they have existed for many years without preventing the rapid growth and rise in living standards that most of the region has enjoyed during the past 30 years or more. They cannot explain, by themselves, the sudden collapse that the crisis countries have experienced.

… but the stage was set by more recent imbalances…

Two major developments stand out which set the stage for the immediate crisis. First, the sustained high growth in the region gave rise both to excessive optimism, throughout the region itself and in financial institutions in Europe, North America and Japan, and to insufficient weighing of downside risks. The result was very high levels of investment which led to:

- a tendency toward overheating, reflected in large current account imbalances (mainly in Southeast Asia); and/or
- excessive, and often highly leveraged, concentrations of capital in particular areas, mainly property and commercial building but also, especially in Korea, important industrial sectors. This led to over-capacity, unsustainable rises in asset prices, and low returns on investment or even operating losses. The result has been severe balance sheet problems which have threatened the viability of both non-financial enterprises and banking systems throughout the region.

Current account deficits were financed in good part by short-term capital inflows, which in the period immediately before the crisis were at record levels. Even where deficits have generally been fairly low (as in Korea and Hong Kong, China) or there have been surpluses (as in Singapore), integration of banking systems with international financial markets was high, and in the case of Korea, rising rapidly. Consequently, the region was vulnerable to international liquidity problems in the event of

Box I.2. **Chronology of the crisis in emerging Asia**

1997

23 January	Hanbo Steel, a large Korean conglomerate, collapses under $US 6 billion in debts, the first of a string of major corporate failures in 1997.
14-15 May	Thailand's baht comes under attack by speculators. Thailand and Singapore jointly intervene to defend the baht. The Philippine central bank raises the overnight rate 1¾ percentage points to 13 per cent.
27 June	Finance One, Thailand's largest finance company, shuts down, along with 15 other finance companies.
2 July	Thailand is forced to abandon the baht's peg with the US dollar – the trigger for the Asian financial crisis.
11 July	The Philippine central bank allows the peso to move in a wider range against the dollar.
14 July	The IMF offers the Philippines around $1.1 billion in financial support under fast-track regulations drawn up after the 1995 Mexican crisis. The Malaysian central bank abandons the defense of the ringgit.
14 August	Indonesia abolishes its system of a managed exchange rate. The rupiah immediately falls.
20 August	Thailand and the IMF agree on a rescue package which could potentially total $17.2 billion, including loans from the IMF and Asian countries.
20-27 October	Speculative attack on the Hong Kong dollar leads to a sharp rise in interest rates to defend the currency peg. The stock market in Hong Kong, China suffers sharp declines and losses ripple through world stock markets.
31 October	The IMF announces a $23 billion multilateral rescue package for Indonesia, which could provide more than $40 billion in aid if bilateral commitments under the second-line defense are included.
1 November	Indonesia shuts down 16 troubled banks.
17 November	Korea abandons its defense of the won, which quickly depreciates to more than 1 000 to the dollar. By the end of the year, it falls to a record low of nearly 2 000 to the dollar.
3 December	Korea signs an agreement with the IMF for a support package which could ultimately provide $57 billion.
8 December	The Thai government permanently closes 56 of 58 previously suspended finance companies.

1998

6 January	Indonesia unveils its 1998/99 budget based on unrealistic assumptions. The rupiah falls sharply.
12 January	Peregrine, the largest investment bank in Hong Kong, China, collapses, falling victim to massive bad loans to Indonesian borrowers. Shares fall sharply in Hong Kong, China, as well as in Singapore.
23 January	Indonesia presents a revised budget closely tracking recommendations by the IMF. The budget expects zero growth in fiscal year 1998, an inflation rate of 20 per cent, and an average rupiah rate of 5 000 to the dollar. The rupiah ends the day at 12 000 to the dollar.
27 January	Indonesia announces a temporary freeze in servicing of corporate debt.
28 January	International creditor banks and the Korean government agree on a plan to exchange $22 billion of short-term debt for government-guaranteed loans. By mid-February, Korea's sovereign risk rating is upgraded by the major rating agencies and the won recovers substantially through end-March.
13 February	The IMF and major OECD countries warn Indonesia not to adopt a currency board system to fix the value of the rupiah, saying it could shake confidence in Indonesia.
26 February	Indonesia's borrowers and lenders start negotiations on rescheduling at least $70 billion in private off-shore debt.
4 March	The IMF approves a release of the third tranche of the support package to Thailand and commends the Thai authorities for resolutely implementing the economic programme. The baht and equity prices continue to gain during the remainder of the month on improved market sentiments.
23 March	Indonesia raises interest rates sharply to control rising inflation and boost the rupiah, meeting a key demand of the IMF. It also drops a plan to levy a 5 per cent tax on foreign exchange purchases. The rupiah gains strongly following the interest rate hikes.

any diminishing of optimism about its prospects, while, at the same time, investment performance was increasingly inviting a more cautious assessment of these prospects.

… and exchange rate policies too oriented to the dollar

Second, most emerging countries in the region have historically adopted a policy of either pegging their currencies to the US dollar or managing them while attaching a higher weight to the dollar than today's trade relations would justify. This policy proved to be misguided when the dollar rose sharply, notably against the Japanese yen, after mid-1995. The erosion of competitiveness put particular pressure on industries, notably in Korea, which compete directly in third markets with Japanese counterparts. It also reduced the incentives for Japanese multinationals, whose direct investment had been a major source of dynamism in some Southeast Asian economies, to continue shifting production from Japan to their subsidiaries in the region. At the same time, the rising export orientation of the Chinese economy, which has benefited from high levels of inward direct investment and low labour costs, put increasing pressure on industries reliant on low skilled labour elsewhere in the region.

When the Thai baht fell, a domino effect set in and the crisis spread

The trigger to the crisis was the reassessment by international financial markets of prospects in Thailand, which resulted in the depreciation of the Thai baht in July 1997. This had two effects which caused the situation in Thailand to deteriorate and created pressures for similar developments to occur or to threaten elsewhere in the region. First, the earlier stabilization of the baht against the dollar had generally been viewed as credible, leading many borrowers to maintain open foreign exchange positions. Depreciation then encouraged local borrowers to rush to hedge or to close these positions, increasing the downward pressure on the currency. At the same time, it increased debt burdens in local currency terms, in some cases turning highly leveraged positions into insolvency and aggravating balance sheet problems in the banking system, even where banks had hedged their own foreign exchange exposures.

Second, depreciation of the baht created a domino effect. As international investors reassessed the situation, the pressure on Malaysia and Indonesia increased, and many aspects of the Thai experience were repeated. This amplified the pressure elsewhere, eventually leading to the present situation in which three countries in the region (Korea, Indonesia and Thailand) are receiving policy-conditional financial support from the International Monetary Fund (IMF). At this stage, only China and Hong Kong, China, have maintained their link to the US dollar. Even there, high interest rates have been needed to support the Hong Kong dollar.

Some financial market issues

Recent financial crises have raised some questions

Recent years have been marked by a series of financial crises of which the current Asian turbulence is but the latest, even if the most severe. In most of these episodes, international capital flows have played a prominent role, often in the context of reforms which have pushed the process of financial market liberalisation forward. This has led some to raise questions both about the extent to which financial liberalisation in emerging market countries has contributed to these episodes and about the wider management of the international financial system.

A strong financial system requires strong institutions and appropriate framework conditions…

Emerging market economies whose development is advancing rapidly generally recognise that ultimately there is virtually no alternative in a modern economy to relying on a strong financial system to mobilise savings, allocate capital and provide for payments mechanisms. Establishing such a system involves building the institutions and establishing the framework conditions which ensure that all activity operates

subject to market constraints and disciplines. Any approach to this which is not balanced and comprehensive is likely to contain elements that lack coherence and give rise to distortions that can lead to serious problems. In particular, issues such as the soundness of institutions, transparency, governance, supervisory arrangements to enforce these and, more generally, the willingness to ensure that the disciplines of a market environment operate are difficult to address but are essential to a strong financial system.

Overall, a common theme in the experience of crisis countries – both in Asia and elsewhere – has been that financial reform, rather than going too far, has been interpreted too narrowly and has not gone far enough. It has also often not been adequately supported by macroeconomic policies and structural reform in other areas. First, financial liberalisation, interpreted narrowly, has often been partial and even incoherent, involving changes which highlight remaining distortions and exaggerate their effects. Korea's capital account opening, for example, allowed banks to borrow heavily in international markets while limiting enterprises' ability to do the same and leaving other restrictions on capital inflows in place. As a result, short-term capital movements were substantially more liberalised than long-term flows and inflows were unnecessarily channelled through banks. This exacerbated the existing systemic weakness once the crisis broke. Furthermore, once the run on banks began, liquidity in the foreign exchange market dried up and the exchange rate went into a free fall. Had liberalisation of financial markets, including the foreign exchange market, been substantially more complete, a broader and more liquid foreign exchange market would probably have limited the won's fall and the banking system would have suffered less damage. The substantial relaxation of limitations on foreign investment in Korean enterprises in December[2] appears to have contributed to the recent revival of capital inflows, some recovery of the won and a rise in the stock market.

Second, a coherent approach to the financial system requires putting appropriate infrastructure and framework conditions in place. These include accounting systems and disclosure requirements to ensure transparency, arrangements to discourage fraud, measures to encourage capital adequacy and prevent financial institutions from operating without capital at risk, and supervisory arrangements to ensure enforcement. Reforms to achieve this usually meet with more resistance from the affected interest groups than does relaxing controls on pricing or how they can operate. Nevertheless, implementing such reforms is a vital part of establishing a healthy market environment. Widespread failure in this regard has played a major role in the crisis in many Asian economies.

… and must be supported by sound macroeconomic and well-designed structural policies

Third, even a coherent and comprehensive financial reform will not deliver good results unless it is supported by sound and stable macroeconomic policies and well-designed structural policies throughout the rest of the economy. As noted above, poorly designed exchange rate policies played an important role in several of the Asian economies affected by the current crisis, and in a number of them current account deficits were allowed to reach levels which, historically, have usually led to problems. Similarly, the crisis in Mexico owed much to an exchange rate policy which was unsustainable in the context of overly lax macroeconomic policies. Major structural problems have also been central to a number of situations which have manifested themselves as financial or currency crises: the debt crises of the 1980s in some Latin America countries were importantly aggravated by structural problems, for example those relating to state-owned enterprises, and issues of corporate

2. Until December 1997, foreign investors were limited to a total of 26 per cent equity ownership in a company, with a maximum individual holding set at 10 per cent. These have now been raised to 55 and 33 per cent, respectively.

governance and the nature of relationships between government officials and the private sector loom large in the current Asia crisis. In all of these episodes, financial market developments have been less the cause of crises than the consequence of more fundamental imbalances and distortions.

The Asia crisis raises wider issues

The crisis in Asia raises wider issues concerning the management of the international financial system. As was the case in Mexico three years ago, the amount of financial resources that have so far been disbursed by the IMF to crisis countries in Asia is large (around $21 billion), and the amounts which might ultimately be involved if all commitments made in support of IMF programmes were to be drawn is substantially larger (around $115 billion). However, these amounts are considerably less than the potential capital movements which the crisis could ultimately entail. This has placed responsibility on private creditors to set up refinancing facilities to overcome short-term funding problems, which is reminiscent of the process of Latin American debt rescheduling during the 1980s. Where negotiations prove successful, as with the recent agreement between Korea and major international banks, favourable effects can become visible in financial markets quickly.

Market participants must not be sheltered from the consequences of their actions

Nevertheless, legitimate questions exist as to whether the Asia crisis could have become so severe if lenders had been behaving with a prudent respect for the risks inherent in lending to borrowers in emerging market economies. If the size of international financial crises is not to continue to rise in the future, it will be necessary to ensure that participants in international capital markets are not sheltered from the consequences of their own actions.

Consequences and risks for OECD countries

The main effects of the Asia crisis will come through trade links

Developments in emerging Asia will affect Japan and OECD countries in other regions mainly through trade linkages, although financial linkages may also be important for some countries. The size of the impact will depend critically on how developments in Asia evolve, particularly as regards exchange rates and the speed with which domestic demand recovers in the crisis countries. Particularly beyond the short term, a high degree of uncertainty attaches to both the size of the trade adjustment that will be required in Japan and countries outside Asia and the time frame in which it will occur.

The trade-related effects on Japan and OECD countries outside Asia can be expected to operate through four main channels:

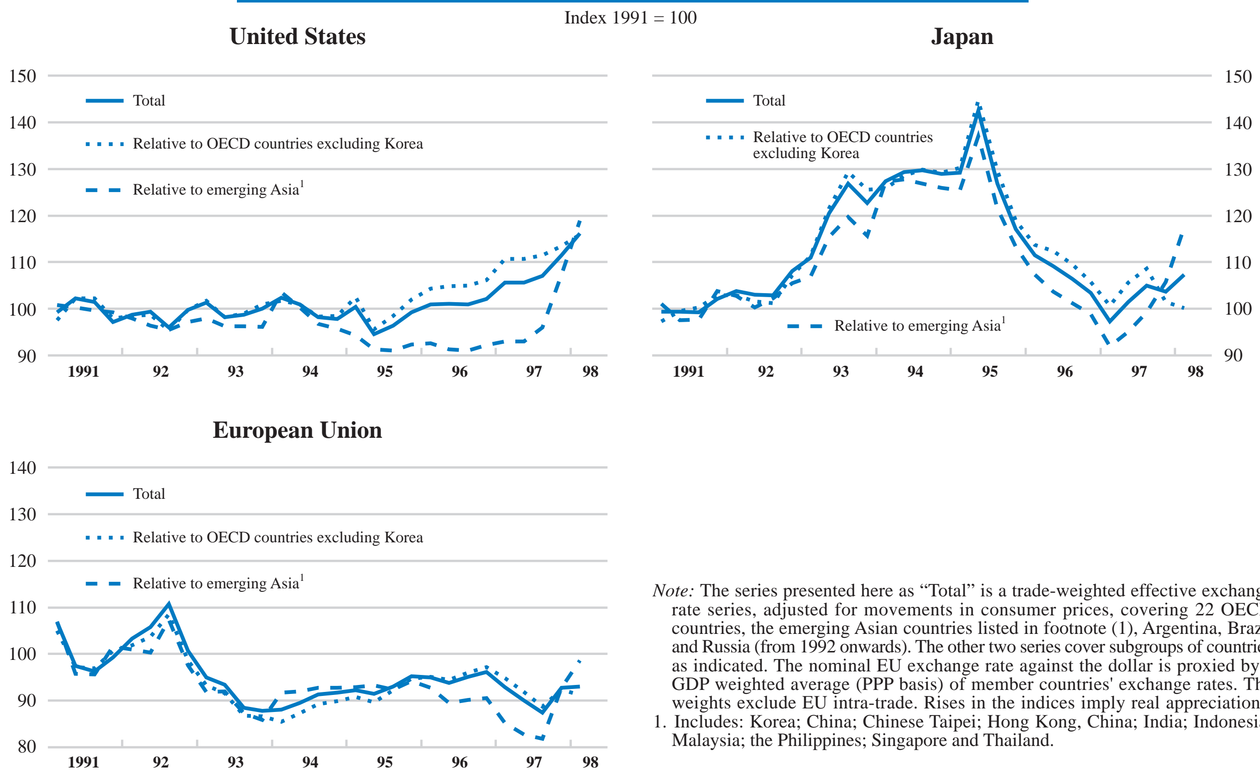
- the collapse in domestic demand in crisis countries, and general weakness elsewhere in the region, will be reflected in slower export market growth (Table I.7);
- exchange rate depreciations in most economies in emerging Asia will affect competitiveness *vis-à-vis* these economies, not only there but in home and third markets as well (Figure I.3);
- depressed activity may encourage businesses in emerging Asia to give higher priority to exporting than cost and price considerations alone might justify; and
- weak oil and commodity prices will affect incomes of important oil or commodity exporting countries, even if they do not rely heavily on markets in emerging Asia.

Table I.7. **Export market growth for goods**

Per cent

	1997	1998	1999
United States	11.2	6.4	7.3
Japan	11.5	6.4	7.6
European Union	9.1	7.9	7.0
Canada	13.9	11.6	8.8
Australia	5.0	1.8	4.6
New Zealand	6.3	4.6	5.8

Figure I.3. Decomposition of real effective exchange rates by region



Note: The series presented here as "Total" is a trade-weighted effective exchange rate series, adjusted for movements in consumer prices, covering 22 OECD countries, the emerging Asian countries listed in footnote (1), Argentina, Brazil and Russia (from 1992 onwards). The other two series cover subgroups of countries as indicated. The nominal EU exchange rate against the dollar is proxied by a GDP weighted average (PPP basis) of member countries' exchange rates. The weights exclude EU intra-trade. Rises in the indices imply real appreciations.

1. Includes: Korea; China; Chinese Taipei; Hong Kong, China; India; Indonesia; Malaysia; the Philippines; Singapore and Thailand.

The $70 billion shift toward surplus in crisis countries will have counterparts mainly in OECD countries

The adjustments in the crisis countries will be reflected in shifts to substantial current account surpluses over the projection period, the counterparts of which will have to be absorbed elsewhere. During 1997 this adjustment was already under way, as a combined move toward surplus of nearly $30 billion took place in Korea and the four ASEAN countries affected by the crisis, and during 1998-99 a further shift of more than $70 billion is projected, some $50 billion of which in 1998 alone (Table I.8). Some of the impact of this will be felt by economies in the region that have been less affected by the crisis, notably China, but even so the shift toward surplus in emerging Asia as a whole will be around $60 billion. Most of the counterparts to this change will fall on OECD countries. (Some estimates of the effect of the Asia crisis on output and current accounts in OECD countries in isolation from other developments are provided in Box I.3 on page 17.)

The swing in Asian current accounts projected here may be on the high side, as it depends on a number of key assumptions which may not be realised. In particular, it depends on exchange rate assumptions which imply no appreciation in crisis countries from the levels prevailing on 18 March 1998 which, notwithstanding substantial recoveries since January, are still very low. Furthermore, it presumes that exports from these countries are not constrained by a lack of trade credit needed to import components and materials or an inability to provide financing for customers.

The effect of the Asia crisis alone is difficult to isolate…

Since current account developments reflect everything that is going on in the global economy, the changes over time do not reflect the impact of the crisis in

Table I.8. **Projected current account adjustment**

$US billion

	Changes in current accounts			Cumulative change during
	1997	1998	1999	1998-1999
Emerging Asia	47.0	41.6	18.6	60.2
of which:				
ASEAN 4[a]	12.8	29.6	11.6	41.2
Korea	14.5	23.0	9.4	32.4
Total crisis countries	27.3	52.6	21.0	73.6
China	15.6	–10.9	–5.9	–16.8
Other emerging Asia[b]	4.1	–0.1	3.5	3.4
Japan	28.7	30.2	22.5	52.7
Other regions	–34.8	–94.4	–38.0	–132.4
of which:				
United States	–18.2	–44.3	–38.4	–82.7
European Union	34.8	–0.9	12.7	11.8
Other OECD countries	–24.0	–26.2	–3.0	–29.2
Total non-Asia OECD	–7.4	–71.4	–28.7	–100.1
Central and Eastern Europe[c]	–4.8	–2.3	–0.7	–3.0
Central and South America	–14.9	–1.8	–3.5	–5.3
Other non-OECD countries	–7.7	–18.9	–5.1	–24.0
Total non-OECD outside emerging Asia	–27.4	–23.0	–9.3	–32.3
Unallocated	40.6	–22.4	3.2	–19.2

a) Indonesia, Malaysia, the Philippines and Thailand.
b) Chinese Taipei; Hong Kong, China; and Singapore.
c) Includes the former Soviet Union.

Asia alone. However, the changes in the outlook for major OECD regions as the crisis has evolved, as seen by the OECD Secretariat, largely reflect the incorporation of events in Asia into the projection (Table I.9). The main changes in the forces shaping the world economy since May 1997, when *OECD Economic Outlook* 61 projections were finalised, other than developments in emerging Asia, have been the weakening of domestic demand in Japan and continuing strength in the United States. Therefore, the changes in the outlook must be interpreted as largely reflecting these three sets of developments.

Several features stand out from Table I.9. First, given the deterioration in the outlook for domestic demand in Japan, that country appears unlikely to contribute to adjustment in the crisis countries. The projected net external contribution to growth in 1998 has been revised upward since November and is now larger than it was before the crisis broke. Second, in the United States, the downward revision since November to the net external contribution, which to an important extent reflects the proximate impact of the Asia crisis, amounts to around ½ percentage point in both 1998 and 1999, and in the European Union it amounts to around ¼ percentage point in both years.

... but lower long-term interest rates should be a compensating force

Third, the outlook for long-term interest rates has been revised downward substantially nearly everywhere. This largely reflects declines that have already taken place, and are at least partly due to the Asia crisis. Lower long-term interest rates will operate to support domestic demand and offset negative trade effects on activity. Fourth, domestic demand has indeed been revised upward, substantially for the

Table I.9. **The changing outlook as the Asia crisis has evolved**[a]

	United States		Japan		European Union	
	1998	1999	1998	1999	1998	1999
	Net foreign contributions to growth[b] *Percentage points*					
May 1997	–0.2		0.5		0.2	
November 1997	–0.8	–0.3	0.3	0.1	0.3	0.3
March 1998	–1.4	–0.9	0.7	0.6	0.1	0.1
	Long-term interest rates[c] *Per cent*					
May 1997	6.8		2.9		6.5	
November 1997	6.4	6.5	2.1	2.6	6.2	6.4
March 1998	5.9	6.1	1.8	2.0	5.4	5.8
	Total domestic demand *Percentage change from previous period*					
May 1997	2.1		2.4		2.6	
November 1997	3.3	2.1	1.5	2.0	2.7	2.7
March 1998	3.9	2.7	–1.0	0.7	2.7	2.8
	Real GDP *Percentage change from previous period*					
May 1997	2.0		2.9		2.7	
November 1997	2.7	1.9	1.7	2.1	2.8	2.8
March 1998	2.7	2.1	–0.3	1.3	2.7	2.8

a) Dates in the left-hand column refer to the time when projections reported in *OECD Economic Outlook* 61 and 62, as well as this issue of *OECD Economic Outlook*, were finalised.
b) Net exports' contributions to changes in real GDP (as a percentage of real GDP in the previous year).
c) Unweighted average of Germany, France, Italy and the United Kingdom for the European Union.

United States although only slightly for Europe. Lastly, the overall net effect on the outlook for growth in both regions is small.

Over the longer term, there are major uncertainties about the pace of adjustment

Beyond the near term, there are major uncertainties about the speed with which crisis countries will deal with balance sheet problems, implement structural reforms, achieve recoveries of domestic demand and regain the confidence of international financial markets. In order to illustrate the possible range of what these uncertainties could imply for OECD countries, the OECD Secretariat has prepared three scenarios based on alternative assumptions about how adjustment in Asia might evolve (see Box I.4). The central scenario, which is an extended version of the short-term projections and serves as the OECD Secretariat's medium-term reference scenario, incorporates cautiously optimistic assumptions about the evolution of the crisis. Two others considered here are an optimistic one, in which reform proceeds more rapidly and capital flows resume to the point where crisis countries can sustain current account deficits, and a relatively pessimistic one in which confidence is not restored and financial pressures on other emerging market economies increase.

The figure in Box I.4 provides an overview of how the major OECD regions might be affected in these scenarios. Monetary authorities respond to developments, running tighter policies in the optimistic scenario and easier policies in the pessimistic one, in order to compensate for any impact on activity. Consequently, while the year-to-year development of growth rates is affected, there is little cumulative effect

Box I.3. **Estimated effects of the financial crisis in Asian emerging market economies**

To isolate the effect of the crisis in emerging market economies in Asia, the OECD Secretariat's INTERLINK model has been used to generate an alternative scenario on the assumption that the Asia crisis did not occur, which can be compared with the current set of projections. This comparison provides an indication of the effect of the Asia crisis which is implicitly incorporated in the projections reported in this issue of *OECD Economic Outlook*. The key assumptions underlying this alternative scenario are:

- the exchange rates of the four ASEAN crisis countries and Korea are maintained at their pre-crisis levels;
- the absence of any import compression, which is estimated on the basis of the May 1997 medium-term reference scenario reported in *OECD Economic Outlook* 61 to be 23 per cent in Korea and 14.5 per cent in the other crisis countries in 1998, and 34 and 18 per cent, respectively, in 1999;
- real interest rates are ½ percentage point higher in the OECD countries in both 1998 and 1999, except in Japan, where nominal interest rates are assumed to be unaffected by the crisis.

Effects of the crisis in emerging Asia on OECD countries in 1998 and 1999

Deviations from scenario involving no crisis in Asia

	Real GDP growth (per cent)		Real GDP level (per cent)	Current account (US$ billion)	
	1998	1999	1999	1998	1999
United States	–0.4	–0.4	–0.8	–13	–27
Japan	–1.3	–0.7	–2.0	–12	–22
European Union	–0.4	–0.2	–0.6	–19	–28
Canada	–0.2	–0.3	–0.5	–2	–3
Australia and New Zealand	–0.9	–0.1	–1.0	–3	–4
Total OECD, excluding Korea	–0.5	–0.3	–0.8	–53	–90
Korea	–6.8	–2.6	–9.2	+28	+34
Total OECD	–0.7	–0.4	–1.1	–26	–55

These results (see table) suggest that the negative impact on overall OECD growth, excluding Korea, amounts to around ½ per cent in 1998 and to around ¼ per cent in 1999, cumulatively amounting to around ¾ per cent of the level of GDP. As suggested in *OECD Economic Outlook* 62,[1] Japan is most affected, and the impact in 1998 is also relatively large in Australia and New Zealand. The impact on the United States is similar to that on the European Union, as trade exposures of these two regions to emerging market economies in Asia are not very different. The overall current account swing in the OECD area, excluding Korea, amounts to around $90 billion.

1. See the box "The trade-related impact of financial turbulence in Southeast Asia on OECD countries", *OECD Economic Outlook* 62, December 1997, page 6.

on output. However, since this is achieved by generating domestic demand changes that offset the impact of variations in the trade adjustment required by developments in Asia, the effect is mainly reflected in the current account (Table I.10). The uncertainty surrounding the impact of Asian developments on the rest of the world over the medium term, therefore, can broadly be measured by the sensitivity of the current account to the degree of optimism assumed about adjustment in Asia. These scenarios suggest that by 2003, depending on how the crisis in Asia evolves, the possible variation in the current accounts of OECD countries (excluding Korea) might run from a surplus of $100 billion in the optimistic case to a deficit of $80 billion in the pessimistic one, or a range of just over ±½ per cent of area GDP.

Box I.4. **Alternative medium-term scenarios**

The OECD Secretariat's medium-term reference scenario, which extends the short-term projections to 2003 (table), is conditional upon the following assumptions governing the period beyond the short-term projection horizon: *i)* the gap between actual and potential output is broadly eliminated by 2003; *ii)* commodity prices and most exchange rates remain broadly unchanged in real terms (Korea is an important exception, see page opposite); *iii)* monetary policy is directed at keeping inflation low, or bringing it down in line with medium term objectives; and *iv)* fiscal policy is consistent with the stated medium-term objective of continued fiscal consolidation, achieved at fixed tax-to-GDP ratios via trend reductions in public consumption and social spending ratios.

The medium-term reference scenario serves as a basis for comparisons with alternative scenarios made under different assumptions about the evolution of the Asia crisis, in particular about the levels of exchange rates and domestic demand in the affected countries:

– The *medium-term reference scenario* is cautiously optimistic, assuming a steady pace of reform and balance sheet adjustment, a gradual restoration of confidence and some appreciation of exchange rates in crisis countries (the Korean won appreciates from won 1 484 per dollar at end-1999 to 1 200 per dollar at end-2000). This allows reductions in interest rates, recoveries in domestic demand,

The main features of the medium-term reference scenario

Per cent

	Real GDP growth	Inflation rate[a]		Unemployment[b]		Current account[c]		Long-term interest rate		Fiscal balance[d]	
	2000-2003	1999	2003	1999	2003	1999	2003	1999	2003	1999	2003
United States	2.4	1.8	2.2	5.0	5.5	–2.8	–2.8	6.1	6.2	0.1	0.8
Japan	2.4	0.0	–0.1	3.6	2.9	3.7	3.8	2.0	3.6	–2.7	–1.2
Germany	2.7	1.3	1.4	11.1	9.7	0.7	1.0	5.5	5.5	–2.4	–0.9
France	2.5	1.3	1.5	11.3	10.1	3.0	3.5	5.5	5.5	–2.6	–0.6
Italy	2.3	2.1	1.7	11.8	10.9	4.1	4.3	5.7	5.5	–2.5	–0.8
United Kingdom	2.2	2.6	2.6	7.2	7.0	–1.3	–1.4	6.4	6.1	–0.4	0.4
Canada	2.8	1.9	2.0	8.3	7.9	–2.6	–1.8	6.0	6.0	2.1	3.6
Major 7	2.5	1.5	1.6	6.7	6.4	–0.2	0.0	5.2	5.5	–1.0	0.0
Australia	3.6	2.8	2.5	7.7	7.2	–4.7	–2.6	6.6	7.1	0.6	2.0
Austria	2.4	1.3	1.5	5.9	5.4	–1.7	–1.5	5.6	5.5	–2.3	–2.0
Belgium	2.2	1.4	1.4	11.9	11.1	6.2	6.4	5.6	5.5	–1.6	–0.2
Czech Republic	2.4	9.2	4.6	6.6	6.8	–4.1	–2.5	15.5	10.5	–2.5	–2.5
Denmark	2.1	2.9	3.0	6.2	7.1	0.7	1.5	5.9	6.4	1.9	2.9
Finland	3.1	2.3	2.8	11.0	8.8	5.7	5.9	4.9	5.5	1.1	2.1
Greece	2.8	3.2	3.1	10.6	10.2	–4.1	–4.0	8.5	7.8	–2.9	–1.4
Hungary	4.6	13.0	4.5	7.3	5.8	–2.6	–1.9	16.0	10.5	–4.9	–3.2
Iceland	2.7	3.6	3.6	3.4	3.7	–1.7	0.1	14.9	14.2	–0.2	0.1
Ireland	5.5	3.2	3.4	8.2	8.1	0.3	1.1	5.6	5.5	1.6	3.4
Korea	5.6	4.4	1.9	6.3	3.6	7.3	2.0	12.0	8.5	1.1	1.9
Mexico	5.0	9.8	7.4	3.4	3.2	–3.9	–4.6	14.5	12.4	. .	. .
Netherlands	2.9	2.0	1.8	4.8	4.7	7.0	7.1	5.5	5.5	–1.6	0.0
New Zealand	3.0	1.9	1.8	6.4	6.0	–6.6	–5.2	7.0	7.1	1.1	1.6
Norway	2.7	3.2	2.8	3.0	3.5	5.2	5.7	6.1	5.7	7.4	6.8
Poland	5.5	9.8	6.4	9.3	8.5	–6.1	–4.8	14.7	12.8	–2.0	0.0
Portugal	3.0	2.4	2.3	6.0	5.8	–1.9	–2.1	5.8	5.5	–2.0	–1.0
Spain	3.3	2.7	2.2	18.4	17.4	0.3	–0.8	5.6	5.5	–1.8	–1.2
Sweden	2.5	1.9	2.1	6.2	6.3	3.2	3.9	5.9	5.8	0.5	1.2
Switzerland	2.1	1.2	1.2	4.1	3.0	8.2	7.9	3.5	3.8	. .	. .
Turkey	5.0	65.0	35.7	5.6	5.2	–2.2	–3.1	110.0	55.8	. .	. .
European Union	2.6	1.9	1.9	10.5	9.7	1.6	1.8	5.7	5.7	–1.8	–0.4
Total OECD	2.7	2.1[e]	2.0[e]	7.0	6.5	0.0	0.1	5.9[e]	6.0[e]	–0.9	0.2

a) Percentage change from the previous period in the GDP price deflator.
b) Per cent of labour force.
c) Per cent of GDP.
d) General government financial surplus (+) or deficit (–) as a percentage of GDP.
e) Excluding Turkey.

of the evolution of the Asia crisis

improving access to international capital markets and declining current account surpluses.

- An *optimistic scenario* assumes a more rapid pace of reform and balance sheet adjustment. This facilitates a stronger return of confidence and capital flows, implying a more marked appreciation of exchange rates in crisis countries (the Korean won rises to 1 000 per dollar by 2001). Interest rates fall more rapidly than in the reference scenario, with a stronger pick-up of domestic demand and sharper reductions in current account surpluses to modest deficit positions.
- In the *pessimistic scenario*, reforms are implemented slowly, if at all, so that financial market confidence is never fully restored and capital flight is a persistent problem in crisis countries. Thus, the exchange rates depreciate further (the Korean won declines to 1 600 per dollar by 2003) and continuing high interest rates and balance sheet problems result in persistently weak domestic demand. China and Hong Kong, China depreciate their exchange rates by 20 per cent, while other regions outside the OECD area are forced by nervous financial markets to maintain restrictive policies which weaken domestic demand.

The main text provides commentary on the assumed monetary policy adjustments and the implications for activity in the major OECD regions, shown in the figure below, as well as the implications for the current accounts reported in Table I.10.

Monetary policy and growth of output in major OECD regions under alternative Asia crisis scenarios

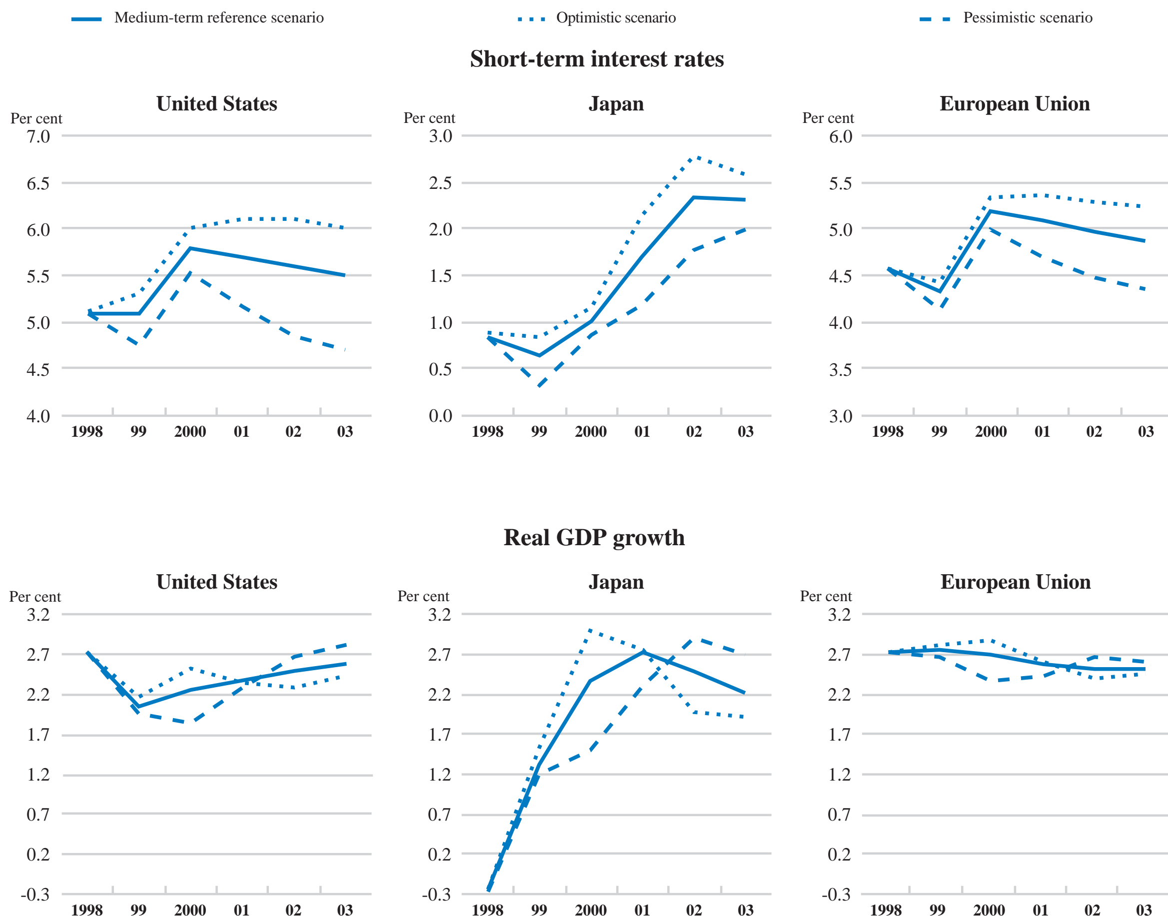


Table I.10. Current account outlook for 2003 under alternative assumptions about the Asia crisis

US$ billion[a] (per cent of GDP in parentheses)

	Scenarios					
	Optimistic[b]		**Reference[b]**		**Pessimistic[b]**	
United States	–270	(–2.5)	–290	(–2.8)	–315	(–3.1)
Japan	205	(4.2)	185	(3.8)	155	(3.3)
European Union	210	(2.0)	185	(1.8)	145	(1.4)
Canada	–12	(–1.5)	–15	(–1.8)	–20	(–2.5)
Australia and New Zealand	–15	(–2.5)	–17	(–2.9)	–19	(–3.5)
Total OECD (excluding Korea)	100	(0.3)	30	(0.1)	–80	(–0.3)
Korea	–17	(–2.5)	11	(2.0)	16	(3.9)
Other emerging Asia	–20		20		95	
Total emerging Asia	–37		31		111	
Other non-OECD countries	–115		–115		–85	

a) Rounded to the nearest $5 billion, except for Canada, Australia and New Zealand, and Korea.
b) See Box I.4 for a description of the underlying assumptions.

Financial linkages are difficult to quantify but some banks' balance sheets could be hurt

Financial linkages are more difficult to quantify, but some observations are possible. First, few of the more mature OECD economies seem likely to be affected by contagion reflecting concerns about bank creditworthiness. An important consideration in this regard is that banks in most North American and European countries are generally in a much stronger position than are those in most emerging Asian countries to absorb financial pressures, although Japan is a special case (see below).

Nevertheless, direct financial exposures to Asia and the other emerging markets which could have negative impacts on balance sheets do exist. They vary by region. European and Japanese bank exposure to Asia is considerably larger than that of the United States (Table I.11), though most of this exposure is to the offshore centres of Singapore and Hong Kong, China rather than to the crisis countries *per se*. However, insofar as these offshore centres on-lend to the rest of Asia and face property market downturns of their own, this exposure could pose risks in the future. Moreover, relatively large exposure of banks in some countries to Latin America and eastern Europe (including Russia) point to further risks, especially in Europe, in the event of any spread of the crisis to emerging markets outside Asia.

Finally, OECD economies may also be exposed via their direct investment linkages with Asia, as the deterioration of domestic demand in the crisis countries could severely depress returns to investments by multinationals in sectors which are oriented to the local market. Direct investments in Asia are largest in terms of GDP for Japan and Australia, though still modest (Table I.12). While there have been scattered reports of cancellations of projects in OECD countries outside Asia by multinational companies based in crisis countries, notably Korea, such inward investment appears to be too small in most OECD countries for this to have a material macroeconomic effect.

Table I.11. Bank lending to emerging markets

	United States	Japan	Canada	European Union[a]
	$US billion, end-June 1997			
Asian emerging markets	43.3	271.4	15.4	353.3
5 crisis countries[b]	23.8	97.2	3.9	98.1
China	2.9	18.7	0.9	28.1
Chinese Taipei	2.5	3.0	1.7	14.4
Singapore and Hong Kong, China	14.1	152.4	8.9	212.8
Eastern Europe and Turkey	14.9	6.0	0.4	92.6
of which: Russia	7.5	0.8	0.0	45.5
Latin America	60.3	14.5	9.8	125.7
Total emerging markets	118.5	291.9	25.6	571.6
	As a percentage of bank capital[c, d]			
Asian emerging markets	12.4	109.5	46.1	48.5
5 crisis countries[b]	6.8	39.2	11.8	13.5
China	0.8	7.6	2.6	3.9
Chinese Taipei	0.7	1.2	5.2	2.0
Singapore and Hong Kong, China	4.0	61.5	26.6	29.2
Eastern Europe and Turkey	4.3	2.4	1.3	12.7
of which: Russia	2.2	0.3	0.1	6.2
Latin America	17.3	5.9	29.4	17.3
Total emerging markets	34.0	117.8	76.8	78.5

a) Germany, France, Italy, the United Kingdom, Austria, Belgium, Finland, Luxembourg, the Netherlands and Spain.
b) Korea, Indonesia, Malaysia, the Philippines and Thailand.
c) Commercial banks for the United States, Japan, the United Kingdom, Canada and Luxembourg; all banks for the other countries.
d) Due to the unavailability of data, capital and reserves figures refer to 1995 while the lending figures are for end-June 1997. Where capital and reserves increased during the interim, the figures in the table are somewhat overstated.
Sources: *The Maturity, Sectoral and Nationality Distribution of International Bank Lending, First half 1997*, Table 2, BIS, January 1998, and *Bank Profitability, Financial Statements of Banks*, OECD, 1997.

Table I.12. Direct investment positions *vis-à-vis* emerging Asia, end-1995[a]

	Absolute amount *US$ billion*			As a share of GDP *Per cent*		
	5 crisis countries[b]	Other emerging Asia[c]	Total emerging Asia	5 crisis countries[b]	Other emerging Asia[c]	Total emerging Asia
	Inward					
United States	2.8	5.2	8.1	0.04	0.08	0.12
Japan	0.1	1.3	1.5	0.00	0.03	0.03
European Union[d]	1.8	2.4	7.7	0.03	0.04	0.12
Australia	0.9	2.4	3.4	0.26	0.73	1.02
	Outward					
United States	23.3	32.7	57.5	0.33	0.47	0.83
Japan	38.6	36.1	76.2	0.76	0.71	1.50
European Union[d]	12.8	26.0	42.3	0.19	0.39	0.64
Australia	1.4	2.9	4.5	0.42	0.88	1.37

a) End-1994 figures for Japan.
b) Korea, Indonesia, Malaysia, the Philippines and Thailand.
c) China; Chinese Taipei; Hong Kong, China; and Singapore.
d) Germany, France, Italy, the United Kingdom, Austria, Finland and the Netherlands.
Source: *International Direct Investment Yearbook*, OECD, 1997.

Policy requirements in OECD countries

Japan

The overall context

Japan must build on its strengths and address its weaknesses

The spectacular success of the Japanese economy throughout most of the post-war period was based on important strengths (notably in areas of human capital and technology), which remain in place and should provide the basis for continued strong performance in the future. However, the deterioration in performance since the

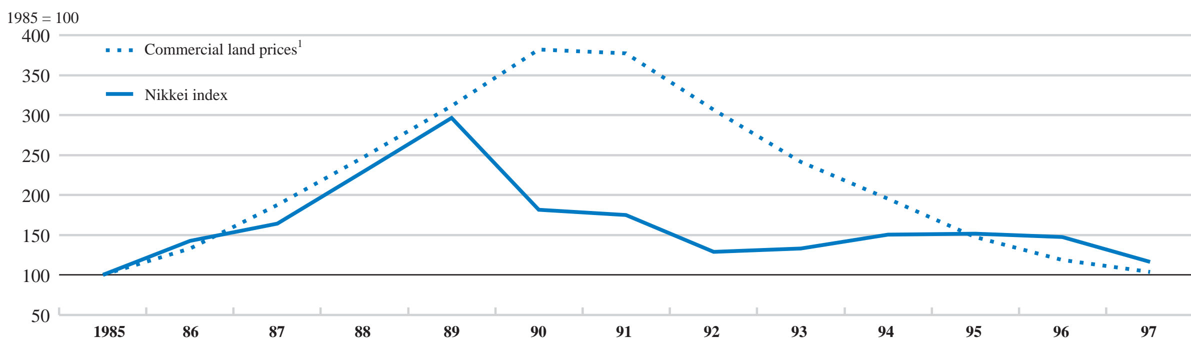
Box I.5. **Balance sheet problems**

Banks in Japan have been faced with serious balance sheet problems since stock and property market "bubbles" burst in 1990 and 1992, respectively (figure). Reinforced by the onset of a severe slowdown in the economy, these asset price collapses have had serious consequences in terms of non-performing loans. Some progress has been made by the authorities in addressing these difficulties, notably liquidating the insolvent *jusen* (housing loan corporations), and encouraging the major banks to use their operating profits gradually to write off and provision bad loans. The latter strategy was successful to the extent that operating profits were high, in part boosted by the low cost of funds owing to interest rate policy. Nevertheless a bad loan problem has persisted, mainly for credit co-operatives and a few major banks. With the deepening of the Asia crisis and the collapse of Yamaichi Securities and Hokkaido Takushoku Bank in November 1997, a market risk premium on Japanese bank borrowing emerged.

Based on a discretionary self assessment by Japanese banks, the total amount of sub-standard "questionable" loans has been estimated at 77 trillion yen – or 15 per cent of GDP – as of September 1997 (table opposite). However, of this amount only 11 trillion yen were classified as "lost" or "doubtful", the remainder having to be "collected carefully". Although actual default rates for the various categories of non-performing loans will depend to a large extent on macroeconomic conditions, ratios used as rules of thumb by regulatory authorities in the United States would imply that defaults on problem loans could ultimately amount to around 20 trillion yen. By contrast, banks' provision for loan losses amounted to 9.4 trillion yen in March 1997. An official re-assessment of the extent of the bad-loan problem will be forthcoming later this year.

The ultimate cost to the financial system of many bad loans will depend on the value of the collateral that can be recovered

Stock market and land prices



1. In the six major urban areas.
Sources: Economic Statistics Annual, Research and Statistics Department, Bank of Japan; *Urban Land Price Index,* Japan Real Estate Institute.

early 1990s, in particular the recent stagnation of domestic demand, has highlighted important weaknesses which must be addressed. Most immediate is the balance sheet problem which has built up in the financial sector since the beginning of the decade (Box I.5), and has led to difficulties for small and medium-sized enterprises in obtaining the bank credit on which they are highly dependent (Figure I.4). It has also contributed to the pervasive low level of confidence and pessimism about prospects for the economy, reflected in abnormally low nominal interest rates (below 2 per cent) on risk-free long-term government bonds.

Two structural problems, less pressing but of longer-term importance, also stand out as major elements of the present context. First, population ageing has already slowed the growth of the labour force and is projected to lead to declines in the near future. Government expenditure will be under considerable pressure from both rising pension

of Japanese banks

Japanese banks' non-performing loans as of September 1997

Yen trillion

	Healthy assets	Assets to be collected carefully	Assets difficult to collect or "doubtful"	Assets impossible to collect or "lost"	Total of non-performing loans
Major banks	377.3	45.3	6.9	2.1	53.3
Regional banks	170.8	20.0	1.8	0.6	22.4
Total	548.2	65.3	8.7	2.7	76.7[a]

a) Under the assumption (used by US regulatory authorities) that 100 per cent of assets impossible to collect, 50 per cent of assets difficult to collect and 20 per cent of assets to be collected carefully provides a good estimate of likely actual losses, the amount of non-performing loans to be disposed of may be estimated at 20 trillion yen.

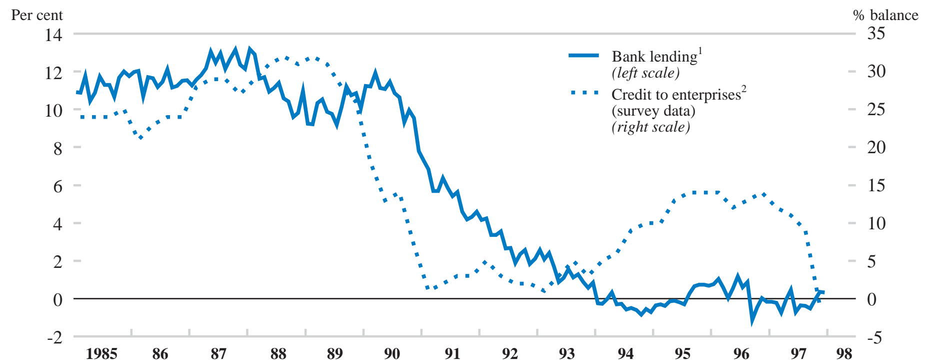
Source: Ministry of Finance and Bank of Japan (January 1998).

from borrowers. Efforts to recover collateral may be hampered by the fact that foreclosure procedures are rarely used in Japan. The experience of the Co-operative Credit Purchasing Company (CCPC) may provide some guidance here. The CCPC was established in 1993 to take over banks' non-performing loans at a discount which would enable them to take tax-deductible write-offs on the losses. By end-March 1997, collateral associated with only 20 per cent of the assets taken over by the CCPC had been sold, and prices on these assets provided recovery of only 30 per cent of the original value of the loans. Thus, only 6 per cent of the face value of the loans transferred to the CCPC had been recovered.

A number of factors may act to increase the potential size and cost of financial sector difficulties. First, bad loans of credit co-operatives are not included in the above estimate of total domestic non-performing loans. Second, asset recovery rates could decline as most of the better-quality assets have already been sold off. Recent anecdotal evidence suggests recovery rates on remaining assets of only around 10 per cent, while property-related losses may keep mounting if land prices continue to fall. Third, the crisis in emerging Asia can only aggravate the balance sheet problem, given large exposures of Japanese banks to the region. Fourth, certain life insurance companies also face difficulties in the context of very low long-term interest rates coupled with high projected yields on older policies.

Notwithstanding the adverse situation they have been facing, banks operating internationally have tried to adhere very strictly to the 8 per cent capital adequacy ratio (Basle) requirement, set to be more rigorously enforced on 1 April 1998, while for domestic banks enforcement of the 4 per cent home standard (*i.e.* the implementation of Prompt Corrective Action) may be conditionally delayed for one year. Domestic equity holdings are an important component of bank portfolios in Japan, and a part of unrealised capital gains on such holdings can be counted as bank capital. Capitalisation ratios have deteriorated in association with renewed equity market declines since mid-1997. While the Nikkei is currently above what is widely thought to be a critical level of 15 000, below which the banking sector as a whole is estimated to have problems meeting capital adequacy ratios, individual banks under pressure may be trying to improve balance sheets by cutting their lending even to the most creditworthy customers.

Figure I.4. Credit market indicators in Japan



1. Year-on-year percentage changes.
2. Enterprises in small business reporting that banks are "accommodative" minus enterprises finding them "severe".
Sources: OECD and Bank of Japan, *Tankan Survey.*

benefits and increasing medical costs for the elderly.[3] This prospect has led the government to emphasize the need to act now to ensure that public finances are sound enough to cope with these pressures as they arise.

Second, many sectors of the Japanese economy, mainly those with little exposure to international competition, are much less efficient than the large industrial exporters. Regulatory reform and greater exposure of these sectors to market forces would lead to better performance in these sectors and higher productivity in the economy overall (Box I.6). Over the longer run this might help to offset the impact of demographic factors on potential output and to ensure that the economy is strong enough to provide for the growing elderly population.

A comprehensive approach involving structural reform, macroeconomic stimulus and strengthening the financial sector is needed now

Structural reform measures to improve productivity performance and raise potential growth rates will work slowly and are unlikely to have much visible impact in the short term. But they will build on the underlying strengths of the economy and have longer run effects which are both favourable and durable. If decisively implemented, they will also help to restore confidence, which is essential if performance in the near term is to improve. High priority should be attached to them. However, improving the near-term outlook will also require early macroeconomic stimulus to revive domestic demand and measures to address the balance sheet problems in the financial sector.

Raising domestic demand

Monetary policy cannot stimulate demand…

Monetary policy is likely to be of little assistance. The exceptionally low policy interest rates which have prevailed since 1995 have supported exports by facilitating the reversal of the yen's previous appreciation, and mitigated problems in credit markets by assisting bank profitability and helping to stabilize equity prices. Nevertheless, domestic demand has stagnated during the past year. At this stage, the scope for the easing monetary conditions has all but disappeared as concern about banks' balance sheet problems now appears to be interfering with the normal monetary transmission mechanism. As

3. If other forms of public expenditure remain constant as a share of GDP, general government spending may rise to around 44 per cent of GDP by 2025, from around 35 per cent now, bringing Japan more into line with the average of the OECD area. See *OECD Economic Survey, Japan*, 1997.

Box I.6. **Regulatory reform in Japan**

The OECD Secretariat has estimated that further deregulation of key sectors (electricity, air and road transport, telecommunications and distribution) could boost GDP up to 6 per cent over the medium-to-longer term, and the Japanese authorities have obtained similar results on the basis of work covering a somewhat wider range of sectors.[1] The Government is planning ambitious deregulation and reform measures in areas such as land and housing, medical care and welfare, labour markets, energy distribution, telecommunications, and the financial sector. This process has been widely criticised for its slow pace, and reform plans have typically included large numbers of minor technical measures, while failing to address key entry and price restrictions. More recently, however, the pace of deregulation appears to have picked up with the announcement of the "Big Bang" programme in the financial sector, the lifting of a number of price regulations and the restructuring of Nippon Telegraph and Telephone (NTT) in the communications sector, and the easing of entry conditions (excess supply criteria) and minimum price requirements in the transport sector. Moreover, there appears to be greater recognition of the effect of regulations in higher prices of non-tradeable goods in Japan compared with those in other developed countries, the recent decision to abolish the taxation of equity transactions within two years will enhance the effectiveness of financial sector reforms, and the Government appears to be moving in the direction of greater transparency in bidding for public works contracts and decision-making by regulators.

However, many more regulations (*e.g.* on prices, entry conditions, and the scope of business operations) remain to be lifted in many sectors. Furthermore, the proposed Big Bang financial sector reforms need to be accompanied by a reconsideration of the role of public financial institutions, such as the postal savings and the Fiscal Investment and Loan Programme (FILP).[2] The government should in this respect also reassess the efficiency of its own investment spending, selectively increasing public investment in such infrastructure as may be required in coping with new technological developments and social demands, while reducing investment in projects with demonstrated low social returns. The transparency of regulations could be further improved, for example by establishing clear criteria and publicly-announced deadlines, and discouraging, or even prohibiting at least for a time, the employment of retiring civil servants in areas they once regulated. Deregulation should also be accompanied by stronger enforcement of competition policy, while measures to increase labour mobility will be needed to allow for intersectoral shifts of jobs that are likely to arise from allowing productivity and prices in key non-manufacturing sectors to converge to international levels. Lower prices in non-traded sectors will not only raise potential output and consumers' purchasing power, but also encourage greater demand for non-traded goods. This would allow for a more balanced basis for growth with less dependence on foreign markets.

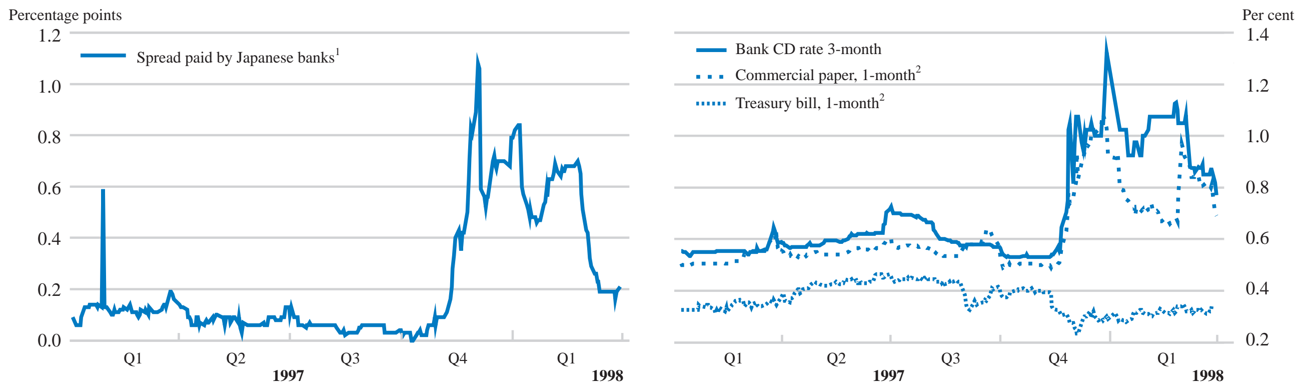
1. See *OECD Economic Survey, Japan*, 1997, pp. 104-105, and *OECD Report on Regulatory Reform*, 1997.
2. The government's involvement in financial intermediation, through collecting postal savings and providing the proceeds to FILP, accounts for fully one-third of total lending in the economy. The investments of FILP, however, have in many cases proven to be inefficient.

recently as November last year, virtually all key money market rates in Japan were very close to 0.50 per cent, the official discount rate. Since then appreciable risk premia have emerged even on short-term instruments issued by private Japanese borrowers, especially banks, both internationally and in Japan (Figure I.5). As of the end of March, these premia have declined considerably from earlier peaks. Nevertheless, the implicit policy easing which is reflected in a decline of the Treasury bill repurchase rate (Gensaki) to around 0.30 per cent has not prevented comparable money market rates paid by private borrowers, including banks, from remaining well above their early November levels.

... so fiscal stimulus is needed

This points to the desirability of fiscal stimulus. Until now, concerns about the ageing population, and the deterioration in public finances and rising government indebtedness caused by the combination of weak activity and repeated expansionary measures between 1992 and 1996 (Figure I.6), have led the government to give high priority to restoring a sounder fiscal position. This led to a sharp reversal of stance in 1997. Although this tightening proved to be premature, and the government has responded to economic weakness with a supplementary budget for fiscal year 1997, the draft budget for fiscal year 1998 ensures that the overall fiscal stance remains on its restrictive medium run path (see Table I.4, above, and the country note on Japan in Chapter II "Developments in Individual OECD Countries").

Figure I.5. Interest rates paid by Japanese banks



1. Spread over 3-month LIBOR in US dollars.
2. Repurchase rate (Gensaki).
Source: Bloomberg; last observation: 31 March 1998.

Nevertheless, given the weakness and uncertainty of the outlook, and the risks that it poses to the rest of the world, renewed fiscal stimulus in the form of one or more supplementary packages for fiscal year 1998 is under discussion. The ongoing debate suggests that the size of the package could well be above 2 per cent of GDP.[4] Although it will probably include tax cuts, increased public works spending is likely to figure prominently.

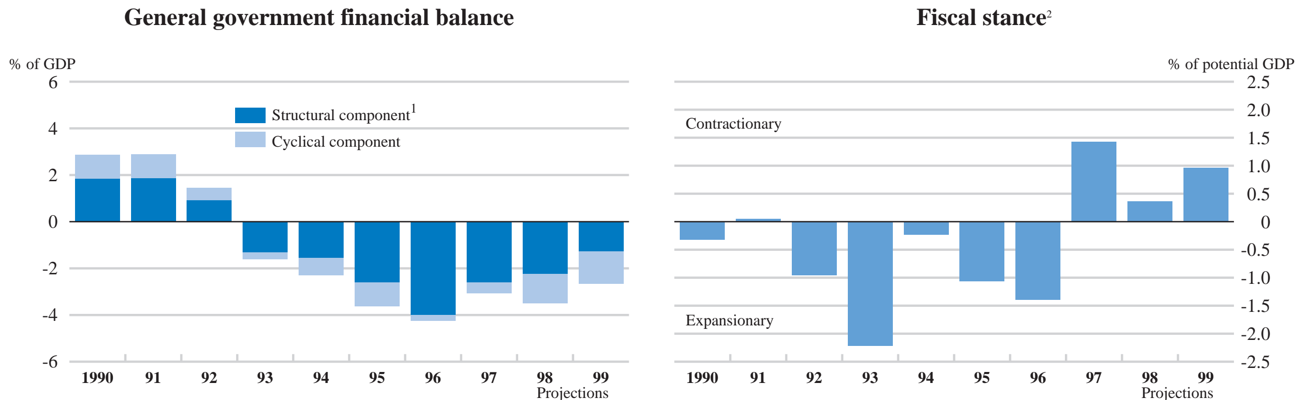
The design of any package will be important

If implemented effectively, such a package would be large enough to compensate for the underlying restrictiveness of the current fiscal stance and put it on an expansionary basis. However, the composition of the package will be as important as its overall size, in terms of both its effect on confidence and its longer-term structural implications. In particular, it should be designed to have favourable effects on incentive systems and to encourage efficient use of resources. Accordingly, to the extent that it relies on tax reductions it should involve reforms in the tax system which can be expected to be permanent.[5] To the extent that it involves public works spending it is important that the investment is targeted to ensure high returns. Eventually the deficit should be reduced by eliminating more marginal public works projects as economic conditions improve.

The OECD Secretariat has attempted to analyse the possible effects of a package along these lines. Two alternatives are considered. The first assumes that an extra fiscal stimulus amounting to around 2 per cent of GDP is spread over 1998-99, roughly three quarters in the form of permanent tax cuts and the remainder in more public works. The tax cuts are assumed to be offset from 2000 to 2003 by an equal amount of investment spending cuts. The second assumes tax cuts as above, but to reconcile the conflicting needs to stimulate activity in the short run and to consolidate the budget in the medium term, expenditure cuts are assumed to be somewhat more aggressive, reaching 2 per cent of GDP by 2003.

4. On 24 April 1998, after the text of this chapter had gone to print, the Japanese Government announced a package of measures whose nominal value comes to more than ¥ 16 trillion, or 3 1/4 per cent of GDP, mainly for fiscal year 1998. Excluding asset transactions, the package amounts to around 2 per cent of GDP, about three fifths of which involves increased public works expenditures and the remainder mostly temporary tax reductions. A box on p. *x* provides an update of most recent developments in Japan and a description and an assessment of this package.
5. The fiscal year 1998 budget, though on balance restrictive, already includes permanent reductions in corporate, securities and land transactions taxes.

Figure I.6. **Fiscal policy indicators in Japan**



1. The structural balance in 1998 excludes a special 5.2% of GDP negative capital transfer associated with the government's assumption of Japan National Railways and National Forest Company debts.
2. Defined as change in structural balance as a percentage of potential GDP.

The OECD Secretariat estimates that these packages, which are identical in the near term, would boost growth by around 1 percentage point in both 1998 and 1999 while the current account surplus would decline by some $^1/_2$ percentage point of GDP by 1999. The package involving more aggressive cuts in government investment would succeed in ensuring that there are no longer-term effects on the budget position, and would therefore have advantages in terms of concerns about ageing. It would, however, entail more risk to the sustainability of the recovery once the larger spending cuts came into effect. On the other hand, over the longer run, rises in the level of output coming from stronger structural reform efforts might lead to a higher tax base and contribute to a better budget position.

Recapitalising and reforming the banking system

Dealing with banking problems must be a priority

Macroeconomic stimulus alone will not suffice to generate a sustained expansion since the access of small and medium-sized business to adequate financing sources must be restored if domestic demand is to recover. This will be essential if confidence about future prospects in the economy is to be revived in a durable way. Therefore, dealing promptly and comprehensively with the crisis in the banking sector, in order to put the financial system on a sound basis, has become an overriding priority. This will involve action on two levels.

First, considerable restructuring is needed in the industry. Balance sheet problems must be resolved and the banking system must be recapitalised. Furthermore, some consolidation is likely to be necessary to reduce overcapacity and raise profit margins. Experience from other countries which have addressed substantial problems of bank restructuring suggests some of the actions required for success (see Box I.7): identifying institutions whose balance sheets are so weak that they effectively have little or no capital at risk; intervening quickly to prevent problems from accumulating; separating good assets from bad ones in problem institutions and closing those institutions that are not viable; ensuring that losses accrue in the first instance to shareholders and that those managers responsible for the poor situation are replaced; and providing adequate funding to protect depositors and to ensure systemic stability. These actions and the reasons for them must be communicated to the public in an open and transparent way.

Box I.7. **Selected episodes of banking crises and**

Several episodes of major banking sector problems in OECD countries since 1980, involving likely ultimate costs to governments of as much as 9-12 per cent of GDP in the cases of Finland and Mexico (table, opposite), offer some lessons about how the resolutions of similar problems might best be handled.

United States

The United States' handling of the Savings and Loan (S&L) crisis up until 1989 provides a good example of what should not be done. Despite technical insolvency resulting mainly from the impact of large interest rate rises of the late 1970s on long-term mortgage assets earning low fixed rates, a significant part of the thrift industry was allowed to continue operating with the benefit of government guarantees on deposit liabilities for as much as a decade. The initial approach of keeping troubled thrifts afloat by regulatory forbearance while waiting for improved operating performance to help them overcome their problems turned out to be very costly. The combination of extended deposit insurance, deregulation, rising bank competition and financial distress encouraged excessive risk taking by managers and made problems much worse. Separately, but around the same time, large commercial banks started to suffer serious balance sheet and liquidity problems due to poor bank management and imprudent lending in foreign markets and real estate.

After 1989, the government took decisive action, ultimately involving more than $130 billion in public funds, to resolve the long-standing insolvency of S&Ls. Insolvent institutions were temporarily placed under the supervision of federal authorities, old management was completely removed, good assets were separated from bad assets which were to be sold or collected by the new supervisory body (the Resolution Trust Corporation) and, most often, institutions were restructured (using public money where necessary). Reorganised institutions were quickly sold to the private sector thus minimising the loss of franchise. At the same time, commercial banks were obliged to make provisions for, and to recognise, losses and to raise large amounts of new capital in equity markets while they were still financially viable. While the economy faced "headwinds" for a period as banks retrenched, a sustained period of low interest rates facilitated adjustment and the commercial banking system recovered strongly without the need to inject public funds to support the bank deposit insurance system.

Mexico

Early action was taken to contain risks of a possible loss of confidence in banks following the sharp depreciation of the peso at the end of 1994. Banks received official support in the form of emergency lending and temporary capitalisation measures. They were asked to provision quickly for loan losses and were required to take steps to improve bank capitalisation. At the same time, they were given incentives to restructure outstanding loans. Bad loan purchases (with a loss-sharing clause between the bank and the government) were made conditional on new capital injections by shareholders. Insolvent banks are being closed down, merged or taken over by other banks, in many cases with substancial foreign participation.

The Nordic countries

Finland, Norway and Sweden acted decisively to resolve severe banking problems that emerged at the beginning of the 1990s due to the bursting of property market bubbles. The prompt response resulted in a rapid recovery of profitability in the banking sector. Policy responses consisted of a full and transparent commitment of public funds to ensure the stability of the system, the operation of viable institutions and the orderly liquidation of non-viable ones. Governments took over a number of large banks and injected capital to help them meet capital requirements and restore profitability without providing support for shareholders. Often good assets were separated from bad, so that banks taken over could be sold or merged with healthy banks. Capital injections were often conditional on the implementation of cost-cutting measures and accompanied by a strengthening of supervisory conditions. Specialised bodies were created to deal swiftly with non-performing assets. Given the magnitude of the problem, this approach required large public budget disbursements during the insolvency episodes; however, a significant proportion of outlays was subsequently, and is still being, recovered.

Spain

In Spain, resolution of most of the bank insolvencies that emerged at the beginning of the 1980s also involved extensive official intervention. Insolvent banks were recapitalised by the Deposit Guarantee Fund (DGF), an institution jointly financed by the private banks and the central bank, which immediately replaced all top management and provided managerial and administrative oversight. Since the Fund had by law to divest ownership within one year of takeover, most restructured banks were quickly resold to private and foreign banks. A substantial portion of non-performing assets was kept and eventually sold by the DGF, thereby allowing some of the costs to be recovered. The banking crisis prompted a strengthening of supervisory and control functions of the Bank of Spain and the improvement of information disclosure rules for banks.

resolution mechanisms in OECD countries

Main characteristics of the crises

	Severity	Estimated final resolution costs
United States **1980-94**[a]	Failure of 1 617 banks (9% of total banks and 9% of banking assets) and 1 300 Savings and Loans institutions (27% of institutions) over the period 1980-94.	Total outlays on resolutions of failed institutions: $196.4 billion (3.4% of 1990 GDP). The use of public funds amounted to $132.1 billion and deposit insurance premia financed the remainder. Thrift failures: $160 billion (2.8% of 1990 GDP). Commercial banks: $36.3 billion (0.6% of 1990 GDP), all covered by deposit insurance premia.
Finland **1991-93**[b]	Non-performing bank loans rose to 9.3% of loans in 1992 (4.6% of 1992 GDP). Crisis affected mostly the savings sector.	Total funds committed by the government: Mk 83 billion (17% of 1993 GDP). Of this, Mk 51 billion were disbursed, Mk 32 billion were guarantees not called. About Mk 12 billion already recovered. Expected final losses (*i.e.* net of assets recovered): Mk 42-49 billion (9-10% of 1993 GDP).
Mexico **1995-97**[c]	Non-performing loans (including those held by the deposit insurance trust fund) amounted to 35% of total loans in 1997 (9.6% of 1997 GDP).	Expected final cost to the government (present value of costs over next decade): Pesos 384 billion (12% of 1997 GDP), including both bank and debtor support programmes. Of this, 70 billion pesos (2.2% of 1997 GDP) have already been disbursed.
Norway **1987-93**[b]	Loan losses reached 6% of loans in 1991 (3% of 1991 GDP). Central bank provided special loans to six banks. State took control of three largest banks equivalent to 85% of commercial bank assets (partly through a Government Bank Investment Fund).	Total funds committed by the government: Nkr 17 billion (2.6% of 1993 GDP). The State is ultimately likely to recover all the costs of bank support with the sale of Den Norske Bank and Christiania Bank.
Spain **1977-85**[d]	52 of the country's 110 banks were affected, mostly small and medium-sized banks accounting for more than 20% of total deposits.	Outlays on failed-bank resolutions: 1 581 billion pesetas at constant 1985 prices (5.6% of 1985 GDP). Of this, 77% borne by the Deposit Guarantee Fund and the Bank of Spain, the remainder by the budget.
Sweden **1990-93**	Loan losses reached 11% of loans in 1992 (4.9% of 1992 GDP). Two main banks were assisted.	Total funds committed by the government: Skr 85 billion (6% of 1993 GDP). Of this, Skr 65 billion disbursed, Skr 20 billion in guarantees not called. Unofficial expected final losses (*i.e.* net of assets recovered): Skr 35 billion (2% of 1997 GDP).

a) Source: "History of the Eighties: Lessons for the Future", Federal Deposit Insurance Corporation, Washington DC, 1997; and "FDIC Historical Statistics on Banking 1934-96", Washington DC, 1997.
b) Estimates of resolution costs are based on the public support received by banks for the period 1989-95. Source: *Bank of Finland Bulletin*, August 1995, Vol. 69, No. 8.
c) Source: *OECD Economic Survey, Mexico*, 1998.
d) Source: Cuervo, Alvaro. "La Crisis Bancaria en España 1977-1985", Editorial Ariel, Barcelona, 1988.

Second, the legal, regulatory and supervisory environment in which financial institutions operate will need to be improved in order to reduce the likelihood that the current situation recurs. In this regard, emphasis needs to be placed on transparency, strengthening the role of market signals in the financial system, and ensuring objective enforcement of laws and regulations to strengthen public confidence in the system.

The Government has responded by committing ¥ 30 trillion…

The Government has responded by creating a new framework for resolving difficulties by providing regulatory authorities with greater discretion to close insolvent banks and to take "Prompt Corrective Action" when capital adequacy norms are not met. It has also committed ¥ 30 trillion in the form of government bonds and guaranteed lending to ensure the stability of the financial system. Over half of this sum (¥ 17 trillion) is available to protect depositors of insolvent banks, *i.e.* by making up losses of, or by purchasing assets from, failed institutions. The remainder is available to recapitalise still solvent banks by purchases of preferred shares and subordinated debt, a process which has already begun. An examining board, accountable to the public, has been established to ensure that such purchases are made on the basis of "strict and objective criteria".[6]

Much of this goes in the right direction. The Government has moved to acknowledge the scale of the problem. It has also recognised that the financial system requires support from outside sources and that there are limits to the extent to which the situation can be resolved by obliging healthy institutions to support their weaker competitors (the old "convoy system") or by waiting for banks to grow their way out of their difficulties. Furthermore, the establishment of a clearer rules-based framework with a strengthened and more transparent system of supervision is also an essential step in both resolving the current problems and preventing their recurrence in the future. Over the longer term, the financial deregulation being phased in according to the "Big Bang" schedule of reforms will strengthen the role of market forces by opening up of banks to greater foreign competition and allowing a range of expanded bank products, while decompartmentalising various financial services.[7]

… but some questions remain

However, some questions remain. First, it is unclear that the public funds that have been made available will be allocated effectively so as to avoid moral hazard and minimise ultimate budgetary costs. In particular, the criteria for choosing banks to be recapitalised does not appear to be narrow enough to avoid inclusion of banks that either do not need the help or that ought to be closed down. Indeed, the Government has indicated that it will recapitalise healthy banks in order to avoid stigmatising weaker banks, although it plans to close down insolvent banks. In early March, twenty-one of the largest banks submitted applications, most of them involving the issuance of similar amounts of subordinated debt and containing restructuring plans. None was rejected and all but two received the full amount of their request, albeit on terms that varied across institutions.

Second, while ¥ 30 trillion has been committed, it is not clear to what extent these funds will actually be used. The recapitalisations which took place in March, noted above, amounted to only ¥ 1.8 trillion, far short of the ¥ 13 trillion available,

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6. It is envisaged that financial institutions satisfying such criteria would include those whose capital ratios have deteriorated due to a take-over of a weaker institution, those that have difficulty in raising funds in both domestic and foreign capital markets, and those that are suffering from contagion of regional and sectoral problems.
7. For a description and analysis of the "Big Bang" programme of reforms planned for the financial system during the next few years, see *OECD Economic Survey, Japan*, 1997, pp. 85-88.

and the remaining ¥ 17 trillion will be held by the Deposit Insurance Corporation until needed for depositor protection. While further recourse to the remaining funds earmarked for recapitalisation is possible, management of the institutions most in need of these funds continues to have strong incentives to avoid the scrutiny which an application for them would involve. Unless the authorities take the initiative by moving to close down insolvent banks or taking other action which would involve disbursing some of the money in the Deposition Insurance Corporation, the funds may remain largely unused except in cases where market conditions force institutions to stop operating.

Finally, in the absence of a comprehensive approach which provides enough funding to reassure the public of the system's stability and, at the same time, forces the necessary restructuring and recapitalisation to proceed, elements of the current approach risk being misdirected in a structural sense. In particular, efforts to ease credit conditions often conflict with the need to address balance sheet problems in a more fundamental way and to reform the framework in which financial markets operate. Reliance on forbearance and introducing accounting changes designed to increase reported capital ratios, for example, may ease the immediate pressures on banks to limit lending in order to strengthen balance sheets. But they risk delaying the actions needed to ensure a longer-term solution to the industry's problems.

Korea

Korea has implemented a tight macroeconomic policy framework and a wide range of structural reforms

Despite its many strengths, the Korean economy in November 1997 experienced one of the worst financial market crises that has ever occurred in an OECD country. Given the risk of a default on its foreign debt, Korea received a $57 billion rescue package led by the IMF in December 1997. The macroeconomic policy response included in the package is intended to limit inflation to less than 9 per cent in 1998 and to shift the current account to a surplus of at least $8 billion. The main features include a tightening of fiscal policy to help offset new spending obligations, especially related to the restructuring of banks and increased support for the unemployed, and high interest rates to support the exchange rate and to offset the second round inflationary effects from the large depreciation that has occurred. However, high interest rates, an exchange rate which is still low despite its recent recovery, and credit problems affecting foreign trade are aggravating balance sheet problems in the highly leveraged corporate sector.

The tight macroeconomic policy framework has been accompanied by initiatives to address underlying structural weaknesses, which made the Korean economy vulnerable to shocks. These weaknesses were not new and were already largely documented, for example in *OECD Economic Survey of Korea*, 1996 – though the full implications were clearly not widely appreciated prior to the crisis. The government has taken steps to rehabilitate the financial system by closing weak institutions and using public money to resolve the bank's balance sheet problems. Financing these operations, which the OECD Secretariat estimates may amount to 1½ per cent of GDP in 1998 alone, will be facilitated by the government's healthy overall fiscal position and the absence of net public debt. The rehabilitation of the financial system has been accompanied by measures to strengthen prudential supervision. In the labour market, flexibility has been increased by legislation relaxing controls on layoffs while the rights of labour unions have been extended. Other important reforms include the further opening of the capital account and steps to encourage corporate restructuring. The government also plans to accelerate the opening of the product market and

to improve corporate governance practices. Negotiations to reschedule $22 billion of Korea's foreign bank debt concluded in January 1998 on terms that were more favourable to Korea than expected.

These policies have helped to restore international confidence, although considerable uncertainties remain

These initiatives, accompanied by the shift of the current account into surplus, have enabled Korea to re-establish access to international capital markets. This has resulted in some recovery in equity prices, as well as an easing in interest rates and a significant rebound of the exchange rate, which, nonetheless, remains volatile. Despite these positive signs, economic conditions will be very difficult this year, with domestic demand falling sharply and output stagnating despite a strong contribution from surging net exports. Unemployment is rising sharply, and this creates a risk of increased social tensions. In this context, the introduction of an adequate safety net and active use of labour market policies are important. Moreover the new framework for prudential supervision needs to be made operational, and further steps are also needed to improve the corporate governance framework which has allowed excessive leverage, insulated management from market discipline and encouraged political interference. If the structural reform programme is implemented effectively, confidence should continue to strengthen and provide increasing scope to ease the macroeconomic policy stance and thus pave the way for economic recovery next year.

OECD countries outside Asia

Monetary policies and sustaining non-inflationary expansions

The Asia crisis has led to an easing of financial market conditions in many countries

The United States and most European countries are in various stages of the expansionary phases of their business cycles. Until the Asia crisis broke, there appeared to be a likelihood that some monetary tightening would be appropriate for these countries so long as they continued to expand at rates around or above potential. This presumption has now been substantially weakened. At the same time, lower long-term interest rates, continued rises in equity prices and terms of trade gains in the aftermath of the crisis have provided a *de facto* stimulus which will help to offset the contractionary effects on activity of the trade volume adjustments.

In the United States, where the expansion has been relatively mature for some time, the principal risk has been that continuing strong domestic demand and tight labour markets could lead to overheating and a re-emergence of inflation. The deflationary impulse from the Asia crisis is having a restraining effect and has obviated, for the time being at least, the need for a monetary tightening. The authorities should nonetheless guard against a possible resurgence of inflation pressure, which has until now been partly contained by falling import prices and strong productivity growth – both of which may not continue.

In the prospective euro area, the deflationary effects of Asian developments have been mitigated to some extent by further exchange rate declines *vis-à-vis* the dollar, but underlying inflation pressure is also low given that the major economies in this region are generally in earlier stages of the expansion. This helps to avoid the need for an early monetary tightening, though it probably does not justify a move to easing as the recovery now appears to have become self-sustaining and the outlook for growth in the area is strong (Table I.13).

Table I.13. **The outlook for the prospective euro area**[a]

	1996	1997	1998	1999
	Percentage changes from previous period			
Private consumption	1.7	1.5	2.3	2.7
Government consumption	1.5	0.5	1.2	1.3
Gross fixed capital formation	0.5	1.9	4.2	5.1
Final domestic demand	1.4	1.4	2.5	3.0
Stockbuilding[b]	–0.5	0.4	0.1	–0.1
Total domestic demand	1.1	2.0	2.7	2.9
Net exports[b]	0.7	0.7	0.5	0.2
GDP at market prices	1.6	2.5	2.9	2.9
GDP implicit price deflator	2.2	1.5	1.6	1.7
Private consumption deflator	2.6	1.9	1.7	1.8
Memorandum items:				
Unemployment rate[c]	12.3	12.4	12.0	11.5
Output gap[d]	–2.0	–1.8	–1.2	–0.7
General government financial balance[e]	–4.3	–2.6	–2.4	–2.2
Current account balance[e]	1.3	1.9	2.2	2.3

a) Includes 11 prospective participants in European Monetary Union in 1999: Germany, France, Italy, Austria, Belgium, Finland, Ireland, Luxembourg, the Netherlands, Portugal and Spain.
b) Contributions to changes in real GDP (as a percentage of real GDP in the previous period).
c) As a percentage of the labour force.
d) Deviation of actual GDP from potential GDP as a percentage of potential GDP.
e) As a percentage of GDP.

Uncertainty favours a "wait-and-see" approach in the United States and the European Union

The damping effects of the Asia crisis on trade and import prices, as well as the favourable impacts on long-term interest rates may prove temporary provided the Asian situation stabilises and improves. On balance, the inherent uncertainty of the situation would appear to favour the "wait-and-see" attitude that has been adopted by the Federal Reserve, and the "steady hand" approach of the Bundesbank.

In the United Kingdom, the economy has also performed strongly for several years, and overheating became increasingly apparent during 1997. A substantial tightening of fiscal and monetary policies has occurred since mid-1996 and the economy now appears to be slowing. The appreciation of Sterling and the impact of the Asia crisis will reinforce this slowing tendency. In this environment, although there is some risk that wage pressures might not ease as activity slows, inflation is likely to be close to the Government's target during most of 1998 and 1999. So long as these conditions prevail, further base rate rises do not appear to be needed.

Canada, Australia and New Zealand are in some ways more exposed to the Asia crisis. All three have significant current account deficits and, except in New Zealand, they appear likely to increase. They are important commodity producers and exporters, and recent commodity price weakness may put pressure on their terms of trade. Australia and New Zealand, furthermore, have deeper trade (including tourism) and investment linkages with the crisis countries than most North American and European countries, and, as in the United States and the United Kingdom, their expansions are quite mature. Although there is little sign of increased inflation pressure, and in Canada a modest output gap persists, weak commodity prices and external positions could translate into exchange rate weakness and rising inflation that is not consistent with inflation targets. This in turn is likely to require monetary policies that are biased toward caution.

The "emerging market" countries of the OECD will need to reinforce their macroeconomic soundness and commitment to structural reform, given the increased scrutiny of markets following the recent financial turbulence in Asia. Most of these countries need to persevere with efforts to reduce fiscal deficits and inflation (especially Turkey), improve tax administration and the effectiveness of public spending, and restructure and, in some cases, privatise state-owned enterprises more rapidly. Moreover, the Asia crisis has shown that ensuring the health of the banking system is critical in being able to withstand shocks from abroad. While banking reforms have been largely successful in Poland and Hungary, many banks in the Czech Republic and Mexico still suffer from serious asset quality problems.

Maintaining open markets will benefit all countries

Finally, while the flexible use of monetary policy should allow OECD countries outside Asia to absorb the macroeconomic consequences of the adjustments that will be required in the region, it will entail a considerable shift toward reliance on domestic demand to support activity and employment. Although many sectors and groups will benefit, and consumers in general will gain from lower import prices, those made worse off as exports fall and import competition rises may press for compensation or protection which would have the effect of impeding the adjustments which must take place at the global level. It is important that the changes that will be involved be seen as a normal part of the broader dynamic process of change and adjustment that occurs continuously in market economies, and that this process operate as smoothly as possible. In particular, maintaining open markets and avoiding protectionist measures, such as excessive use of anti-dumping arrangements, to block competition from Asia will be beneficial to non-Asian countries as well as those in crisis.

Convergence within EMU

The project to create a monetary union is on track

At the end of March, the European Commission in its "Convergence Report" recommended that the eleven countries planning to participate in EMU from January 1999 have all met the necessary conditions to adopt the single currency, the euro.[8] In early May, decisions in line with these recommendations were taken by the European Council concerning participation in monetary union and the bilateral exchange rates at which conversion into euros will take place. Institutional arrangements are moving forward in terms of the creation of a council of Finance Ministers of the euro member countries (Euro-X Council) and instituting exchange rate relationships between the euro and other EU currencies (ERM II).

In order to ensure a smooth transition, it will be important to avoid intra-European exchange rate tensions during the run-up to monetary union, which will occur on 1 January 1999. And even though remarkable convergence has been achieved among the prospective EMU members in important respects (including long-term interest rates, inflation rates, and budget deficits), the sustainability of budget deficit reductions achieved to date must be assured and debt levels are still generally high (Table I.14). Indeed, the Convergence Report of the European Monetary Institute pointed out that substantially more fiscal consolidation is required in many EU countries.[9] This will be necessary to achieve budget balance or even surplus positions and to ensure lasting compliance with the

8. See European Commission, *Convergence Report 1998*, Brussels, 25 March 1998.
9. See European Monetary Institute, *Convergence Report: Report required by Article 109j of the Treaty establishing the European Community*, Frankfurt, March 1998.

Table I.14. **General government budget balances and debt in the European Union**[a]

As a percentage of GDP

	General government financial balances			General government gross debt[b]		
	1997[c]	1998	1999	1997[c]	1998	1999
Germany	–2.7	–2.3	–2.4	61.3	60.7	60.5
France	–3.0	–3.0	–2.6	57.7	58.9	59.5
Italy	–2.7	–2.6	–2.5	121.6	118.5	116.0
United Kingdom	–1.9	–0.8	–0.4	53.3	52.1	50.5
Austria	–2.5	–2.2	–2.3	65.2	64.8	64.4
Belgium	–2.1	–1.7	–1.6	122.4	118.4	115.4
Denmark	0.4	1.1	1.9	61.8	57.3	53.2
Finland	–1.0	0.6	1.1	55.8	53.4	54.6
Greece	–4.0	–3.0	–2.9	108.4	108.2	105.6
Ireland	0.9	1.5	1.6	65.3	57.0	50.3
Netherlands	–1.4	–1.7	–1.6	71.4	69.5	68.9
Portugal	–2.5	–2.3	–2.0	65.3	63.4	61.9
Spain	–2.6	–2.2	–1.8	69.3	68.5	67.5
Sweden	–0.8	0.8	0.5	76.9	74.5	71.1
Total	–2.4	–2.0	–1.8	73.6	72.5	71.4

a) Excluding Luxembourg.
b) Maastricht definition. The debt figures for 1997 are provided by the Commission of the European Communities whereas the GDP figures are OECD estimates. The 1998-99 debt ratios are projected forward in line with the OECD Secretariat's projections for general government gross financial liabilities and GDP.
c) Provisional estimates.

Stability and Growth Pact. In particular, countries with government debt-to-GDP ratios over 100 per cent (Italy, Belgium and Greece) were urged to bring these ratios down substantially.

Interest rates are declining toward German levels

Currently, financial market pressures appear to be lower than they have been for many years. Confidence regarding the commitment to proceed with EMU and that conversion of exchange rates will take place at central parities is high. This has contributed importantly to a high degree of convergence of long-term interest rates toward German levels. Given that cyclical divergences among the major continental European economies are not large and are not projected to change appreciably in the near future (Table I.15), the potential difficulties of formulating a single monetary policy appropriate to the prospective euro area as a whole have been reduced. For Italy, further projected falls in interest rates would seem to be a favourable development given the existence of some margin of spare capacity. In the northern part of the country, however, capacity is tighter and bottlenecks have begun to emerge. It will be important, therefore, that wage moderation continues.

Table I.15. **Output gaps in the prospective euro area**[a]

	1997	1998	1999
Germany	–1.6	–1.4	–1.0
France	–2.2	–1.4	–0.8
Italy	–2.4	–1.8	–0.9
Austria	–1.3	–0.8	–0.3
Belgium	–2.2	–1.4	–0.6
Finland	–0.5	0.8	0.4
Ireland	2.4	3.1	2.3
Netherlands	0.3	0.7	0.6
Portugal	–1.2	–0.2	0.1
Spain	–1.8	–1.2	–0.9

a) Excluding Luxembourg.

In Finland, the Netherlands, Ireland, Portugal and some other countries, cyclical conditions are tightening rapidly. In some of these countries, the effects of convergence toward low euro interest rates may be less helpful and all face an increasing risk of overheating. While inflation remains low in all of these countries, property prices have begun to rise significantly in some (Ireland, the Netherlands) and signs of labour market tightness are appearing in most. Stepped

up fiscal consolidation might be helpful in this context even where budget positions are already in good shape, to limit the risk that costs and asset prices move so far out of line with those elsewhere in the euro area that deflationary corrections are ultimately required.

Sustained progress on deficit reduction will require reforms to restrain spending…

If continued fiscal consolidation is to be achieved without further increases in taxation, structural reforms to control budgetary pressures will be required. Progress has already been made on pension reform in some countries, and some other types of expenditure have been restrained (notably, however, public investment), but the future demands of population ageing necessitate continued progress, especially given other social spending pressures and the unhelpful labour market incentives such spending can create. And insofar as deficit reduction has been helped by temporary measures such as one-time receipts, expenditure freezes, and accounting changes, sustainability is in question.[10] This reinforces the need for continued fundamental reforms.

… but structural flexibility is also needed

There will be limits to what macroeconomic policies can do in a single currency area to respond to disturbances in individual countries. Thus, structural flexibility needs to be increased throughout the area in order to ensure the smooth functionning and long run success of EMU. Closer integration of product markets and greater labour mobility are essential in this regard, as they would help wage and price formation increasingly to take account of euro area-wide developments and not just national conditions. One critical aspect of this will be ensuring that all countries maintain open policies regarding the employment of labour from elsewhere in the European Union.[11]

A precondition for achieving durably low unemployment is that real wages correspond across regions to productivity levels. Wage-setting behaviour, and industrial relations more generally, are therefore crucial. In the transition phase to EMU, and before comprehensive structural reforms can have their effects, it is particularly important that firms and workers set wages so as to safeguard low inflation and, thus, prevent future rises in unemployment. Depending on national traditions and institutions, governments may contribute to creating a climate conducive to wage moderation, though fiscal incentives in this regard should be avoided.

Reducing structural unemployment is critical

Perhaps the greatest challenge will be to reduce structural unemployment. Implementation of the required policies is proceeding in a number of European countries, and some (the United Kingdom, Denmark, Ireland and the Netherlands) have enjoyed some visible success in bringing down their structural unemployment rates during the 1990s.[12] Nevertheless, progress remains uneven across policy areas and countries, and much remains to be done.

Access to unemployment, disability, and other social benefits has been tightened in the context of the effort to meet the Maastricht goals. However, benefit generosity remains high in many countries, with early retirement and disability programmes being used to a large extent to exit the labour market, and such generosity may need to be

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10. These were discussed in *OECD Economic Outlook* 61, June 1997. The EMI, in its Convergence Report (*op. cit.*), estimates that the effect of temporary measures varies, depending on the country, within a range of around 0.1 to 1.0 per cent of GDP.
11. As an example of a backward step in this regard, Germany has recently moved to discourage inward labour mobility by imposing minimum wages in the construction sector, where firms from lower wage countries (such as the United Kingdom, Portugal and Spain) had been winning a growing number of contracts.
12. Over the period 1995-97, *OECD Economic Surveys* presented detailed, country-specific recommendations for implementing the OECD Jobs Strategy. Progress since then in turning these recommendations into actions is reported in Chapter V "Implementing the Jobs Strategy: Progress Report".

reduced.[13] Reforms to ease the taxation of labour and reduce high marginal tax rates have also been enacted in a number of countries, but generally relief has been limited for lower income groups (where structural unemployment is concentrated). This points to the need to reduce the high average tax burden.[14] Sanctions and subsidies (*e.g.* work to welfare, employment conditional benefits, and reduced payroll taxes for lower-paid workers) have been introduced in some countries in an effort to counteract the disincentives of the tax-benefit system, and these may merit close attention in other countries. While labour markets have in many ways been made more flexible, many governments need to make more progress in implementing policies that risk antagonising insider groups, for example by relaxing minimum wage requirements, allowing for a wider dispersion of wages and easing employment protection.

Product market reforms are proceeding…

Policies to enhance product market competition are being pursued in the context of the European Union's competition policy. In the public sector, significant progress has been made, despite resistance from the affected groups, in opening activities to competition, thereby increasing efficiency and assisting the fiscal consolidation effort. Moreover, there has been progress, albeit in some cases slow, in privatisation and other ways of opening up the telecommunications, transport, gas and electricity sectors to greater competition. However, there has been little progress in cutting subsidies and other forms of state assistance and, while an EU framework is in place to open government procurement, change has been slow. In the private sector, the drive for change has come largely from the competition authorities of the European Union.

… and banking and financial sectors will have to restructure

In the financial sector, European banks will be challenged by monetary union at the same time that they face potential stresses from exposures in emerging markets. The creation of EMU will increase competitive pressures as banks will lose much of their home-currency advantage in lending and deposit-taking activities, as well as a substantial source of revenues from currency transactions. Moreover, the elimination of currency risk in cross-border financial transactions will lead to the end of segmentation of capital markets and unleash the development of broad and deep Europe-wide securities markets, a trend which would be reinforced by policies to promote the growth of private pensions schemes. This may to some extent diminish the role of traditional bank intermediation.[15] These developments will lead to pressure on banks' profitability and require that they consolidate and restructure, which is likely to require labour shedding in the sector. Over the longer term, such changes in the financial sector will improve the Europe-wide allocation of resources and promote new enterprise and job creation. It will be important that policies facilitate such restructuring as is necessary to ensure adequate profitability in the sector, in particular by allowing the necessary labour market adjustments to take place.

Management of fiscal surpluses

Many countries now enjoy budget surpluses…

Sustained fiscal consolidation, often in conjunction with favourable cyclical conditions, has produced fiscal surpluses in the United States, Canada, Australia, and New Zealand as well as in some of the smaller European countries (Denmark, Ireland,

13. See Chapter VI "The Retirement Decision".
14. See Chapter IV "Forces Shaping Tax Policy".
15. Apart from its core of internationally highly competitive financial institutions, Europe in general appears to be "overbanked", with too many retail banks, many of which are overstaffed and inefficient. Bank loans are also the predominant form of finance, accounting for 54 per cent of outstanding EU financial instruments (bonds, equities, and loans), compared with only 22 per cent in the United States.

Finland, and Sweden). Policy debates concerning these surpluses have revolved around the issue of whether they should be used to lower taxes, raise spending, or run down the public debt. Political pressures have often been strong especially in favour of either of the first two alternatives.

… but fiscal discipline must be maintained

Resolving such debates will largely depend on the medium and long-term outlook for spending, deficits, and debt in view of society's future needs, in large part related to ageing. Decisions regarding to what degree to maintain the surplus will also depend on cyclical and structural needs of the economy. Some cushion will be needed to allow for some flexibility during downturns of the cycle. Beyond this, a surplus which is sustained by a high tax ratio may be undesirable from an efficiency point of view, and lowering taxes may well be more important than further reducing the debt. Furthermore, surpluses could also make it politically difficult to maintain fiscal discipline and expenditure control.

On the other hand, a highly indebted country may be forced to maintain large surpluses on a sustained basis in order to work down its debt and debt service burdens. For example, Canada and, until fairly recently, New Zealand have both faced high levels of public debt which has made them vulnerable to shifts in market sentiment and, as New Zealand is finding, reduces the scope for either permanent tax reductions or temporary fiscal boosts. Ireland has succeeded in recent years in both reducing debt and tax rates, thanks to strong growth. However, it is now committed, in the context of the revaluation of its central parity in the European Exchange Rate Mechanism, to giving priority to debt reduction.

A case in point where policy makers will need to be especially vigilant against the danger of relaxing fiscal discipline is the United States. There, the fiscal outlook has brightened considerably, in particular as tax outcomes have boomed. The Administration has proposed a balanced federal budget for 1999, three years ahead of schedule, and (at least small) surpluses are now in sight for future years. It has also proposed that these surpluses be reserved, *i.e.* not spent, in order to strengthen the Social Security Trust Fund over the longer term. At the same time, new social spending is now being proposed, and numerous new targeted tax credits to meet social goals have already been enacted, whereas reforms that are needed to restrain entitlement spending (mainly Medicare and social security), which is projected to rise rapidly over the longer term, have not yet been implemented.[16] However, in the absence of measures to control social spending and the erosion of the revenue base which tax credits may entail, the future surpluses to be reserved are unlikely to materialise. It will be important to address these issues in a prudent way to ensure that the fiscal progress that has been made is preserved, not least in view of the low private saving rate and the rising external deficit and indebtedness.

16. The United States Congressional Budget Office has estimated that, on present policies, federal spending on health care will rise from less than 4 per cent of GDP currently to more than 8½ per cent in 2030, while on social security it will rise from 4½ per cent to 6 per cent of GDP.

II. DEVELOPMENTS IN INDIVIDUAL OECD COUNTRIES

United States

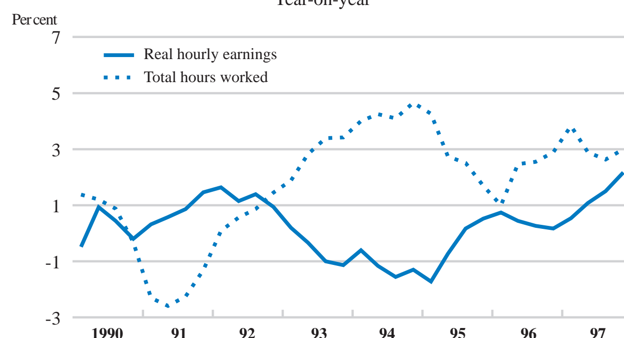
The US economy performed extremely well in 1997. Growth was at a nine year high, the unemployment rate was at its lowest level for a generation and inflation close to the rates seen in the mid-1960s. With equity prices increasing and bond yields falling, foreign investors have financed a widening current account deficit and pushed the dollar higher. During 1998, weaker external demand and increased foreign supply may be sufficient to slow the economy, despite the strength of domestic sales. Nonetheless, the labour market will remain tight and the level of production above the OECD Secretariat's estimate of potential output. In these circumstances, some rise in inflation seems likely during 1999, when the fall in import prices is projected to end and growth picks up once again. Moreover, the current account deficit seems set to increase further.

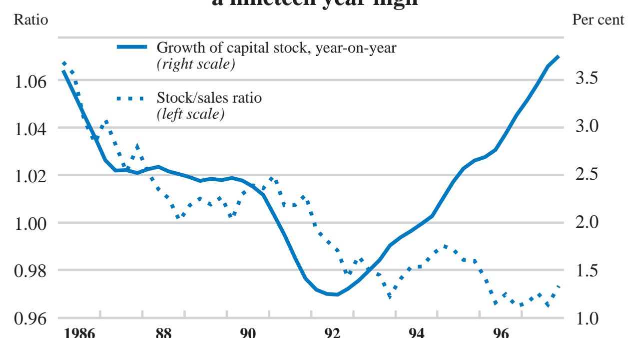
The OECD Secretariat's projection suggests a soft landing for the economy, with growth easing back spontaneously and inflation staying under control. Because the unemployment rate is projected to remain below the Secretariat's estimate of the non-accelerating inflation rate of unemployment, however, policy makers should be watchful for any possible resurgence of inflationary pressure, the more so since the recent slowdown in inflation appears to be essentially linked to the fall in import prices, which could be quickly undone. This suggests that monetary policy may at some point need to be lean towards tightness once again. As to fiscal policy, the balanced budget objective is being achieved only because the social security surplus is included in the unified government accounts. As this surplus is expected to decline gradually over time, there will be a continuing need to keep expenditures in other areas under check.

The economy remained strong at the end of 1997…

The US economy continued to expand rapidly at the end of 1997, with GDP increasing 3.7 per cent in the fourth quarter, in line with average output growth for the year as a whole – the most rapid annual pace seen in almost a decade. In contrast to the two previous quarters, business investment fell, but personal consumption remained strong. Much of the increase in demand, however, came from three sources – an acceleration in exports, deceleration in imports and higher stock building – that are unlikely to be sustained.

United States





Employment, income and inflation

Percentage changes from previous period

	1995	1996	1997	1998	1999
Employment[a]	1.5	1.4	2.2	1.5	0.8
Unemployment rate[b]	5.6	5.4	4.9	4.8	5.0
Employment cost index	2.8	2.8	3.1	3.5	3.5
Compensation of employees	5.1	5.0	6.2	5.9	4.8
Unit labour cost	3.0	2.2	2.4	3.1	2.7
Household disposable income	5.8	4.3	4.9	5.2	5.0
GDP deflator	2.5	2.3	2.0	1.6	1.8
Private consumption deflator	2.6	2.4	2.0	1.0	1.7

a) Household basis.
b) As a percentage of labour force.

… combining a tight labour market with low inflation

In line with the strength of output, there were substantial gains in employment and hours worked, with the unemployment rate dipping to a low of 4.6 per cent in November, its lowest level since 1973. The strength of the labour market brought some acceleration in both hourly average earnings and total employment costs, especially in the service sector. In the manufacturing sector, the growth of wages was stable. This – together with increased labour productivity, a rapid expansion in capacity and falling import prices – helped to keep goods' prices under control. Indeed, despite output in the whole economy moving further above the estimated level of potential output, inflation moderated.

Few signs of a slowdown are evident yet…

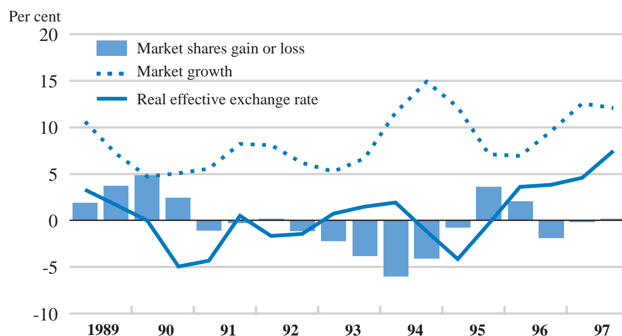
Preliminary indicators for the first quarter of 1998 point to continued strong growth of the economy. Personal consumption has been particularly brisk as employment continued to grow strongly and inflation, measured by the consumer price index, eased again to show an increase of only 1.4 per cent in the twelve months to February 1998 – the lowest rate in a decade. Housing activity has also been buoyant, reflecting lower mortgage rates. However, the strength of final domestic demand appears to have been balanced by weaker exports and a rebound in imports that has led to a slackening in the growth of manufacturing output. Looking forward, export orders appear to have fallen.

… but the impact of the Asia crisis on exports will grow…

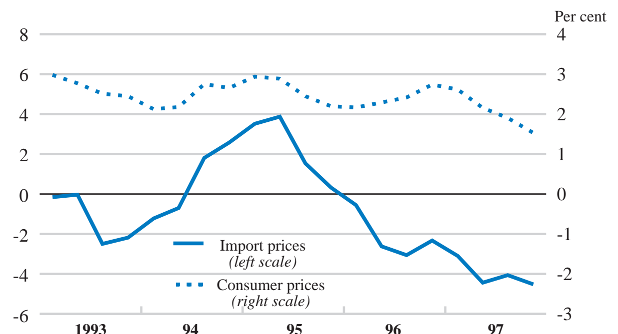
In the period ahead, the economy is likely to be held back by the consequences of the financial crisis in Asia, which are being felt through two channels. First, the fall in domestic demand in the east Asia area, which accounts for 29 per cent of US exports, may lower the growth of US export markets in that area by 7 percentage points between 1997 and 1998, equivalent to 0.2 per cent of GDP. Second, the collapse in the value of the

United States

A strong dollar will dampen exports



Falling import prices have lowered inflation



Financial indicators

	1995	1996	1997	1998	1999
Household saving ratio[a]	5.1	4.4	4.0	4.4	4.7
General government financial balance[b]	–1.9	–1.1	0.0	0.4	0.1
Current account balance[b]	–1.8	–1.9	–2.1	–2.5	–2.8
Short-term interest rate[c]	5.5	5.0	5.1	5.1	5.1
Long-term interest rate[d]	6.6	6.4	6.4	5.9	6.1

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

… leading to a continued neutral stance of monetary policy…

currencies of these countries had, by the first quarter, boosted the effective exchange rate of the dollar on OECD's new broader basis to 9.4 per cent above its 1997 average. This appreciation is likely to exert a substantial drag on the economy well after the impact of the fall in Asian aggregate demand has passed. On the other hand, the appreciation is also improving the terms of trade and boosting real incomes, thereby pushing up consumption.

In December 1997, as the full extent of the crisis in Asia became evident and with confidence growing that inflation would remain under control for some time, the Federal Reserve ended its disposition towards the tightening of monetary policy and held interest rates constant. Despite some concerns about the tightness of the labour market, interest rates remained unchanged at the subsequent Federal Open Market Committee's meeting in February. With activity slowing as the result of weak export demand and inflation being held back by the strength of the dollar, the OECD Secretariat projections assume that there is now little likelihood of any increase in short-term rates until the end of 1999. In contrast to the stability of short-term rates, long rates have fallen back to 5.7 per cent by March, as the result of a fall in inflation expectations which is assumed to be partly reversed during the projection period.

… at a time when, with the budget in balance, public debt is falling

The Federal budget deficit is now close to being eliminated, some three years ahead of the plan in the last budget. Indeed, when measured on a national accounts basis, the central government (including social security) should report a slight budgetary surplus in 1998 and 1999, for the first time since the 1960s – a marked change from a deficit as large as 2$^{1}/_{4}$ per cent of GDP in 1995. The improvement in Federal finances has mainly been due to a rise in the average tax rate on households that has occurred without any increase in nominal tax rates. Some of this rise reflects normal cyclical factors but, once again, part of it seems related to the strength of the stock market. Rising equity prices have indeed led to higher realised capital gains and income from stock options. As such, if equity prices were to stabilize, some of the gain in tax yields might be reversed. On the other hand, lower interest rates will pull down the cost of servicing government borrowing. Given the healthy financial position of state and local governments, the general government sector should show a surplus of 0.4 per cent of GDP in 1998, with the result that between 1996 and 1999 both gross and net public debt are projected to fall by 2$^{1}/_{2}$ percentage points of GDP, to 60 and 45 per cent, respectively.

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

The projections incorporate enacted legislation governing taxation and spending policies until 2002. In addition, they assume that the run up in the ratio of personal tax receipts to GDP is maintained in 1998 on the strength of high realisations of capital gains but then falls off in 1999 as collections decelerate because of the tax cuts. On the spending side, the projection assumes that the discretionary spending limits in the Balanced Budget Act are met and that mandatory spending increases are in line with official projections. State and local government budgets are projected to continue in slight surplus.

Demand and output

Percentage changes, volume (1992 prices)

	1994 current prices billion $	1995	1996	1997	1998	1999
Private consumption	4 717.0	2.4	2.6	3.3	3.8	3.0
Government consumption	1 107.1	–0.1	0.0	1.2	0.6	1.1
Gross fixed investment	1 152.5	4.4	7.5	6.6	8.2	4.9
Public	205.9	0.5	3.2	–0.6	0.9	1.8
Residential	286.0	–3.8	5.9	2.7	6.3	2.5
Non-residential	660.6	9.0	9.2	9.9	10.6	6.4
Final domestic demand	6 976.6	2.4	3.0	3.5	4.1	3.1
* stockbuilding	61.2[a]	–0.5	0.0	0.6	–0.2	–0.4
Total domestic demand	7 037.8	1.8	3.0	4.1	3.9	2.7
Exports of goods and services	721.2	11.1	8.3	12.3	4.7	5.1
Imports of goods and services	812.1	8.9	9.1	14.2	13.2	9.4
* net exports	–90.8[a]	0.1	–0.2	–0.5	–1.4	–0.9
GDP at market prices	6 947.0	2.0	2.8	3.8	2.7	2.1
Industrial production	–	4.9	3.5	5.0	4.6	2.5

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

The externally driven slackening in demand may be amplified by destocking…

After the strong growth of the past year, the economy is expected to slow during 1998 as the impact of the Asian crisis and the appreciation of the dollar lowers external demand. In the first half of 1998, the contribution of exports to the growth of demand may be almost a percentage point lower than in the previous year, reflecting the marked slackening in market growth and a loss of market share. The appreciation of the dollar will also boost the growth of imports, with the result that the current account deficit is projected to rise from 2.1 to 2.8 per cent of GDP in the period from 1997 to 1999. Two factors, however, may moderate the negative impact of trade volumes on the economy. First, private consumption should hold up well. The fall in import prices should result in a further moderation of inflation in 1998, so boosting real wages sufficiently to sustain the growth of consumption while at the same time permitting some increase in the savings ratio. Second, the fall in nominal long-term interest rates should support residential investment as well as household spending on durable goods. However, the offset will not be complete, so the growth of final sales is expected to moderate. Moreover, companies seem likely to reduce the growth of stocks which have been expanding more rapidly than sales recently.

… but as the headwinds from Asia lessen in 1999, output and inflation may recover

Output growth should increase during 1999 – though such a pattern is masked by the annual average figures that show a progressive slowdown in the growth of the economy to 2.7 and 2.1 per cent in 1998 and 1999 respectively. The impact of the Asian headwinds should subside, and the negative swing in stock building may end. On the other hand, private consumption growth may slow. Real wages will no longer be boosted by improving terms of trade and may not be sufficient to offset the slackening in total hours worked. Moreover, there should be markedly less spending generated by capital gains on investment portfolios, and this may lead to some further increase in the savings ratio. The growth of business investment also seems likely to slow, given the rapid growth of the capital stock which, by 1999, will be at a twenty-year high. Overall, the strengthening of external sales should outweigh the deceleration in final domestic demand, so boosting the growth of output. As a result, output may remain above its potential level. Similarly, while unemployment may edge up, the labour market will remain tight. With import prices stabilizing, inflation is projected to pick up

External indicators

	1995	1996	1997	1998	1999
	$ billion				
Merchandise exports	575.9	612.1	678.3	690	728
Merchandise imports	749.4	803.2	877.3	916	988
Trade balance	–173.6	–191.2	–198.9	–226	–260
Invisibles, net	44.5	43.0	32.5	16	11
Current account balance	–129.1	–148.2	–166.4	–211	–249
	Percentage changes				
Merchandise export volumes[a]	12.6	9.5	15.1	5.2	5.4
Merchandise import volumes[a]	9.5	9.9	15.0	13.6	9.7
Export performance[b]	4.5	2.3	5.0	–1.1	–1.8
Terms of trade	–0.4	–0.6	1.3	5.2	1.8

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

somewhat by the end of 1998, reaching just under 2 per cent by the end of 1999, but profits may nonetheless come under increasing pressure.

If capital spending turns down, interest rates will need to be cut…

The above projections represent a benign evolution of the economic situation. Other more extreme cases could develop. There is some risk that the slowdown projected for the second half of 1998 might result in businesses revising downwards their plans for fixed investment, given the rapid growth of the capital stock. This might push the economy towards a recession if real incomes were subsequently adversely affected, corporate earnings decelerated, stock market prices dropped and confidence fell. In such circumstances, the task of monetary policy could be complicated if the widening of the current account deficit were to result in a reversal of the dollar's appreciation, as inflationary pressures might then intensify at time when demand was weakening.

… although, a buoyant stock market could signal the opposite

On the other hand, the risk premium on equities could fall further, as investors continue to diversify their asset portfolios. Additional stock market gains might then boost both consumption and investment. In addition, growth in North America might turn out to be stronger than expected. In such circumstances, the labour market would become even tighter, setting the stage for a wage-price spiral that would call for a significant tightening of monetary conditions.

Japan

Japan's economy is on the edge of recession. The modest recovery in 1995-96 faltered owing to last year's fiscal tightening, combined with a domestic financial crisis resulting from the lingering effects of asset price deflation and the collapse in a number of Asian economies. Even though financial markets have been stabilized through a massive provision of liquidity and a series of moves designed to ease credit supply conditions and boost spending, activity looks set to contract slightly this year, the first decline since 1974. Barring policy or other exogenous changes, a resumption of even modest growth in 1999 is predicated on a return of private sector confidence associated with regulatory reforms and a successful conclusion to the twin crises in the banking system and in the rest of Asia. But slack in the economy will continue to rise for some time, putting downward pressure on wages and prices. The restraining effects of depressed domestic demand conditions on the volume of imports, combined with terms of trade gains, are also expected to outweigh the unfavourable impact of the Asia crisis on exports, leaving the current external surplus on a rising path beyond 3 per cent of GDP.

The challenge facing policy-makers is enormous. In order to convince consumers and investors that the situation is being handled appropriately, a comprehensive strategy is required, combining clear action in the banking sector, rapid easing of the regulatory burden and as stimulative a macroeconomic policy stance as feasible. But it may not be possible for the monetary authorities to ease credit conditions any further, with policy-controlled interest rates already at record lows. Thus, at a minimum, fiscal policy should avoid exerting further restraint at this critical juncture so that output has the chance to return to its potential growth path as quickly as possible. This looks unlikely under the terms of the budget for fiscal year 1998 and the guidelines of the medium-term deficit reduction legislation. Additional stimulus is currently being considered; it would most usefully be provided by implementing tax reforms which are justified by their medium-term impact on incentives and their immediate effect on activity, as well as by those public investments with the highest social returns. Such measures need to be accompanied by a stepping up of the regulatory reform programme. It is to be hoped that the strengthened deposit insurance system and the public provision of capital to major banks, together with the imminent intensification of bank supervision procedures, will lead to a resolution of the long-standing non-performing loan problem once and for all.

The causes of the current weakness are several

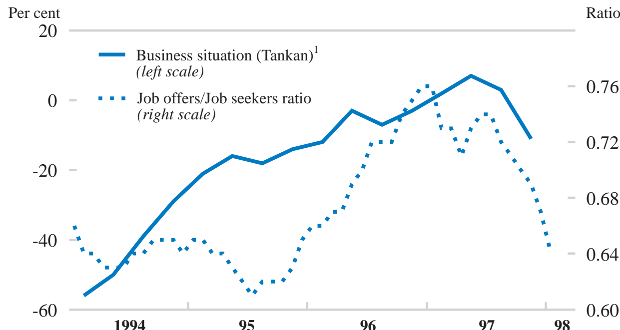
A number of significant contractionary forces have been building up over the past year to add to the deflationary effects of ongoing declines in land and equities prices. First, fiscal policy turned sharply toward restraint in fiscal year (FY) 1997, with tax and spending changes withdrawing more than $1^1/_2$ per cent of total demand from the economy. Second, credit supply conditions have worsened significantly since late last year, at least for smaller firms, as banks have been trying to improve their balance sheets and boost capital adequacy ratios in order to prepare for the new financial era that has just begun in April. Third, the failure of several major financial institutions in November and spreading corruption scandals constituted a major shock to confidence and expectations, and the ensuing uncertainty has further damped private sector spending propensities. Finally, the Asia crisis has begun to impact on export market growth and to harm prospects for manufacturers who now face more competitive foreign rivals. The result of these developments is that firms' self-assessment of business conditions has deteriorated severely.

The rebound in demand since mid-1997 was meagre

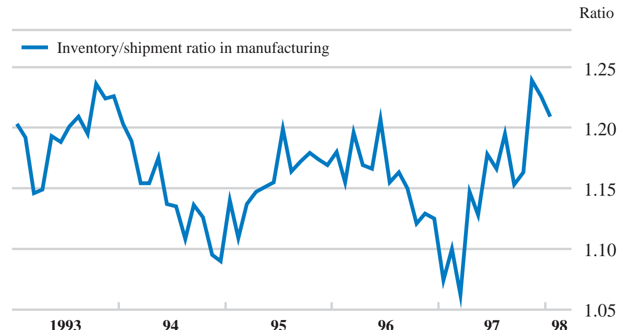
As widely predicted, real GDP did bounce back in the second half of 1997 from the spring plunge, but only feebly. Activity was supported by increased government spending and net exports: rapid increases in exports to Europe and North America more than compensated for declines to Asia, and import growth fell for two further quarters, pushing the current account surplus to its highest level in three years. However,

Japan

The economy has begun to deteriorate



Stocks are still building



1. Balance of positive and negative answers.

in the summer residential investment recorded two more consecutive quarters of massive decline, retreating to levels last seen a decade ago. With falling capacity utilisation, persistently weak domestic demand and convincing signs of a credit crunch, firms cut back their orders for both construction and especially for equipment, and the 1995-96 business investment boom came to an end. In the current environment of spreading bankruptcies and perceived job insecurity, stagnating private consumption recently gave way to renewed outright declines. The upshot of the sudden and unanticipated falloff in spending was an undesired increase in manufacturers' inventories, despite a cutback in hours worked.

Employment and wage/price effects are beginning to be felt

Other impacts of slowing production trends on the labour market have so far been fairly muted: the rise in the unemployment rate has been buffered by continued employment gains, with resulting declines in labour productivity, as well as by the usual highly cyclical labour force participation rate. Nonetheless, the turnaround in the job offers/job seekers ratio since last summer reveals more clearly the underlying weakness in the labour market. This is only just beginning to be reflected in wages and prices, which are now showing signs of easing back toward stability, once purged of the effects of last year's policy-related increases.

Budgetary policy in 1997 was clearly restrictive

The year 1997 was marked by a significant tightening of fiscal policy amounting to an estimated 1.6 percentage points of GDP: the consumption tax was raised from 3 to 5 per cent; temporary tax cuts from 1994-96 were not renewed; public investment was cut back sharply; and households were asked to pay a greater share of

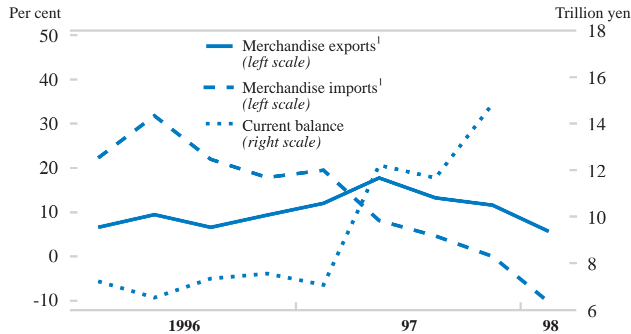
Employment, income and inflation

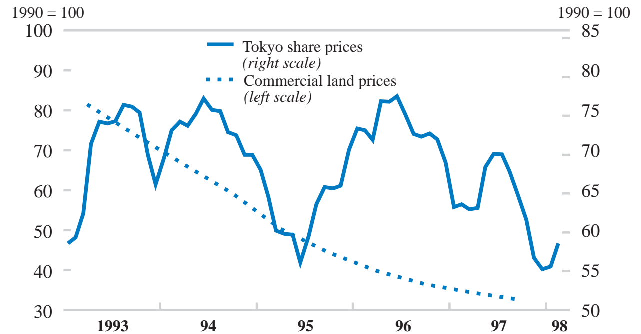
Percentage changes

	1995	1996	1997	1998	1999
Employment	0.1	0.5	1.1	–0.1	0.2
Unemployment rate[a]	3.1	3.4	3.4	3.5	3.6
Compensation of employees	1.7	1.9	2.9	0.3	1.1
Unit labour cost	0.2	–1.9	2.0	0.5	–0.2
Household disposable income	1.9	3.1	2.6	0.8	0.8
GDP deflator	–0.6	–0.5	0.6	0.5	0.0
Private consumption deflator	–0.5	0.1	1.6	0.5	0.1

a) As a percentage of labour force.

Japan





1. Year-on-year percentage changes. Q1 1998 is the January-February average.
Sources: Bank of Japan; Japan Real Estate Institute; OECD.

health care costs. This improvement in the primary structural deficit reversed about one quarter of its deterioration over the previous seven years and was in line with the government's medium-term plan to bring the deficit of central and local government back down to 3 per cent of GDP by FY 2003 as laid out in the Fiscal Structural Reform Act (FSRA) that was approved by the Diet in November.

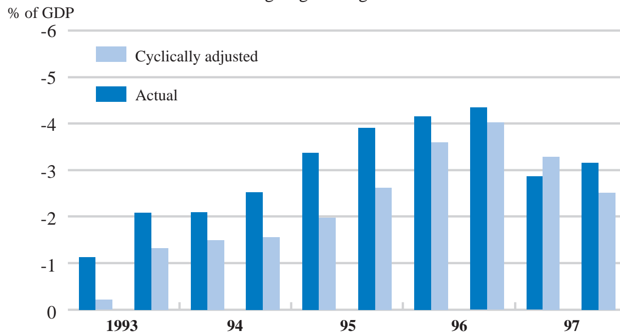
Despite some easing, fiscal policy remains oriented towards deficit reduction

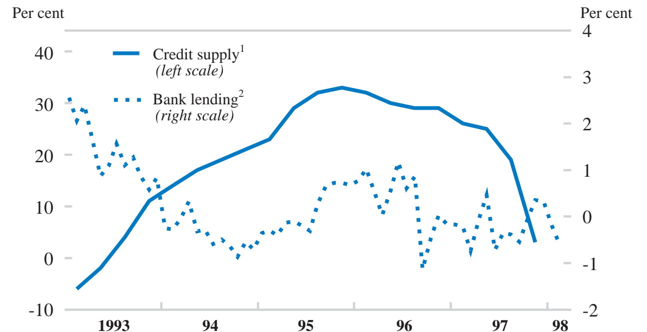
As signs of recession spread, the authorities decided to slow the progress toward budget consolidation by passing a supplementary budget for FY 1997. Its highlights were yet another temporary personal tax cut worth about ¥ 2 trillion, to be implemented in the first half of 1998, and some additional funding for public works projects focused on disaster relief. Also announced were tax reform measures for FY 1998 whose net effect is to reduce tax revenues by some ¥ 1 trillion by cutting the corporate tax rate by 3 percentage points, raising personal allowances, halving various securities-related tax rates and modifying others with respect to land values and capital gains thereon. But in other respects the FY 1998 budget is still restrictive, as it adheres fully to the FSRA: real spending is projected to decline some 2 per cent from the initial FY 1997 budget, with reductions concentrated on public works and development assistance. At the overall general government level the projection – which does not take into account possible stimulative measures – is for consolidation to continue with a further $^1/_2$ percentage point fall in the primary structural deficit. Further tightening is assumed in the projections for 1999 in line with the terms of the FSRA.

Credit supply conditions became tight by November, if not before

Increasing concern has been expressed regarding the perceived "credit crunch" as well as the markets' reactions to heightened risk within the banking sector following the financial failures in November. However, while overall bank loan growth (including securitisation and write-off effects) edged down over the year ending in March, some of that weakness is no doubt attributable to slack demand for loans. Nonetheless, it is the case that from the beginning of November Japanese banks were forced to pay much higher rates in the world's interbank money markets: the so-called "Japan premium" (the difference between what Japanese banks must pay and what other international banks are charged) rose from nearly nothing to as much as 100 basis points in early December. Higher financial costs were also in evidence in the securities market, where yields on bonds issued by Japanese banks climbed well above those of their competitors.

Japan





1. Balance of positive and negative answers as to lending attitudes of financial institutions in *Tankan* survey..
2. Year-on-year percentage changes.
Sources: Bank of Japan; OECD.

The authorities have countered the year-end domestic financial crisis in a number of ways

In these crisis conditions the authorities adopted a multi-pronged approach. First, the Bank of Japan injected substantial amounts of liquidity, ¥ 13.6 trillion (2¾ per cent of GDP) in total during the fourth quarter, with a resulting pick-up in the broadly defined money supply. But even that failed to prevent a nearly half a percentage point jump in short-term market interest rates along with a 0.3 percentage point rise in the long-term prime rate, as well as renewed sharp declines in equity prices and in the value of the yen against the dollar. A second step was to combine a one-year conditional delay in implementation of Prompt Corrective Action (a system of increasingly severe regulatory penalties as banks' capital adequacy ratios fall short of predetermined standards) for banks not active internationally with a plan to provide as much as ¥ 30 trillion (6 per cent of GDP) in public money and loan guarantees to stabilize the financial system. Of that amount, ¥ 17 trillion will be made available to fully protect deposits at all financial institutions including credit co-operatives; the remainder may be used to purchase banks' subordinated debt and preferred equity in order to shore up their capital bases and limit the fallout from banks' attempts to meet capital adequacy requirements. To this point, 21 mainly large banks have benefited from this facility, with disbursements of ¥ 1.8 trillion in exchange for a limited amount of restructuring by each recipient bank. Third, public financial institutions were instructed to provide more loans to smaller firms. Finally, a number of other reforms have been suggested or implemented, such as changes in permitted accounting rules, allowing more flexibility in the treatment of capital gains on land and equities. The effect of all these policy announcements on financial markets was initially dramatic, with much of the autumn's deterioration reversed by the end of January: the "Japan premium" was halved and eventually further reduced; the equities indices bounced back, and the dollar exchange rate returned to pre-crisis levels. But some of those currency and equities gains have since been eroded, as foreign investors have

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

The fiscal measures announced in December 1977, including the supplementary budget for FY 1997, are fully incorporated. These include additional public investment of 0.8 trillion yen, as well as a special income tax cut of 2 trillion yen. For FY 1998, public works and other forms of spending in the projections are assumed to be consistent with the budget's 7.8 per cent cut and 2¾ per cent increase, respectively, compared to the previous initial budget. The projections also allow for the cuts in corporate and other financial taxes, worth around 0.7 trillion yen and a tax increase on tobacco. In 1998, liabilities worth 26.3 trillion yen (5¼ per cent of GDP) will be transferred to the central government's account from that of the Japan National Railway Settlement Corporation and National Forest Special Account, but the projections do not account for these as entering into the deficit. The bond issue of 10 trillion yen used to support the banking sector will increase the gross debt of the general government, but no transfer in the flow account is assumed, as the transaction is assumed to be financial. *No supplementary budget for FY 1998 is assumed.* For FY 1999, spending is assumed to respect the terms of the Fiscal Reform Act. Implementation in late 1999 of the provisional plan to raise social security contributions from 17.35 to 19.5 per cent of standard earnings and to re-rate benefits in line with the movement of real average earnings has also been assumed.

Financial indicators

	1995	1996	1997	1998	1999
Household saving ratio[a]	13.7	13.8	13.6	14.1	13.7
General government financial balance[b, e]	–3.6	–4.3	–3.1	–3.5	–2.7
Current account balance[b]	2.1	1.4	2.3	3.2	3.7
Short-term interest rate[c]	1.2	0.6	0.6	0.8	0.6
Long-term interest rate[d]	3.4	3.1	2.3	1.8	2.0

a) As a percentage of disposable income.
b) As a percentage of GDP.
c) 3-6 month CDs.
d) Ten-year Central government bonds.
e) The 1998 deficit would rise by 5.2 percentage points if account were taken of the expected assumption by the central government of the accumulated deficits of the Japan National Railway Settlement Corporation and the National Forest Special Account.

perceived a lack of permanent solutions being proposed to confront the inter-related challenges facing the economy.

The outlook is for stagnation in 1998, followed by modest growth if consumer and producer fears can be allayed

The most likely scenario therefore is that the economy will continue to stagnate in 1998. Tax refunds cannot be counted on to boost the economy much right away because of the likelihood that households will refrain from spending the additional disposable income in an environment of damaged confidence and worries about financial fragility and job insecurity, especially as the tax cuts are temporary. Businesses are not expected to react to lower corporate tax rates to the extent that they have difficulty getting financing, capacity utilisation is still falling, and restructuring has only just begun. Inventory-shipments ratios are also uncomfortably high. In addition, while the direct effects of the Asia crisis on export growth to these countries might not worsen beyond what has already been felt, the indirect effect of lost competitiveness is expected to be large, especially with respect to Korea whose export structure is very similar to Japan's; the effects are only partially compensated

Demand and output

Percentage changes, volume (1990 prices)

	1994 current prices trillion yen	1995	1996	1997	1998	1999
Private consumption	286.2	2.1	2.9	1.1	–0.4	1.3
Government consumption	45.7	3.3	1.5	–0.1	0.4	0.3
Gross fixed investment	137.3	1.7	9.5	–3.4	–2.3	–0.1
Public[a]	41.3	0.6	7.2	–11.1	–3.3	–6.1
Residential	25.7	–6.5	13.9	–15.7	–10.0	2.8
Non-residential	70.2	5.2	9.5	4.5	0.1	1.9
Final domestic demand	469.2	2.1	4.8	–0.5	–0.9	0.8
* stockbuilding	0.0[b]	0.2	0.1	0.0	–0.1	0.0
Total domestic demand	469.2	2.3	4.8	–0.5	–1.0	0.7
Exports of goods and services	44.4	5.4	3.5	10.9	3.9	6.6
Imports of goods and services	34.4	14.2	11.5	–0.1	–1.5	2.7
* net exports	10.0[b]	–0.8	–0.8	1.4	0.7	0.6
GDP at market prices	479.3	1.5	3.9	0.9	–0.3	1.3
Industrial production[c]	–	3.5	2.7	4.3	–1.6	1.7

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

External indicators

	1995	1996	1997	1998	1999
			$ billion		
Merchandise exports	428.0	400.4	409.2	400	433
Merchandise imports	296.8	316.8	307.4	273	286
Trade balance	131.2	83.6	101.8	127	147
Invisibles, net	–20.8	–17.8	–7.4	–2	1
Current account balance	110.4	65.8	94.5	125	147
			Percentage changes		
Merchandise export volumes[a]	3.3	0.6	9.5	4.5	7.0
Merchandise import volumes[a]	12.5	3.4	1.6	–1.1	3.1
Export performance[b]	–7.6	–8.9	–1.3	–1.8	–0.5
Terms of trade	–0.5	–8.0	–2.2	3.6	–0.5

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

by the yen's depreciation against the dollar, as on a broader basis (inclusive of the currencies of the Asian crisis countries) the yen rose significantly in effective terms over the year to mid-March. However, there may be a gradual improvement in consumer sentiment through the year and into 1999, assuming the crisis in the financial system is appropriately managed; and once the housing sector bottoms out, the economy may return to a modest growth path, albeit one with higher unemployment and a still substantial output gap. This should hold down wage and price increases. Import price stability and recent regulatory reforms should also contribute to disinflation. Continuing slow import growth is likely to outweigh the slacker growth in exports emanating from the Asia crisis, putting further upward pressure on the current external surplus, which could exceed 3 per cent of GDP already this year and reach 3¾ per cent in 1999.

But mainly downside risks remain, especially from the financial sector

The principal upside alternative to this projection would stem from further fiscal stimulus. But downside risks are both several and serious. Further bankruptcies in the banking and brokerage sectors could be joined by renewed failures in the equally beleaguered insurance sector, and the pace of non-financial closures could also pick up more than foreseen. Intimately related to these risks are those emanating from further deterioration in the rest of Asia, given Japanese banks' exposure in the region. Overall it is unclear what it will take for private sector sentiment to improve sufficiently for discretionary spending growth to resume.

Germany

After two years of slow growth, GDP expanded by some 2¼ per cent in 1997, driven by strong exports. Activity is projected to accelerate somewhat in 1998, and its basis should broaden as rising investment in machinery and equipment compensates for slower, but still substantial, export growth. Inflation should remain low. Underpinning these developments is a favourable level of international competitiveness which has not been significantly affected by the new constellation of exchange rates in Asia, and a relatively expansionary monetary policy. However, the labour market is projected to recover only slowly, with unemployment remaining high throughout this year and next, and this is likely to act as a restraint on consumption.

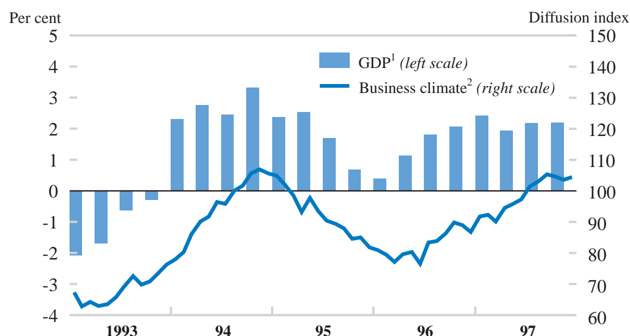
With inflation expectations subdued and the output gap closing only slowly, monetary policy is under little domestic pressure to shift to a less accommodative stance. In the run up to European Economic and Monetary Union (EMU), monetary conditions will be influenced by the need to ensure a sound monetary framework for the whole monetary area, but the stance of policy is expected to remain relatively expansionary. In bringing the general government deficit down to the level required by the Maastricht Treaty, the budget was helped by a substantial temporary surplus in the social security system which will be phased out in 1999 and has to be replaced by more permanent measures in order to maintain the required medium term consolidation path. In addition, further pension and tax reforms remain necessary to ensure longer term fiscal sustainability. In the key area of labour market reform, progress has been substantial, but if unemployment is to be significantly reduced further steps are needed by the government and social partners towards greater wage, working time and employment flexibility.

Activity has picked up…

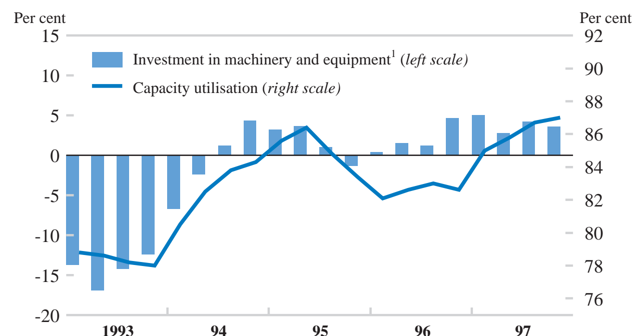
Following two years of sluggish growth, activity picked up in 1997, GDP growing by some 2¼ per cent. Growth was driven by surging exports, which led to a marked recovery in industrial production and to a rise in capacity utilisation. Export growth, while significant, has now slowed to more sustainable rates, while domestic orders for machinery, a good leading indicator of investment activity, have strengthened. Despite the crisis in Asia, business sentiment regarding current and prospective conditions, which had improved throughout 1997, has remained buoyant, with export expectations particularly positive. Reports from trade associations indicate that orders from Asia are declining but that these are being offset by strengthening orders from Europe and by rising domestic demand. Although consumer sentiment remains negative, it has been improving and domestic car sales have started to increase.

Germany

The business climate is improving



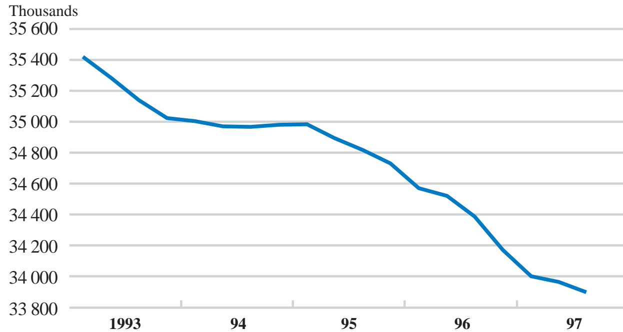
Rising capacity utilisation should support investment



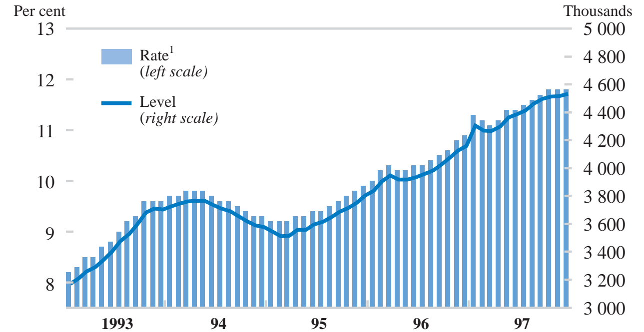
1. In 1991 prices. Percentage change over one year.
2. Western Germany. Weighted average of present and future (six months ahead) business situation. A level of 100 corresponds to “normality”.
Sources: IFO; OECD.

Germany

Employment has declined



Unemployment has reached record levels



1. As percentage of labour force.
Source: Deutsche Bundesbank.

… but unemployment has risen further

Unemployment reached record levels of 12.6 per cent at the start of 1998 (11.6 per cent seasonally adjusted) due in equal measure to a continuing run down of the number of persons on job creation programmes and to a further reduction of employment in the troubled construction sector, especially in the new states. In contrast to developments in the eastern states, the rate of unemployment has been stable in western Germany since the summer of 1997 and employment has also been showing signs of stabilizing.

Inflation is at levels close to virtual price stability

By the start of 1998, lower mineral oil prices had contributed to consumer inflation dropping to an annual rate of 1 per cent and, abstracting from these temporary effects, underlying inflation probably remained under 1 1/2 per cent. Due in part to falling commodity prices, import prices have also fallen and the underlying rate of producer price inflation is now around 1 per cent. Contractual wage growth has been running at an annual rate of around 1 1/2 per cent, with actual wage costs developing more modestly. Partly as a result, unit labour costs have been declining in both eastern and western Germany.

Competitiveness has strengthened substantially

Export growth is being underpinned by the improved competitiveness of recent years and by strong market growth. The sharp fall in the exchange rates of some Asian countries has not led to any significant appreciation of the Deutschemark in effective terms, so that competitiveness remains strong. Concern to preserve this advantage, together with market opening in protected sectors such as telecommunications and energy, will serve to place downward pressure on price inflation while the combination of moderate wage growth and significant productivity gains should ensure further falls in unit labour costs.

Employment, income and inflation

Percentage changes

	1995	1996	1997	1998	1999
Employment	–0.3	–1.2	–1.3	0.1	0.8
Unemployment rate[a]	9.4	10.3	11.4	11.5	11.1
Compensation of employees	3.3	1.0	0.7	1.8	2.7
Unit labour costs	1.4	–0.4	–1.4	–0.9	–0.2
Household disposable income	3.5	3.5	2.3	3.5	4.1
GDP deflator	2.1	1.0	0.6	0.9	1.3
Private consumption deflator	1.7	2.0	1.9	1.7	1.7

a) As a percentage of labour force.

Monetary policy will remain supportive

The positive outlook for inflation, in combination with moderate output growth, is expected to result in continuing supportive monetary conditions in the immediate future. EMU convergence is assumed to result in only a limited shift of monetary policy toward a less accommodative stance. Long term interest rates have fallen substantially, partly due to influences associated with financial turbulence in Asia which could unwind, but the positive outlook for inflation is expected to sustain a low level of long-term rates throughout the projection period, despite a narrowing output gap.

Financial indicators

	1995	1996	1997	1998	1999
Household saving ratio[a]	11.6	11.7	11.8	12.1	12.0
General government financial balance[b, c]	–3.3	–3.4	–2.7	–2.3	–2.4
Current account balance[b]	–1.0	–0.6	0.0	0.4	0.7
Short-term interest rate[d]	4.5	3.3	3.3	3.7	4.0
Long-term interest rate[e]	6.9	6.2	5.6	5.1	5.5

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

Fiscal consolidation has been significant but its pace will ease

Significant fiscal consolidation brought the general government deficit down to 2$^{3}/_{4}$ per cent of GDP in the course of 1997. The general government deficit is projected to decline to 2$^{1}/_{2}$ per cent of GDP this year and to remain at this level in 1999 (see box), so that the fiscal policy stance will tighten less than in recent years. A sharp turnaround in the finances of the social security system contributed importantly to meeting the Maastricht fiscal criterion in 1997 and this year they are expected to run a surplus of around DM 15 billion (0.5 per cent of GDP). Once reserves are rebuilt, the surplus will be reduced substantially in 1999 and will need to be replaced by longer term measures to ensure that the budget remains on a sustainable consolidation path. Although the cyclically adjusted deficit is smaller than the actual, there is little room for manoeuvre within the confines of the Stability and Growth Pact in the event of any slowdown in activity. Privatisation revenues of some DM 26 billion will help to reduce gross general government liabilities in 1998.

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

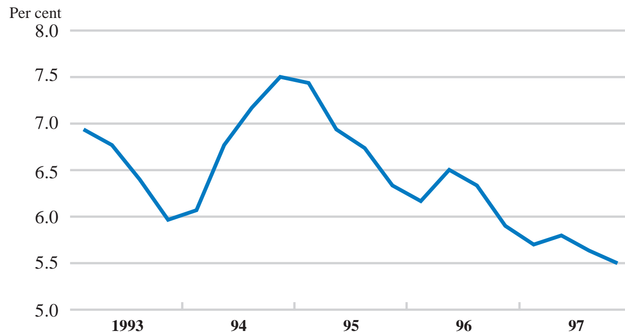
The federal budget for 1998 has been incorporated in the projections, including the reduction in the "Solidarity" income tax surcharge from 7.5 to 5.5 per cent and the abolition of the business capital tax. Associated savings are projected to fully compensate for lost revenues from the business capital tax. Social security contribution rates are assumed to remain constant in 1998 with the prospective increase in pension contribution rates substituted by a rise in the general value-added tax rate from 15 to 16 per cent in April. Contribution rates are assumed to fall in 1999 leading to a reduction of DM 10 billion in the system's surplus. While public sector wage growth is projected to accelerate somewhat in 1999, the existing policy to restrict current expenditures is expected to continue with general government consumption growing by around 1.5 per cent on an annual basis over the projection period.

Promoting labour market flexibility and structural reforms remains a priority

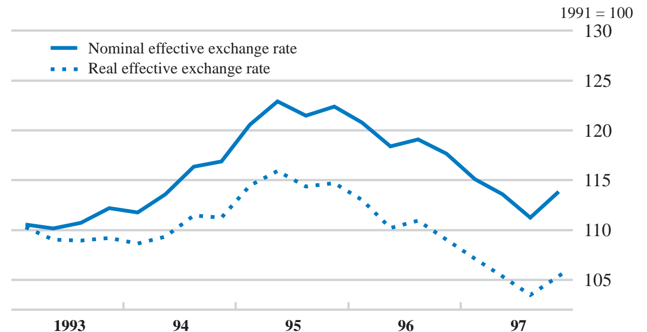
With respect to labour market reform, a substantial number of measures have been implemented although some including a relaxation of dismissal protection and a further reduction of early retirement opportunities, will become fully effective only in 1999. The impact of these measures on labour market performance will depend on wage bargaining procedures which continue to evolve. In this area the government needs to support moves towards greater flexibility. After running down active labour

Germany

Interest rates[1] are at low levels



Competitiveness has recovered strongly



1. 10-year government bond yields.

market measures in 1997, policy in 1998 has shifted to encouraging local governments to provide work for the recipients of social security. With respect to product markets, liberalisation of telecommunications is well under way but progress in the energy sector is proving more difficult. Tax and pension reforms also remain to be completed and are fundamental for longer term growth and fiscal prospects.

GDP growth is projected to pick up with investment contributing more to growth

Composite leading indicators point to growth moderating in the opening months of 1998 from a peak of some 3 per cent in the third quarter of 1997 to around 2.5 per cent (year on year). However, continuing strong exports are projected to underpin GDP growth of around $2^3/_4$ per cent for the year as a whole, with some acceleration in 1999 to around 3 per cent, despite the downturn in Asian countries

Demand and output

Percentage changes, volume (1991 prices)

	1994 current prices billion DM	1995	1996	1997	1998	1999
Private consumption	1 906.0	1.8	1.4	0.2	1.4	2.5
Government consumption	658.6	2.0	2.6	–0.4	1.0	1.5
Gross fixed investment	726.2	0.8	–1.2	0.2	2.6	4.4
Public	86.4	–4.6	–7.3	–8.6	–0.4	1.9
Residential	243.7	2.6	0.1	–0.3	–2.4	1.3
Non-residential	396.0	0.9	–0.7	2.2	5.9	6.4
Final domestic demand	3 290.8	1.6	1.0	0.1	1.6	2.7
* stockbuilding	16.4[a]	0.4	–0.3	1.1	0.5	0.0
Total domestic demand	3 307.2	2.0	0.8	1.2	2.1	2.7
Exports of goods and services	757.0	6.6	5.1	10.7	9.3	7.1
Imports of goods and services	735.9	7.3	2.8	7.0	7.5	6.8
* net exports	21.0[a]	–0.2	0.6	1.0	0.6	0.2
GDP at market prices	3 328.2	1.8	1.4	2.2	2.7	2.9
Industrial production	–	2.0	0.5	3.6	4.2	3.6
Memorandum items						
Investment in machinery and equipment	258.1	1.6	1.9	3.9	7.2	7.3
Construction investment	468.0	0.3	–3.1	–2.2	–0.6	2.2

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

and the improvement in their competitiveness. Historically high levels of capacity utilisation should lead to rising levels of investment in plant and machinery, although the construction sector will remain a brake on activity and on employment growth, particularly in eastern Germany. While employment should start to pick up in the course of 1998, growth is not projected to be strong enough to lead to any marked reduction in unemployment before 1999. Inflation is projected to remain low throughout the period. Although wages could accelerate somewhat as employment recovers, the rise in wage costs is likely to remain muted. Continuing the trend of recent years, the current account deficit should continue to decline and the traditional pattern of surpluses is projected to reappear.

External indicators

	1995	1996	1997	1998	1999
			$ billion		
Merchandise exports	523.3	519.6	504.0	528	574
Merchandise imports	458.3	448.3	426.7	439	476
Trade balance	65.0	71.3	77.2	89	98
Invisibles, net	–88.6	–84.4	–78.3	–80	–83
Current account balance	–23.6	–13.1	–1.1	9	14
			Percentage changes		
Merchandise export volumes[a]	6.7	4.7	13.1	9.9	7.3
Merchandise import volumes[a]	6.9	2.2	9.2	7.8	7.1
Export performance[b]	–2.9	–2.3	2.8	1.8	0.2
Terms of trade	1.2	–0.3	–1.5	1.4	0.0

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

There is a risk that interest rates could rise and wages might accelerate

Instability in emerging markets represents a general trade and finance risk. More specific risks for the projection are associated with the run up to EMU: following decisions on membership of the Union in May, pressures could mount for further increases in Bundesbank policy rates beyond the modest increase assumed, in order to re-position the monetary policy stance from a European perspective. Wage growth could also be stronger than projected if traditional patterns of bargaining were to return. Any acceleration of wage growth would be likely to lead in the first instance to lower employment growth rather than to price increases.

France

In contrast with a lacklustre performance in 1996, economic growth gathered momentum in the course of 1997, underpinned by dynamic exports coupled with reinvigorated domestic demand. Historically low inflation and interest rates set the stage for sustaining the expansion in 1998-99, although slower export growth will probably dampen it somewhat. The impact of the Asia crisis on France's foreign trade is projected to be limited, but with some downside risk. Unemployment may fall while remaining high, notwithstanding job creation in the non-market sector and subsidies for hiring associated with the shortening of working hours. It is yet too early to foresee how employers and employees will respond to the new working time incentives, all the more so as some of them will only be specified late next year.

The present fiscal policy stance leaves little margin for slippage relative to the terms of the Stability and Growth Pact in the event of a weakening of growth, suggesting the need for some further tightening. With the advent of European Economic and Monetary Union, the need is greater than ever to reduce the structural rigidities impeding the adaptability of the French economy, notably in the labour market.

Growth accelerated, increasingly pulled by domestic demand

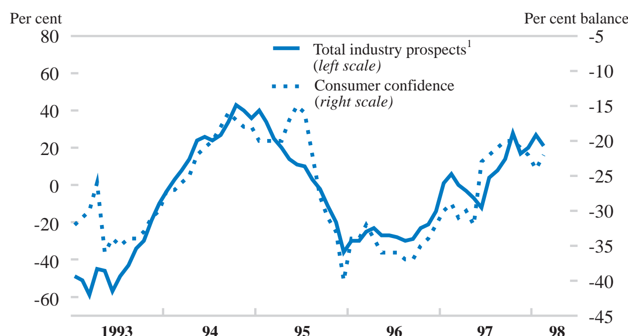
The momentum of the recovery witnessed since last spring was sustained throughout 1997, with real GDP growing by 2.4 per cent for the year. Industrial output rose particularly fast across most sectors and the overall capacity utilisation ratio reverted to its medium-run average. While exports drove the rebound in the first half of 1997, boosted by a weaker effective exchange rate, domestic demand picked up in the second half. Spurred by quickening income growth, household consumption strengthened, as did fixed investment and stockbuilding (though the pace of the latter was more cautious than during earlier recoveries). Despite the acceleration of imports in the second half, the current account surplus reached a record level of around 2.8 per cent of GDP last year.

Employment expanded, but unemployment barely declined

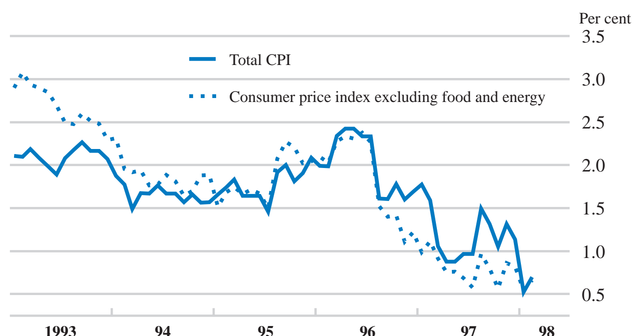
The expansion has resulted in a revival of private sector employment, with continuing job losses in industry and construction more than offset by gains in services, largely in the form of temporary employment. The unemployment rate marginally

France

Businesses and consumers are becoming more optimistic

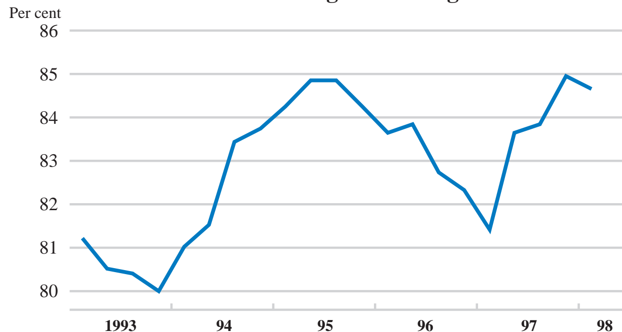


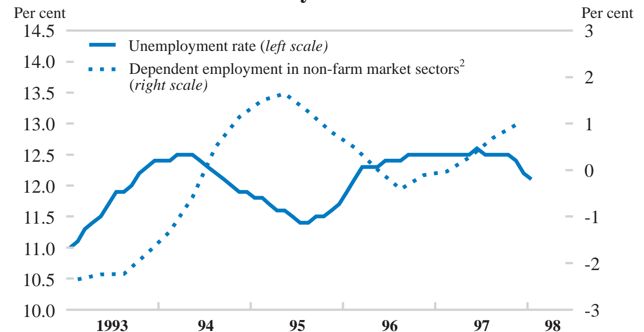
Inflation reached historical lows[2]



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

France





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

declined, towards the very end of the year, to 12.2 per cent. While long-term joblessness kept rising last year, youth unemployment fell somewhat. Continued wage moderation contributed to keeping inflation at historically low levels, with consumer prices rising by only 1.1 per cent in the course of 1997.

Monetary conditions remain accommodative

Monetary conditions were slightly tightened in October 1997, when the central bank's intervention rate was last increased, by 20 basis points. Acting in the same direction has been a slight effective exchange rate appreciation over the past few months. Narrow as well as broad money growth distinctly quickened in the course of 1997, and credit expansion remained on a rising trend. Long-term interest rates declined to their lowest level in decades, down to 5 per cent in early 1998. Overall, monetary conditions have remained accommodative.

The fiscal deficit has been brought down to 3 per cent of GDP

The initial budget law was substantially amended during the second half of 1997, which brought the deficit back on track to its targeted reduction. The general government balance ended the year in the neighbourhood of 3 per cent of GDP, helped also by the buoyancy of output. The 1998 budget combines overall expenditure restraint and selected tax increases. These measures, together with some cyclical gains, should be sufficient to keep the deficit unchanged substituting in 1998 for the one-off revenue gains from the France Telecom payment that reduced the 1997 deficit below its trend.

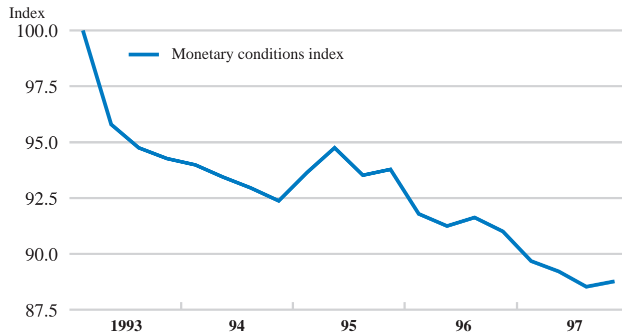
Financial indicators

	1995	1996	1997	1998	1999
Household saving ratio[a]	14.5	12.7	13.6	13.5	13.4
General government financial balance[b, c]	–5.0	–4.0	–3.0	–3.0	–2.6
Current account balance[b]	0.7	1.3	2.8	2.9	3.0
Short-term interest rate[d]	6.6	3.9	3.5	3.7	4.0
Long-term interest rate[e]	7.7	6.5	5.7	5.1	5.5

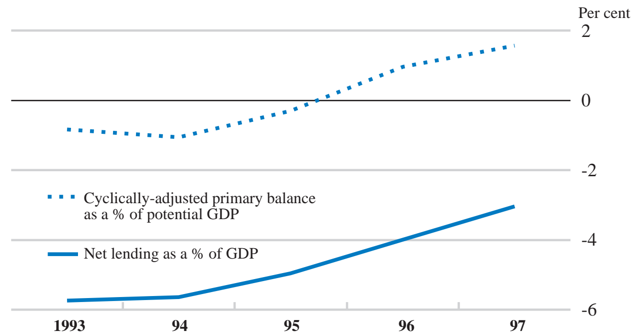
a) As a percentage of disposable income.
b) As a percentage of GDP.
c) Maastricht definition.
d) 3-month interbank deposit rate.
e) 10 year public and semi-public sector bonds.

France

Monetary conditions are accommodative



The fiscal deficit is shrinking[1]



1. Maastricht definition.

The legal working week is to be reduced to 35 hours…

One of the most prominent and controversial policy initiatives of the government since its debut last spring is a draft law on working time.[1] The bill foresees the shortening of the legal work week from 39 to 35 hours by January 2000 (firms employing fewer than 20 persons being granted two extra years). Substantial lump-sum social contribution rebates are to be provided to firms cutting work time by at least 10 per cent and increasing employment by at least 6 per cent.[2]

… but the impact of this measure is hard to predict

The ultimate impact on jobs and *a fortiori* on unemployment of the new legislation is difficult to ascertain, as illustrated by the wide variety of results obtained in published and unpublished simulations. Partly depending on the behavioural assumptions that underlie them, the estimated net effect ranges from small job losses to an increase in employment approaching 3 per cent after three years (if some very advantageous assumptions are introduced). The uncertainty surrounding such simulations is compounded by the fact that some important parameters such as overtime premia may be changed in late 1999, following an initial assessment of the law's implementation. Likewise, the net

Employment, income and inflation

Percentage changes

	1995	1996	1997	1998	1999
Employment	0.9	0.0	0.3	1.1	1.3
Unemployment rate[a]	11.5	12.3	12.4	11.9	11.3
Compensation of employees	4.1	3.0	3.5	3.9	4.1
Unit labour cost	2.0	1.5	1.1	0.9	1.3
Household disposable income	4.4	1.9	3.2	3.5	3.9
GDP deflator	1.6	1.2	1.0	1.2	1.3
Private consumption deflator	1.6	1.8	1.2	1.0	1.3

a) As a percentage of labour force.

1. Parliament started to examine this bill in January 1998. It shares a number of features with the so-called 1996 de Robien Law. A key difference, however, is that while the latter simply offered incentives to firms reducing working hours and safeguarding or creating jobs, the new bill makes the cut in legal working time compulsory.
2. Small firms enjoy easier conditions, and more generous subsidies are granted for firms introducing the measures early on or mainly employing low-wage workers. These will mitigate the direct impact on unit labour costs, especially for low wage firms. The bill covers all private sector enterprises and some public sector ones. Negotiations on working time are to take place separately for government sector employees, once an assessment of working hours in that sector is completed.

budgetary cost and the impact on other macroeconomic variables vary considerably across scenarios. The effect on competitiveness clearly hinges among other things on the degree to which the reduction in working hours is accompanied by greater flexibility. Against this background, the OECD Secretariat estimates that the move to a shorter working schedule will have only small impacts over the projection horizon, all the more as the change in regime is gradual and likely to extend well into the next decade.[3]

Demand and output

Percentage changes, volume (1980 prices)

	1994 current prices billion FF	1995	1996	1997	1998	1999
Private consumption	4 442.3	1.7	2.1	0.9	2.5	2.7
Government consumption	1 457.4	0.0	1.7	1.6	1.4	1.5
Gross fixed investment	1 332.1	2.5	–0.5	0.2	3.5	4.1
General government	241.4	–0.4	–1.2	1.5	1.4	1.3
Household	340.6	2.3	–0.2	-0.4	3.4	3.6
Other	750.0	3.5	–0.4	0.0	4.3	5.3
Final domestic demand	7 231.8	1.5	1.5	0.9	2.5	2.8
* stockbuilding	–3.2[a]	0.3	–0.5	0.1	0.2	0.0
Total domestic demand	7 228.6	1.8	1.0	1.0	2.8	2.8
Exports of goods and services	1 684.1	6.3	4.8	11.3	7.8	6.2
Imports of goods and services	1 523.1	5.1	2.8	6.6	7.5	6.3
* net exports	161.1[a]	0.3	0.6	1.5	0.2	0.1
GDP at market prices	7 389.7	2.1	1.5	2.4	2.9	2.8
Industrial production[b]	–	2.1	0.2	3.8	5.0	3.6

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

Growth is projected to remain above potential and unemployment to fall somewhat

Recent surveys point to sustained confidence on the part of households and businesses, whose order books remain well garnished. However, the slower growth in export markets entailed by the Asian turmoil coupled with some real exchange rate appreciation will weaken the dynamism of exports, and the pace of economic expansion is projected to drop from the peak reached in the second half of 1997. The carry-over effect and the projected vigour of domestic demand would nonetheless be strong enough to ensure that output growth for the year would continue to exceed its potential. The recent and long-awaited revival of investment would be largely sustained, helped by low long-term interest rates. The employment gains induced by output growth would be augmented by the government's creation of youth jobs. The unemployment rate would drop

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

The OECD Secretariat's fiscal projections for this year reflect the policy measures included in the laws on the 1998 budget and social security finances described in *OECD Economic Outlook* 62 and enacted in late 1997. It is further assumed that wages and pensions in the government sector will be raised in accordance with the agreement reached at the end of January between the government and the trade unions. It is also assumed that the additional youth positions to be created in 1999 in or around the public sector will be financed by restructuring other support schemes, thus imparting no net budgetary burden. A number of important tax reforms are under preparation, notably pertaining to local taxation, the taxation of wealth and green taxes; but these are too sketchy to be taken into account in the projections. Ongoing work on a law on social exclusion that could affect the composition of social expenditure is also abstracted from.

3. The OECD Secretariat's calculations assumed that one-fourth of the 7.4 million full-time employees immediately concerned by the new legislation will see working hours cut by 10 per cent by the end of 1999, with most of the shift taking place towards the end of the projection period; that productivity in participating firms rises thanks to a distribution of working hours over the year that more closely matches that of effective work loads; that participating firms increase employment by 6 per cent (some may hire more, to receive higher subsidies; on the other hand, hiring is postulated to take place instantly, whereas firms are expected to be able to spread it over the year); that the induced drop in unemployment equals two-thirds of job creation, with one-third of the latter absorbed by entries into the labour force; and that monthly wages in participating firms are frozen for two years, broadly in line with the pattern observed in many of the 1 500 firms that in 1996-97 shortened working time under the de Robien Law.

External indicators

	1995	1996	1997	1998	1999
			$ billion		
Merchandise exports	278.6	281.8	277.3	290	314
Merchandise imports	267.6	266.9	249.5	258	279
Trade balance	11.0	15.0	27.8	32	35
Invisibles, net	–0.1	5.6	11.9	8	8
Current account balance	10.9	20.5	39.7	40	43
			Percentage changes		
Merchandise export volumes[a]	7.9	5.1	11.5	8.3	6.7
Merchandise import volumes[a]	5.8	2.5	6.7	8.0	6.6
Export performance[b]	0.2	–0.6	2.0	0.3	–0.4
Terms of trade	–0.8	–1.2	0.0	1.0	–0.1

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

but remain well above the average in European OECD countries. Inflation is projected to pick up somewhat but to remain comfortably below the central bank's medium-run 2 per cent benchmark. The general government deficit is on course to meet the 3.0 per cent of GDP target in 1998, though budget execution would be complicated if growth turned out to be lower than projected.

There remain uncertainties as to the effects of the reduction in working hours and of the Asia crisis

Two sources of uncertainty surround the OECD Secretariat's projections. It is as yet unclear what the impact will be of the move towards the 35 hour legal working week on hiring and wage bargaining (including in sectors not encompassed by the draft bill). Hence, its impact on competitiveness remains to be seen, as are its net fiscal implications. The other risk factor pertains to the size of the negative shock to net exports caused by the Asia crisis. While trade with this region contributed positively and significantly to growth in France last year, the converse is projected for 1998. France's overall competitiveness is also affected, as is business confidence in certain sectors. While the magnitude of the direct and indirect effects of the Asia crisis is estimated not to exceed a few tenths of a percentage point of GDP, some downside risk remains.

Italy

After a temporary setback, economic growth recovered in 1997, spurred by buoyant demand for automobiles and a rebound in exports. Both the average rate of inflation and the budget deficit have fallen to levels consistent with the criteria for entry into the European Economic and Monetary Union (EMU). In this setting, premia on long term interest rates have almost disappeared and the Bank of Italy has been able to pursue a policy of gradual interest rate reductions. With less restrictive economic policies and improving corporate cash flow, the growth in domestic demand should quicken, lifting projected real GDP growth to nearly 2½ per cent in 1998. The unemployment rate, though declining, will remain high, dampening nominal wage growth. Inflation is thus likely to remain low. The current account surplus is expected to widen with the disappearance of the deficit on net investment income: Italy became a net international creditor in 1997.

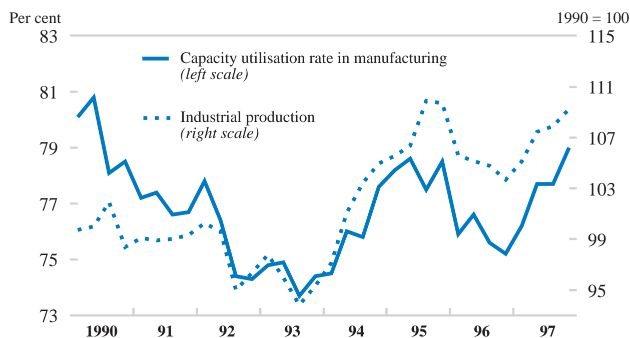
Fiscal consolidation will need to continue, to buttress last year's gains, to anticipate the requirements of the Stability and Growth Pact, and to put the public debt ratio on a firmly declining path. In such a context, structural reform has become increasingly important for economic growth and employment creation. Significant progress has been made in some areas in 1997, particularly in the domain of tax reform, entitlement spending, corporate governance and privatisation. This momentum should be maintained. In other areas, the pace of reform needs to be stepped up, especially with respect to labour markets, and further progress in regulatory reform.

Economic growth recovered in 1997

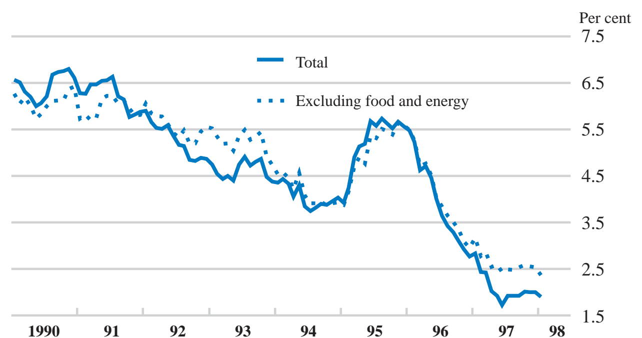
Economic growth picked up in 1997, real GDP growing by 1.5 per cent as against 0.7 per cent in 1996. Domestic demand was stimulated by stronger private consumption, based on rising real wage gains and special incentives for car purchases. Consumer confidence also strengthened with improving inflation and budget performance. Stronger growth of foreign markets made for buoyant export demand from the second quarter, and the recovery of gross fixed investment became quite broadly based in the course of the year. Having contracted by 3 per cent in 1996, industrial output posted a gain of 2.5 per cent for the year as a whole, the rate of capacity utilisation in manufacturing rising in the fourth quarter to the highest level since the previous cyclical peak in 1990. There was also a strong surge in imports.

Italy

Activity continues to recover



Inflation[1] remains low



1. Consumer price index, year-on-year percentage changes.

Employment, income and inflation

Percentage changes

	1995	1996	1997	1998	1999
Employment	–0.6	0.4	0.0	0.3	0.4
Unemployment rate[a]	12.0	12.1	12.3	12.0	11.8
Compensation of employees	4.2	5.6	4.3	3.2	3.1
Unit labour cost	1.3	4.9	2.7	0.8	0.3
Household disposable income	6.8	3.3	3.1	3.3	4.1
GDP deflator	5.1	5.0	2.6	2.5	2.1
Private consumption deflator	5.7	4.4	2.4	2.3	2.0

a) As a percentage of labour force.

Unemployment has remained high…

Given the slow pace of the recovery, the economy is still below its potential growth path: capacity utilisation is almost 2 points below the level seen in 1990 and labour market conditions, though slowly improving, have remained weak. With employment in large industrial and service firms falling further in 1997, the unemployment rate reached 12.4 per cent in the fourth quarter, declining to 12.2 per cent in the following three months. This improvement conceals diverging regional trends, labour market conditions tightening in the North and weakening further in the South. As a consequence, the gap between the Northern and Southern unemployment rates widened to 16 percentage points in the first quarter of 1998.

… and inflation has fallen to a historical low

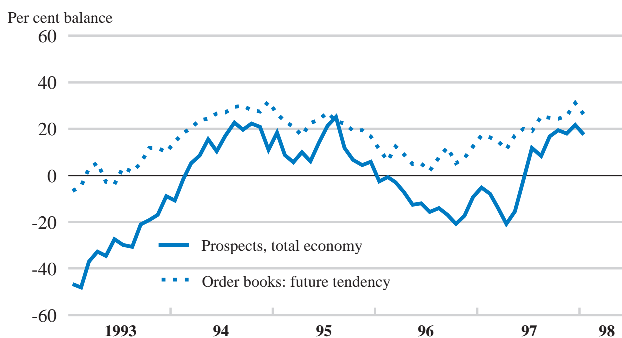
The process of disinflation strengthened in 1997, influenced by tight monetary policy and rapid fiscal consolidation. The annual rate of consumer price inflation averaged only 1.7 per cent in 1997, well below the official target of 2.5 per cent. The current configuration of the yield curve points to a framework of persisting low inflation expectations. At the producer level, inflation was broadly stable over the second half of 1997, a cyclical upturn having been offset by the dampening effects of the Asia crisis on prices of imported raw materials. At the same time, a reduction in the growth of contractual hourly wages – to 3.9 per cent in the fourth quarter of 1997 – and accelerating labour productivity have allowed a significant deceleration in unit labour costs.

While surging imports reduced the trade surplus in 1997…

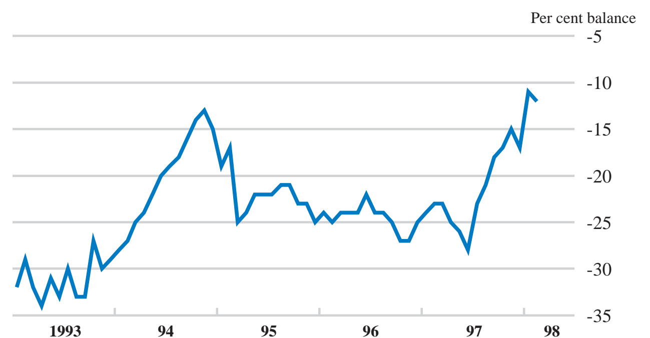
On the external side, the large trade surplus (balance-of-payments data) narrowed in 1997 mainly due to some currency appreciation against major European Union

Italy

Business confidence[1] continues to improve



Consumer sentiment[1] remains supportive



1. Balance between positive and negative answers.

External indicators

	1995	1996	1997	1998	1999
	$ billion				
Merchandise exports	234.0	250.8	238.9	247	266
Merchandise imports	189.2	190.1	188.9	195	211
Trade balance	44.7	60.7	50.0	51	55
Invisibles, net	–19.6	–19.8	–13.4	–9	–6
Current account balance	25.2	40.9	36.6	42	49
	Percentage changes				
Merchandise export volumes[a]	8.8	5.2	6.4	9.7	6.7
Merchandise import volumes[a]	6.5	0.0	9.6	11.2	7.3
Export performance[b]	0.2	–1.4	–2.6	1.9	–0.4
Terms of trade	–2.0	1.9	–0.7	1.0	0.4

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

(EU) trading partners in the first half of 1997, together with higher domestic demand as a result of the car incentive scheme, which translated into higher import volumes for automobiles and intermediate goods.

… the momentum of strong export growth may continue

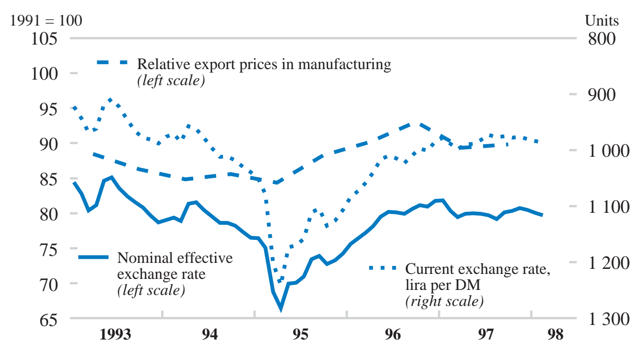
Export market growth is expected to decelerate in 1998 from the rapid pace registered in 1997, but is still expected to be in the range of 7 to 8 per cent. The nominal effective exchange rate has been relatively steady over the past two years and, measured by relative export prices in manufacturing, the real exchange rate is assumed to play a relatively neutral role in the projection, at a level which is projected to lead to a slight loss in market shares in 1999.

The budget deficit fell to the Maastricht limit in 1997 and fiscal consolidation is expected to continue

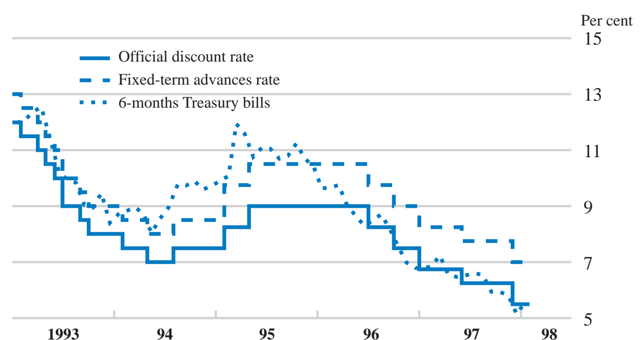
Fiscal targets for 1997 have been met, the general government deficit shrinking to 2.7 per cent of GDP, slightly below the target and down from 6.7 per cent in 1996. The deficit cut reflected lower interest payments (a consequence of falling interest rates and debt redemption permitted by surging receipts from privatisation), improved control of primary spending, temporary tax measures (Eurotax) and changes in accounting procedures approved by Eurostat. Stronger output growth than expected

Italy

Exchange rates have become more stable



Monetary policy has been eased further



also contributed to the favourable fiscal outcome. In line with the stabilization programme of May 1997, the 1998 budget foresees a deficit of 2.8 per cent of GDP, incorporating a fiscal adjustment of around 1.2 per cent of GDP relative to trend estimates, almost evenly split between revenue increases and expenditure cuts. The tax reform measures embodied in the 1998 budget, including the introduction of *Imposta regionale sulle attività produttive*, IRAP, and *Dual income tax*, DIT, and the revision of *Imposta sul reddito delle persone fisiche*, IRPEF, are the most important since the early 1970s. On the expenditure side, structural measures include cuts in pension payments and a reform of the state budget, ensuring improved control of public expenditure. The OECD Secretariat projection of deficits amounting to 2½ per cent of GDP in 1998 and 1999 reflect that lower interest payments will more than offset the effects both of tax revenues falling and primary spending rising relative to GDP. For the first time in many years, there would be no need for a supplementary budget, and current receipts would match current expenditure.

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

For 1998, the projections for the general government deficit assume full implementation of the 1998 budget, providing for a fiscal adjustment of L 25 trillion relative to trend. The changes in value-added tax rates and other indirect taxes since October 1997 have been taken into consideration. Combined with cyclical revenue gains, they are assumed to more than compensate for revenue losses associated with the expiration of the temporary Europa tax and other one off measures introduced in 1997. In addition, tax reform measures have been taken into account, together with the reorganisation of the health system. The net impact of the new pension measures is projected to be L 4.1 trillion. Of this amount, the bulk (70 per cent) is assumed to come from lower pension spending and the rest from higher pension contributions paid by the self-employed. Other current transfers are projected to increase modestly, as a result of measures to curb transfers to state railways and other state entities. For 1999, the projections assume no further measures.

Monetary policy caution has fostered exchange-rate stability setting the stage for further interest-rate convergence

Persistently low inflation and expectations of Italy's early EMU membership have narrowed the spread between Italian and German long-term rates below 30 basis points. Given the combination of favourable fiscal and inflation developments, in December 1997 the Bank of Italy lowered the discount rate by 75 basis points to 5.5 per cent and the rate of fixed-term advances to 7 per cent. Short-term term interest rates are projected to remain at this level in the first half of 1998, with full convergence being projected to occur by the end of the year. This entails a fall of about 150 basis points in short-term rates.

Conditions for a further strengthening of output growth are favourable…

Most forward-looking indicators, including consumer sentiment, investment surveys and order data, signal a strengthening of economic activity in 1998. The most dynamic component of domestic demand could be gross fixed investment, responding to improved demand prospects, high and rising rates of return on capital and falling nominal and real interest rates. Tax reform measures (the new dual corporate income tax), fiscal incentives for house renovation and stronger public investment should reinforce this trend. Largely due to the expiration of the car incentive scheme in July 1998, private consumption may temporarily lose some strength in the current year, recovering thereafter in response to improved confidence and gains in real disposable income.

Financial indicators

	1995	1996	1997	1998	1999
Household saving ratio[a]	14.7	12.9	11.4	10.5	10.1
General government financial balance[b]	–7.7	–6.7	–2.7	–2.6	–2.5
Current account balance[b]	2.3	3.4	3.2	3.7	4.1
Short-term interest rate[c]	10.5	8.8	6.9	4.8	4.0
Long-term interest rate[d]	11.9	9.2	6.7	5.3	5.7

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

… easing unemployment, while inflation may stay low…

With rising real GDP growth, projected to be 2½ per cent in 1998 and 2¾ per cent in 1999, the rate of unemployment could begin to decline in the first half of 1998, falling to 11.7 per cent at the end of the projection period. Remaining above the estimated structural rate, unemployment should continue to curb nominal wage growth, the 1997 autumn wage settlements having produced moderate outcomes. Consumer-price inflation should remain close to 2 per cent. On the external side, improving terms of trade, together with relatively stable export competitiveness, are projected to enlarge the trade surplus, more than offsetting the negative effects of currency depreciation in Asian countries. Together with a sharp decline in the deficit on the invisible account, associated with the projected disappearance of the deficit in net investment incomes, this may raise the current account surplus to 4 per cent in 1999.

Demand and output

Percentage changes, volume (1990 prices)

	1994 current prices trillion L	1995	1996	1997	1998	1999
Private consumption[a]	1 029.2	1.9	0.8	2.4	2.2	2.5
Government consumption	284.5	–1.0	0.2	–0.7	0.4	0.5
Gross fixed investment	272.8	7.1	0.4	0.6	4.8	6.2
Machinery and equipment	129.7	13.8	–0.3	2.6	6.2	7.3
Construction	143.1	0.6	1.1	–1.6	3.2	4.9
Residential	83.1	–1.7	–2.4	–0.4	4.4	6.5
Non-residential	60.0	3.9	5.6	–3.0	1.7	2.8
Final domestic demand	1 586.5	2.3	0.6	1.5	2.4	2.8
* stockbuilding	9.7[b]	0.0	–0.3	1.0	0.0	0.0
Total domestic demand	1 596.2	2.3	0.3	2.5	2.4	2.8
Exports of goods and services	361.6	11.6	–0.2	6.3	10.5	6.5
Imports of goods and services	319.1	9.6	–2.0	11.8	11.5	7.0
* net exports	42.5[b]	0.7	0.4	–0.9	0.1	0.1
GDP at market prices	1 638.7	2.9	0.7	1.5	2.4	2.7
Industrial production	–	6.1	–2.9	2.5	4.0	4.2

* 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.

… provided the new monetary policy regime keeps inflation expectations low

The main uncertainties attaching to the projections relate to the impact of more accommodating monetary conditions on demand and wage inflation. The expectation is that labour-market slack will continue to damp wage growth, but it is important that expectations continue to adapt positively to the new monetary policy regime.

United Kingdom

In 1997, the UK economy achieved a highly favourable although unsustainable set of results. Output rose strongly and labour market conditions improved further while inflation was virtually at the government's target rate of 2½ per cent. Moreover, the current account was in balance and the budget deficit narrowed by some 2½ percentage points of GDP. But with growth significantly above trend, and after five years of expansion, an inverted output gap emerged in early 1997, and the economy began to manifest signs of overheating. Tight labour market conditions and high capacity utilisation threatened to increase wage and price pressures. As a response, the macroeconomic policy stance was tightened, initially in mid-1996, with sizeable additional restraint since the second half of 1997. Together with a sharp appreciation of sterling, it has started to slow the economy and is likely to lead to below potential growth over the next two years. This, as well as lower commodity prices, should ease inflation pressures, and keep inflation close to the target over the projection period.

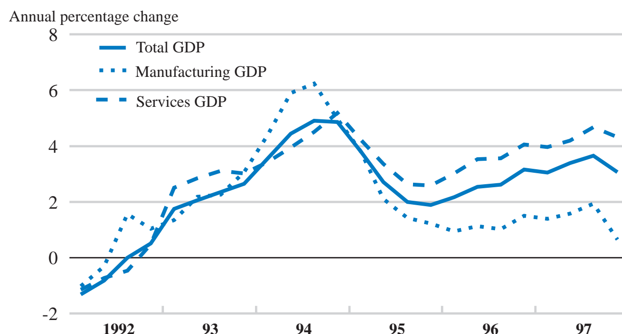
The orderly unwinding of imbalances – the currency appreciation has slowed tradeables output, while services still grow strongly – will be a test for the new macroeconomic policy framework and also important for structural reform, since the Welfare to Work programme has the best chance to succeed in strong labour market conditions. The setting of policy is complicated by the difficulty of judging the strength of underlying inflationary pressures as well as the timing of an economic slowdown. Given the lagged effects of earlier tightening still in the pipeline, and with sterling at current high levels, there appears to be little need for further base rate increases. The new government has a broad structural reform programme to boost potential growth and employment; some initiatives have already been implemented while others are still being shaped, making an overall assessment at this stage premature.

Favourable results in 1997, but growth became uneven…

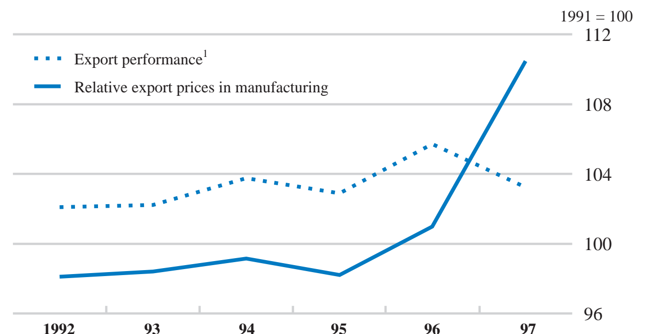
At 3.3 per cent, output growth was significantly above trend in 1997 and, on most measures, remaining cyclical slack was absorbed by early 1997. Consumer spending underpinned the sharp rise in domestic demand, fuelled by strong job creation, real income gains and high consumer confidence. Consumption was especially strong in the middle of the year, when the bulk of the spending from the windfall proceeds from building society demutualisations probably occurred. Capacity utilisation at record levels, high profitability, and falling long-term borrowing costs spurred business investment spending in 1997.

United Kingdom

Manufacturing output growth slows



External competitiveness deteriorates



1. Export performance is the ratio between export volumes and export markets for total goods.

… due to lower international competitiveness

Following sterling's appreciation since the middle of 1996, international competitiveness has deteriorated and output growth has become uneven. While the services sector continues to grow rapidly, with output rising by 4$^{1}/_{2}$ per cent over the past year, growth in manufacturing output, which is more exposed to international competition, has been considerably weaker. The initial response in trade volumes has been muted by slow pass through of the exchange rate appreciation into the prices of tradeables, reflecting existing contractual arrangements, a squeeze on profit margins, and faster market growth. Nonetheless, export growth dropped sharply towards the end of 1997 in line with survey-based evidence earlier in the year, and import volumes have risen significantly. Since mid-1997 the external sector has become a significant drag on output growth. The current account, however, remains broadly in balance, due largely to an improvement in net investment income receipts.

Labour market conditions are tight…

Rapid output growth has had a positive influence on labour markets. Employment growth accelerated to close to 2 per cent in late 1997 and the rate of claimant unemployment is at its lowest level since 1980. The reduction in unemployment is broadly based, with falls in all age groups, and in the proportion of long-term unemployed. On most estimates, including those of the OECD Secretariat, unemployment is now below or close to the structural rate and signs of labour market tightness are increasingly evident. These include a high vacancy to unemployment rate, reported skill shortages and recruitment difficulties, and upward pressures on wages.

… and inflationary pressures have risen…

Average earnings rose by 4$^{1}/_{2}$ per cent in the twelve months to January 1998, close to their highest rate in five years. Part of the increase reflects unusually large bonus payments, but even abstracting from these and adjusting for average hours worked, a pick-up in earnings has clearly occurred. At this stage of the cycle, when productivity gains are usually slow, such a rate is barely consistent with the official inflation target. Growth in private sector wage settlements also rose, but public sector settlements have been subdued over the last couple of years at less than 3 per cent a year.

… but so far inflation has been close to target

Sterling's appreciation since August 1996 and recent falls in commodity prices have dampened inflation. The retail price index excluding mortgage payments (RPIX) (the index on which the inflation target is based) rose by 2.6 per cent in the twelve months to February 1998, fractionally above target. But the downward pressure on price levels from the appreciation is transitory and underlying inflation pressures remain. Bank of England estimates suggest that prices of domestically produced goods and services rose by 3 per cent over the twelve months to December 1997.

Employment, income and inflation

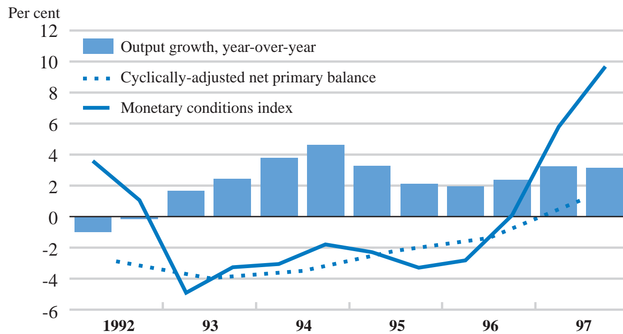
Percentage changes

	1995	1996	1997	1998	1999
Employment	1.2	1.1	1.7	0.5	0.0
Unemployment rate[a]	8.6	8.0	6.9	6.8	7.2
Compensation of employees	4.4	5.1	6.5	5.6	4.7
Unit labour cost	1.7	2.9	3.1	3.8	2.9
Household disposable income	5.9	5.9	6.4	5.3	4.7
GDP deflator	2.5	3.1	2.6	2.5	2.6
Private consumption deflator	2.6	2.5	2.1	2.4	2.6

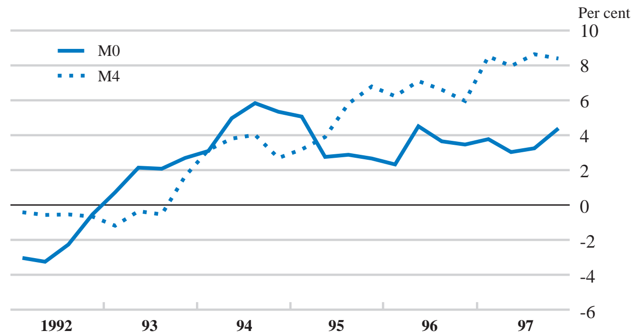
a) As a percentage of labour force.

United Kingdom

Policy has tightened



Monetary aggregates continue to grow strongly[1]



1. Deflated by the GDP deflator, annual percentage change.

Monetary conditions have become very tight…

The Bank of England's repo rate has been raised five times since May 1997, by 1/4 percentage point on each occasion, to reach its current 7 1/4 per cent in November 1997. The rate increases underpinned the strength of the sterling effective rate, which is currently some 30 per cent above its trough in 1995 and 10 per cent higher than the level prior to its suspension from the European Exchange Rate Mechanism (ERM) in 1992. Monetary conditions tightened sharply from 1996 onwards and are now very tight. However, while interest rates have gone up at the short end, their effect on restraining domestic demand has probably been partly counterbalanced by the fall in long-term interest rates – the granting of operational independence over monetary policy to the Bank of England increased the credibility of the Government's inflation target and triggered a decline in long-term interest rates. The strength of asset prices and rapid broad money growth are further counterbalancing factors.

… and fiscal policy is restrictive…

Fiscal policy is also dampening demand. The fiscal year (FY) 1997/98 turned out more restrictive than planned, and the March 1998 Budget maintains tight overall spending controls and is moderately contractionary. Revenues are officially estimated to rise by 9 1/2 per cent in FY 1997/98 and a further 5 1/2 per cent in FY 1998/99. Revenue measures include higher excise and stamp duties and reforms to corporate taxation and National Insurance contributions. Expenditures are forecast to rise by 2 per cent in FY 1997/98 and some 4 per cent in FY 1998/99, reflecting additional outlays on education and health and an expansion of initiatives to encourage work, including a working families tax credit. The OECD Secretariat's projections, which are on a national accounts and calendar year basis, show a further decline in the cyclically adjusted deficit between 1997 and 1999, with the budget close to balance in 1999. The Government has decided to implement a Code for Fiscal Stability, which aims to raise transparency and accountability. The new fiscal policy approach centres on observance of the Golden Rule – a deficit no larger than government investment. The rule would be comfortably adhered to over the projection period.

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

It is assumed that the revenue measures contained in the March 1998 Budget are fully implemented in 1998 and 1999. These include reforms to National Insurance contributions, the abolition of Advance Corporation Tax and the introduction of quarterly payments of corporation tax, partly compensated by lower corporate tax rates, and higher excise and stamp duties. Announced Budget measures that raise spending on education, health and initiatives to encourage work are included and overall continued expenditure restraint is assumed, implying a slight fall in cyclically-adjusted expenditure as a share of GDP. Government wages in 1998 are assumed to grow at a slightly faster pace than the increase awarded in January by the official pay review body, reflecting some drift, and come closer to private sector developments in 1999, after several years of tight public sector wage ceilings.

Financial indicators

	1995	1996	1997	1998	1999
Household saving ratio[a]	11.7	11.4	11.1	10.7	10.7
General government financial balance[b]	–5.6	–4.7	–1.9	–0.8	–0.4
Current account balance[b]	–0.5	–0.3	0.6	–1.0	–1.3
Short-term interest rate[c]	6.7	6.0	6.8	7.2	5.7
Long-term interest rate[d]	8.2	7.8	7.0	6.2	6.4

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

… which should eventually slow the economy…

Output growth is projected to slow significantly in 1998 and remain below potential in 1999 and as this happens, monetary conditions are projected to ease, with short-term interest rates falling to 5 1/2 per cent in the second half of 1999. GDP could rise by around 1 3/4 per cent in both years, although yearly averages hide a fairly sharp slowdown in 1998 with some bounce-back in 1999. Weaker growth could lead to a small output gap by 1999. Current momentum and tight supply conditions are largely compensated by weak commodity prices and the strength of Sterling, with inflation projected at close to the target.

… initially from net exports, but more broadly based in 1999

The projected slowdown in economic activity is due initially to weak export growth related to low competitiveness and the negative shock in Asia. Net exports are forecast to detract significantly from growth in 1998 and to have a neutral impact in 1999, although carryover effects will continue to pull growth down in year average terms. The overall impact of turmoil in Asia could lower output by about half a percentage point. Domestic demand growth, on the other hand, is projected to remain

Demand and output

Percentage changes, volume (1990 prices)

	1994 current prices billion £	1995	1996	1997	1998	1999
Private consumption	427.4	1.7	3.6	4.6	3.3	2.1
Government consumption	144.1	1.3	1.2	–0.5	0.8	1.2
Gross fixed investment	100.3	1.5	1.5	4.8	5.0	3.5
Public[a]	17.2	–7.2	–23.2	–14.2	1.6	0.8
Private residential	18.2	2.1	1.1	7.4	7.3	4.7
Private non-residential	64.9	3.9	8.3	7.8	4.9	3.6
Final domestic demand	671.7	1.6	2.7	3.6	3.1	2.2
* stockbuilding	3.7[b]	0.2	–0.2	–0.1	–0.1	0.0
Total domestic demand	675.4	1.8	2.5	3.5	3.0	2.2
Exports of goods and services	176.6	7.8	6.8	8.0	5.0	4.8
Im ports of goods and services	183.0	4.2	8.4	9.2	9.0	5.7
* net exports	–6.4[b]	0.9	–0.5	–0.4	–1.4	–0.5
GDP at market prices[c]	669.1	2.7	2.2	3.3	1.7	1.8
Manufacturing production	–	1.7	0.3	1.5	1.1	1.7

* 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.

strong for some time. Rising real personal incomes, high levels of confidence, house price increases, capacity constraints and healthy corporate balance sheets are the forces supporting the continuation of this "twin-track" economy into 1998. In 1999, growth is likely to be more balanced as earlier macroeconomic policy tightening has its full impact. Both consumption and investment spending growth are projected to decline to rates closer to their long-term average and the lagged effects of lower competitiveness will continue to have a restraining influence on export volumes, while slower domestic demand growth will soften import volumes. This could lead to the current account deficit widening to around 1 1/4 per cent of GDP in 1999.

External indicators

	1995	1996	1997	1998	1999
			$ billion		
Merchandise exports	241.6	261.5	277.4	280	294
Merchandise imports	259.9	281.3	298.7	312	330
Trade balance	–18.3	–19.8	–21.3	–32	–36
Invisibles, net	12.5	16.7	28.6	18	17
Current account balance	–5.8	–3.1	7.4	–13	–19
			Percentage changes		
Merchandise export volumes[a]	8.6	7.5	7.0	4.8	5.0
Merchandise import volumes[a]	4.8	9.6	7.5	8.7	5.7
Export performance[b]	–0.4	1.3	–2.6	–3.0	–2.1
Terms of trade	–2.2	1.7	0.6	0.3	–0.2

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

The slowdown is likely to ease labour market strains and inflationary pressures

With the slowdown in activity, demand for labour is projected to weaken and the unemployment rate could rise by about half a percentage point, to reach 7 1/4 per cent in 1999 – somewhat above its estimated structural level. Labour market strains should also be alleviated by the Government's Welfare to Work measures. As cyclical slack develops only in late 1998, some escalation in average earnings can be expected during 1998. Private sector wage growth is projected to peak at close to 5 1/2 per cent. Given the strength of sterling and weaker commodity prices, such a wage profile is unlikely to push inflation above the target in 1998. In 1999, rising unemployment is expected to moderate earnings growth to a level compatible with fulfilling the inflation target.

Risks are finely balanced

A major risk to these projections concerns the assessment of labour market tightness, which could be greater in the near term and trigger stronger wage pressures, compromising the likelihood of achieving the inflation target. This would imply more buoyant near-term prospects, but also a strong reaction from the monetary authorities, with significantly slower growth thereafter. On the other hand, the lagged effects of policy restraint and the impact of developments in Asia could be underestimated and business and consumer confidence could fall sharply from their current high levels, exacerbating the slowdown in domestic demand.

Canada

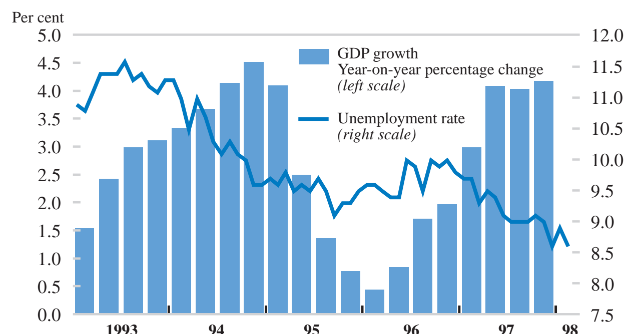
The economy has continued to grow at a healthy pace. While the expansion has been broadly based, domestic demand has remained the main source of growth, with soaring business investment leading the way. As demand has been especially strong for import-intensive goods and declining prices for natural resources have dampened export earnings, the external current account has moved back into substantial deficit. Although cost and price pressures have remained subdued, the authorities have raised short-term interest rates further to offset the potential inflationary impact of a depreciating Canadian dollar. While this, together with the fallout from the Asia crisis, will dampen activity in the period ahead, there are a number of mitigating factors: the outlook for the United States remains favourable; exchange-rate depreciation has enhanced Canada's competitive position; long-term interest rates have kept falling; and fiscal policy is moving towards a neutral stance following the achievement of a budget surplus.

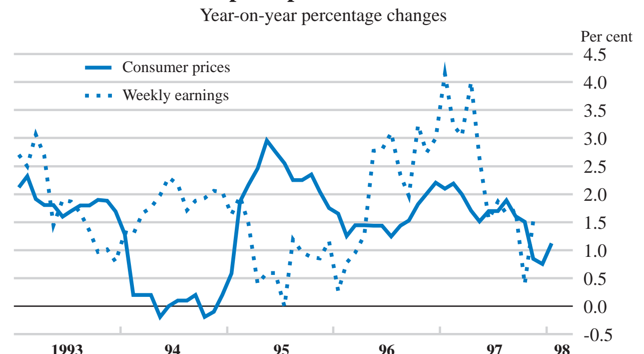
While some rise in short-term interest rates was appropriate in the light of the momentum of the recovery, in the near term further moves need to be carefully considered given the contractionary effect of the negative terms-of-trade shock and the downside risks associated with the Asian crisis. However, a tightening of monetary conditions might be required from 1999 onwards to achieve the inflation target over the medium term. While the improvement of the fiscal position provides some room for manoeuvre, priority should be given to maintaining a clear downward trend in the high public debt-to-GDP ratio. In this context, it would be desirable to complete the reform of the retirement income system without delay.

Continued strong growth…

In the second half of 1997, real GDP growth kept pace with the 4 per cent rate recorded in the preceding semester, despite the adverse effects of major labour conflicts. Business investment was the driving force in the economy, continuing to expand at double-digit rates. While spending on machinery and equipment was particularly buoyant, non-residential construction also recovered strongly in response to rising capacity utilisation and low vacancy rates for offices. Financing such investment was facilitated by a marked increase in profits and favourable conditions for new stock and bond issues. Household spending slowed somewhat but remained robust, sustained by solid advances in employment and personal wealth. Consumer outlays for motor vehicles continued to lead the way. Given the high import content of machinery

Canada





Employment, income and inflation

Percentage changes

	1995	1996	1997	1998	1999
Employment	1.6	1.3	1.9	2.2	1.8
Unemployment rate[a]	9.5	9.7	9.2	8.6	8.3
Compensation of employees	3.4	2.5	3.8	4.3	4.9
Unit labour cost	1.2	1.3	0.0	0.9	1.8
Household disposable income	3.1	1.6	1.4	3.8	4.9
GDP deflator	2.6	1.4	0.5	1.1	1.9
Private consumption deflator	1.4	1.5	1.8	1.3	1.6

a) As a percentage of labour force.

investment and consumer durables, import growth far outpaced that of exports, despite strong foreign demand for Canadian products. The worst ice storm of the century in Quebec and eastern Ontario significantly affected spending and production in early 1998. Much of the output loss is likely to have been made up subsequently, however, and reconstruction and repair efforts will stimulate activity in the regions concerned.

… has boosted employment but has also led to a deterioration in the external balance

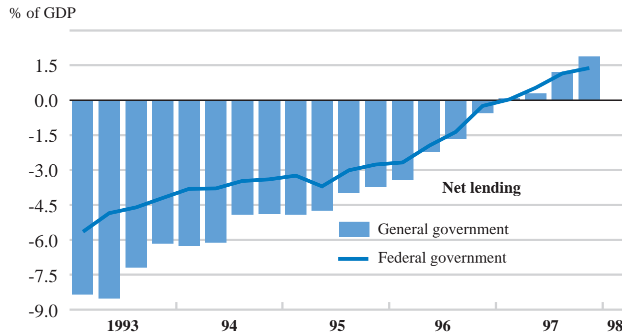
The strength of the economic upturn during 1997 boosted employment, with virtually all of the additional jobs created being full-time positions in the private sector. As a result, unemployment has fallen below the 9 per cent mark, a level last seen at the beginning of the decade. Persistent – albeit diminishing – slack in labour and product markets continues to put downward pressure on costs and prices. Reflecting modest wage increases and solid gains in productivity, unit labour costs were below their year-earlier level in late 1997. Twelve-month consumer price inflation has been running near the bottom of the official 1 to 3 per cent target range since November. World market prices of the major commodities produced in Canada have fallen since early 1997. As average import prices have declined less than export prices, Canada's terms of trade have deteriorated over the past year. Together with import volume growth in excess of that of export volumes, this has led to a marked worsening in the external current account, which moved from a slight surplus in 1996 to a deficit of almost 3 per cent of GDP in late 1997.

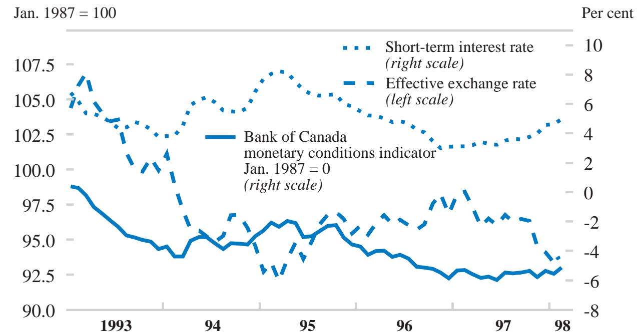
External indicators

	1995	1996	1997	1998	1999
			$ billion		
Merchandise exports	193.0	205.7	217.8	230	251
Merchandise imports	168.5	175.7	200.9	218	237
Trade balance	24.6	30.1	16.9	12	14
Invisibles, net	–30.1	–27.4	–29.1	–31	–31
Current account balance	–5.5	2.7	–12.3	–18	–17
			Percentage changes		
Merchandise export volumes[a]	11.9	4.5	8.9	8.4	7.9
Merchandise import volumes[a]	9.6	5.6	17.9	10.2	7.8
Export performance[b]	2.7	–4.9	–4.5	–2.9	–0.8
Terms of trade	2.7	3.3	0.2	–0.9	0.2

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

Canada





With downward pressure on the exchange rate, short-term interest rates have risen

Since mid-1997, the Bank of Canada has raised its operating band for the overnight financing rate in several steps by 175 basis points in total, bringing it to 4½ to 5 per cent. Contrary to earlier moves, which were aimed at moderating the extent of monetary stimulus in response to strong growth, recent interest rate increases have been intended to maintain roughly constant monetary conditions in the face of the depreciation of the Canadian dollar. Indeed, as measured by the Bank's Index, which captures the combined effect on output and inflation of short-term interest rates and the effective exchange rate, overall monetary conditions have tightened only little. The projections outlined below, which are based on the technical assumption of a constant exchange rate, assume no further rise in short-term interest rates in the near term. The forward-looking nature of the monetary policy framework would seem to call for a resumption of interest rate increases later in the projection period, however. In contrast to short-term interest rates, long-term rates have kept declining, leading to a marked flattening of the yield curve. Over the projection period, they are assumed to firm slightly in line with developments in the United States. This implies ongoing negative spreads with corresponding US rates owing to favourable economic fundamentals in Canada, including a sound fiscal position.

Fiscal consolidation has made further progress, but the pension reform is not yet complete

The rapid improvement in public finances has continued, with the general government financial balance (on a national accounts basis) in rising surplus since the second quarter of 1997. While buoyant economic activity has contributed, two-thirds of the positive swing in the fiscal balance in 1997 can be traced to discretionary measures: according to OECD Secretariat estimates, fiscal tightening withdrew 2 per cent of GDP from domestic demand, as compared with over 2½ per cent

Financial indicators

	1995	1996	1997	1998	1999
Household saving ratio[a]	8.0	5.9	1.9	1.0	1.4
General government financial balance[b]	–4.3	–2.0	0.9	1.8	2.1
Current account balance[b]	–1.0	0.4	–2.0	–2.9	–2.6
Short-term interest rate[c]	7.0	4.4	3.5	4.8	5.0
Long-term interest rate[d]	8.4	7.5	6.5	5.7	6.0

a) As a percentage of disposable income.
b) As a percentage of GDP.
c) 3-month prime corporate paper.
d) Over 10-year federal government bonds.

in 1996. Progress in budget consolidation has been made at all levels of government. Although some provincial budgets are still in deficit, overall the provinces like the federal government are already running surpluses. As a result, the public sector's debt-to-GDP ratio declined markedly in 1997, following an almost continuous increase since the beginning of the 1980s. Budget plans imply a move of fiscal policy towards a neutral stance in the period ahead. This still means some further rise in the actual budget surplus as economic slack is taken up. The reform of the Canada Pension Plan, which provides for income-related benefits, became effective at the beginning of the year. However, legislation on the announced new Senior's Benefit, which will rationalise various schemes that provide a minimum income for the elderly, has still not been introduced.

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

The OECD Secretariat's fiscal projections are based on the February 1998 Budget which covers the period until March 2000. The projections adjust the budget figures to a calendar year basis and to national accounting conventions, and further adjust revenues and expenditures in light of differences between OECD Secretariat and national projections for economic growth and interest rates. They assume that the contingency reserves will not be used. The fiscal situation of the provinces is expected to be consistent with their latest budget and legislated or stated medium-term objectives, which call for an elimination of remaining deficits by the end of the decade at the latest.

The recovery is projected to continue at a slower pace…

Reflecting higher short-term interest rates and the adverse effects of the Asia crisis, economic growth is projected to moderate, averaging just over 3 per cent through 1998-99. With potential output expanding at a rate of 2¾ per cent over that period, according to OECD Secretariat estimates, this implies a gradual narrowing of the output gap which may currently amount to around 1 per cent. As foreshadowed by a recent deterioration in consumer and business confidence, domestic demand is projected to grow at a slower pace, following its spurt in 1997. The expansion of private consumption is expected to fall below that of disposable income as households raise their saving ratio which is at a historically low level. While business investment should remain robust, helped by low long-term interest rates, it is unlikely to keep rising at the high rates achieved over the past two years. Following substantial restocking, inventory formation is not expected to make a significant contribution to growth. On the other hand, government spending will again give some support to domestic demand, following five years of fiscal retrenchment.

Demand and output

Percentage changes, volume (1992 prices)

	1994 current prices billion C$	1995	1996	1997	1998	1999
Private consumption	445.9	1.7	2.4	3.9	3.3	2.8
Government consumption	169.6	–0.4	–1.3	–0.1	0.6	1.0
Gross fixed investment	137.8	–2.8	4.8	11.4	7.0	6.4
Public[a]	20.1	–1.2	–3.7	–5.4	1.6	3.6
Residential	42.0	–14.1	10.9	13.1	5.7	5.5
Non-residential	75.8	3.0	4.2	14.5	8.7	7.3
Final domestic demand	753.3	0.4	2.0	4.4	3.4	3.2
* stockbuilding	2.1[b]	0.6	–0.9	0.7	0.3	0.0
Total domestic demand	755.5	1.0	1.1	5.1	3.7	3.1
Exports of goods and services	261.7	9.3	5.7	8.6	8.3	7.5
Imports of goods and services	253.7	6.7	5.2	13.4	9.8	7.7
* net exports	8.0[b]	0.9	0.3	–1.4	–0.5	0.0
* error of estimate	–1.2[b]	0.2	–0.1	0.3	0.1	0.0
GDP at market prices	762.3	2.2	1.2	3.8	3.3	3.0
Industrial production	–	4.1	1.5	4.9	4.4	3.9

* 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.

Export growth is projected to slow gradually, reflecting several partly offsetting influences. In the short run, continued strong US demand is expected to moderate adverse effects of the Asia crisis; thereafter, improved competitiveness due to exchange rate depreciation should moderate the impact of slower US growth on Canada's exports. The current account deficit should stabilize as import growth slows in line with domestic demand and the deterioration of Canada's terms of trade comes to a halt. Although wage growth is projected to pick up somewhat as unemployment declines gradually towards its estimated structural rate, inflation is expected to remain low – and consistent with the official target – during the projection period, given persistent excess supply in the economy.

... with developments in Asia posing some downside risks

Because the Canadian economy is so closely linked to that of the United States, unexpected changes in its southern neighbour are by far the most important risk to the outlook. With Asia, including Japan, making up less than 10 per cent of total Canadian exports, related downside risks would seem to be comparatively small. While falling commodity prices could adversely affect business confidence and investment, such effects are likely to remain limited to some regions. Nonetheless, the relative importance of commodities to Canada could complicate macroeconomic management, being a major factor behind the recent weakness of the Canadian dollar. While, to some extent, the rebalancing of monetary conditions – that is, a shift in the exchange rate/interest rate mix – has been desirable, further downward pressure on the currency and concomitant increases in interest rates could abort the expansion of domestic demand which remains the main source of growth.

Australia

Economic activity continued to strengthen in the second half of 1997, driven by rising domestic demand. Employment growth also resumed, cutting the unemployment rate to a little over 8 per cent in recent months. And underlying inflation fell to the lowest rate on record. Output growth is projected to remain a little over 3 per cent, buoyed by strong domestic demand but weighed down by weak export markets in East Asia. This will entail a deterioration in the current account deficit, projected to reach some 5 per cent of GDP in 1998 but to fall somewhat in the following year.

Continued efforts will be required to raise national saving, notably through the implementation of fiscal consolidation, so as to ensure that financial market confidence is retained in the face of a cyclical rise in the current account deficit. Inflation is likely to rise gradually over the next two years, partly reflecting higher import prices, but is expected to remain consistent with the central bank's medium-term target. The financial crisis in East Asia has underlined the importance of the sound institutional arrangements in the financial and corporate sectors. Structural reforms aimed at ensuring that such arrangements continue to support an efficient allocation of resources should proceed as planned.

The domestic economy is strengthening…

The strengthening in economic growth during the first half of 1997 continued in the second half of the year, with annualised growth in GDP(A)[1] rising slightly above 3 per cent. This pick up in economic activity has been driven by domestic demand, especially investment in plant and equipment and in dwellings. Private consumption expenditure remained weak until early 1997, but since then has strengthened markedly. Despite some weakening in both business and consumer confidence in the wake of the Asian crisis, they remain high, pointing to further solid growth in private consumption and investment expenditures. Business investment intentions suggest that growth in equipment investment is likely to be particularly high in fiscal year (FY) 1997/98. The recovery of housing investment seems set to continue in view of the ongoing strong increase in the number of building approvals and high levels of housing affordability.[2]

… employment growth has resumed, and inflation is low

Following a period of stagnation, growth in employment resumed during the second half of 1997 and has progressively strengthened. By early 1998, employment was 1¼ per cent higher than a year earlier, with most of this growth due to a rise in the number of full-time jobs. In combination with a fall in the participation rate, this cut the unemployment rate to a little over 8 per cent. Wage increases remain stable, with average weekly ordinary time earnings continuing to grow 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) fell to 1.4 per cent in the year to the fourth quarter of 1997, the lowest rate since the series was first compiled in 1972. Falling prices for imported items contributed to this outcome. The headline rate of consumer price inflation (including mortgage interest charges) was actually slighter negative over the same period.

"One-off" transactions boosted exports (and cut inventories) in 1997

The current account deficit fell to A$18 billion (3.4 per cent of GDP) in 1997. The reduction in the deficit was attributable to "one off" transactions – sales of gold (A$ 2.5 billion) by the Reserve Bank of Australia and the export of a frigate

1. The average of the expenditure, income and production measures of GDP.
2. Housing affordability is measured by the ratio of average household disposable income to the ("qualifying") income required to meet payments on a typical dwelling.

(A$ 0.5 billion). Despite the "El Niño" climatic effect, above-average agricultural production is being maintained in FY 1997/98. However, recent dry conditions in eastern Australia may be the precursor of a serious drought, which would cut agricultural production and exports next fiscal year.

The East Asian crisis is set to cut export growth markedly

The drastic deterioration of economic prospects in East Asia in recent months will prove to be a major drag on growth in Australia as countries in this region (excluding New Zealand) take almost two-thirds of its exports. Prices for primary commodities have been falling since the crisis broke, although a depreciation of the Australian currency against the US dollar has meant that, overall, Australian dollar commodity prices have risen and are providing incentives to maintain production. While the trade weighted exchange rate index (TWI) has appreciated since mid-1997, reflecting weakness in some Asian currencies, the third-country export-weighted exchange rate index, which is relevant for export competitiveness, has returned to around its pre-crisis level. The difference between developments in the two series reflects the fact that Australia's main export competitors are not in Asia, where it sells most of its exports, but in America and New Zealand. Similarly, the import-weighted exchange rate index has also returned to around its pre-crisis level as again Asian countries only have a moderate weight in this index. The crisis should have only a minor effect on Australian companies' foreign investment income, which is mostly derived from outside East Asia. Australian banks have only a moderate East Asian exposure (6 per cent of Australian banks' global assets) and have sufficient reserves to absorb potential losses.

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

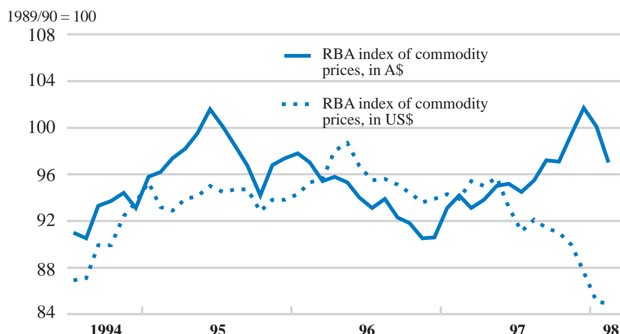
It is assumed that policy measures announced (see above) in the 1996 and 1997 Commonwealth Budgets are fully implemented and have the expected effect of reducing the deficit by $1^1/_4$ per cent of GDP in each of FY 1997/98 and FY 1998/99. Some of these measures, notably the savings rebate which replaces the former government's proposal to subsidise employee superannuation contributions, will only be fully phased in from FY 1999/2000. Consistent with the states' own projections, it is assumed that the state/local government sector will remain in small underlying surplus.

Monetary policy is providing economic stimulus while fiscal consolidation continues

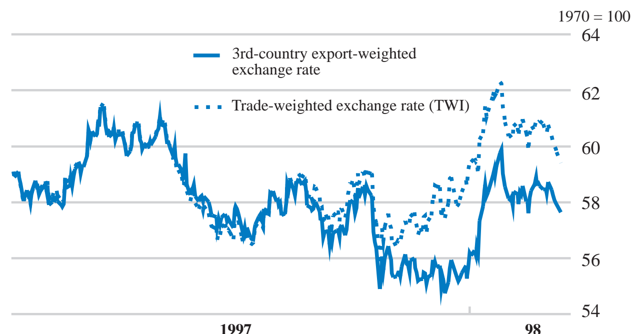
There have been no more reductions in the officially targeted cash rate since it was lowered by 0.5 percentage point to 5 per cent in July 1997. This brought to 2.5 percentage points the total reduction in the cash rate since monetary easing began one year earlier. These cuts in the cash rate should have their greatest impact on economic activity over the coming 18 months. The ten-year government bond rate has eased somewhat in recent months and is currently just under 6 per cent. The Commonwealth government is in the midst of a fiscal consolidation programme which should deliver a

Australia

Commodity prices down (up) in US$ (A$)



TWI overstates loss of competitiveness



Source: Reserve Bank of Australia (RBA).

Demand, output and prices

Percentage changes, volume (1989/90 prices)

	1994 current prices billion A$	1995	1996	1997	1998	1999
Private consumption	277.4	4.8	3.0	3.5	4.2	3.4
Government consumption	78.2	2.3	2.9	1.4	1.8	2.1
Gross fixed capital formation	94.5	3.7	5.7	10.0	7.7	4.5
Final domestic demand	450.2	4.1	3.6	4.6	4.6	3.5
* stockbuilding	2.4[a]	0.4	–0.2	–1.7	1.2	0.3
Total domestic demand	452.6	4.6	3.4	2.9	5.9	3.8
Exports of goods and services	83.5	4.8	11.1	11.2	–0.8	5.5
Imports of goods and services	88.2	10.1	9.8	13.8	9.8	7.5
* net exports	– 4.7[a]	–1.0	0.3	–0.5	–2.7	–0.7
* Statistical discrepancy	– 1.1[a]	0.6	0.1	0.3	0.0	0.0
GDP at market prices[b]	446.8	4.1	3.7	2.7	3.2	3.2
GDP deflator[b]	–	2.5	2.1	2.0	2.0	2.8
Memorandum items						
GDP average measure[c]	–	3.5	3.6	3.1	3.2	3.2
Private consumption deflator	–	2.3	2.0	1.3	1.8	2.6
Industrial production	–	0.5	2.7	1.5	2.0	2.5
Unemployment rate	–	8.6	8.5	8.6	8.1	7.7
Household saving ratio[d]	–	3.1	4.6	3.9	3.0	2.7
General government financial balance[e]	–	–2.0	–0.9	–0.3	0.2	0.6
Current account balance[e]	–	–5.4	–4.0	–3.3	–5.1	–4.7

* 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.

small underlying[3] budget surplus by next fiscal year. The largest contributions to these deficit reductions come from reduced transfers to the states, increased student contributions towards university tuition costs and a major refocusing of labour market programmes. Meanwhile, the states' small underlying surplus is officially projected to grow slightly over the next few years. The OECD Secretariat projects that the general government underlying balance will increase from a small deficit in 1997 to a surplus of around 1/2 per cent of GDP in 1999. This improvement is estimated to be structural.

Steady economic growth is projected to continue but the current account deficit should increase

Output growth is projected to remain at slightly above 3 per cent, buoyed by continued strong growth in consumption expenditure (partly boosted by the demutualisation of a large provident life fund) and in dwelling and equipment investment but held back by weak export markets. Employment growth should continue to strengthen, reaching 1 3/4 per cent in 1999 and lowering unemployment slightly, to 7 3/4 per cent. Declining productivity growth and the fading effects of falling import prices in recent years should contribute to an increase in the inflation rate to around 2 1/2 per cent in 1999. The current account deficit is projected to rise to 5 per cent of GDP this year but to decline somewhat in 1999. The major risks surrounding these central projections concern the outlook for East Asia. At this stage, it is difficult to predict how long it will take for the countries in crisis to recover and whether any other countries in the region will be engulfed in the crisis. There is also considerable uncertainty concerning the likelihood and severity of a drought in eastern Australia.

3. The underlying budget balance, as officially defined, excludes net advances, consisting primarily of asset sales and net repayment of debt by the states.

Austria

Exports and investment in equipment and machinery both expanded rapidly in 1997, but due to fiscal consolidation and continuing problems in the construction sector, GDP growth amounted only to some 2 per cent. Domestic demand, underpinned by a more favourable fiscal stance and supportive monetary conditions, should strengthen over the projection period, and with exports remaining robust, GDP growth is projected to accelerate modestly. Inflation should, nevertheless, remain at rates approaching virtual price stability.

The fiscal authorities have been remarkably successful in bringing the budget deficit down to $2^1/_2$ per cent of GDP in 1997, thereby comfortably fulfilling the deficit condition for membership of the European Economic and Monetary Union (EMU). Medium term fiscal objectives leave little room for manoeuvre within the confines of the Growth and Stability Pact. With monetary policy flexibility limited, as in the past, by exchange rate commitments, achieving growth and employment objectives within the context of EMU will require additional measures to create labour market flexibility and to strengthen competitive conditions in some previously sheltered sectors.

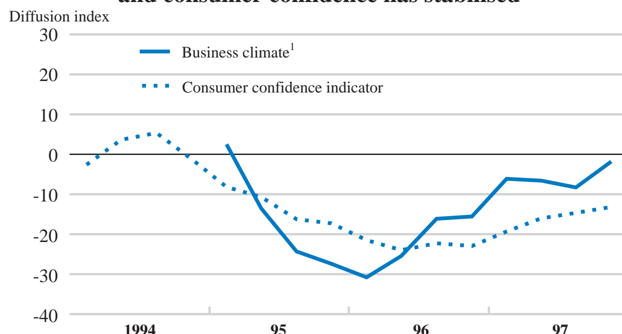
Activity picked up in 1997…

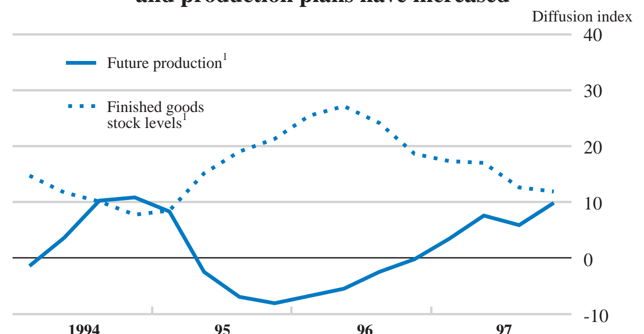
Driven by rising exports, especially to eastern Europe, GDP growth has picked up since mid-1996 and amounted to some 2 per cent in 1997. Business sentiment improved throughout the year and has remained strong in early 1998, despite the turbulence in Asia. Production plans have been revised upwards, supported by a normalisation of inventory levels. Fixed investment is robust, high levels of investment in plant and machinery being attributable to continuing industrial restructuring following entry into the European Union, but also to moderate wage growth and agreements to increase work-time flexibility. Construction continues to be sluggish, but consumption has been cushioned to some extent by a fall in the saving ratio, and is now being supported by growing personal income as the fiscal squeeze abates.

… and employment has increased slowly

Despite difficulties in the construction sector, employment has continued to increase slowly, although with discouraged workers apparently returning to the labour

Austria





1. Seasonally adjusted. Balance of positive – negative replies.
Sources: WIFO; OECD.

force this has not been reflected in a falling unemployment rate. Consumer price inflation has declined to a little above 1 per cent, which represents virtual price stability. With commodity exports rising strongly, the trade balance has improved markedly, but the current account deficit remained at some 2 per cent of GDP in 1997.

Monetary conditions will remain expansionary

Monetary conditions have been supportive of the recovery during the past year, with long- and short-term interest rates low and the effective exchange rate depreciated. They should continue to support the expansion within the framework of prospective Austrian membership of the European Economic and Monetary Union. The established credibility of monetary policy, stemming from the link with the Deutschemark, means that Austrian interest rates exactly mirror those in Germany. They could rise somewhat, as the process of EMU convergence is completed, but any upward movement in rates is expected to be limited.

Fiscal consolidation has been marked but will slow

Fiscal consolidation has been marked in recent years, with the general government deficit having been reduced from 4 per cent in 1996 to 2$^1/_2$ per cent of GDP in 1997. The extent of deficit reduction is projected to be much more limited in 1998 than in previous years and, following the recent decision to raise family allowances in 1999, the deficit could stabilize at around 2$^1/_4$ per cent of GDP. Moves to take business entities out of the budget sector have served to lower the debt/GDP ratio, but the budgetary consequences remain unclear and a financial control system for these entities still needs to be put in place. The build-up in pension liabilities also remains an important future challenge. The new pension reform widens the contribution base and lowers the incentives for early retirement significantly, but does not fully solve the longer term financing of the pension system.

Demand, output and prices

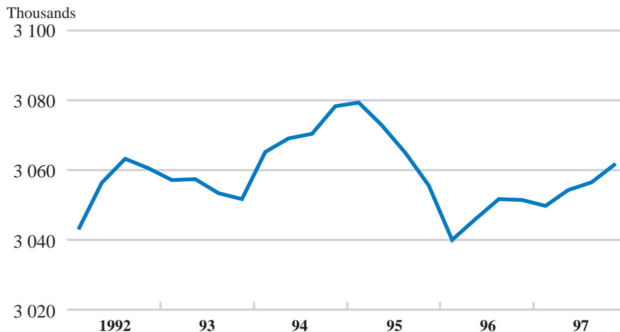
Percentage changes, volume (1983 prices)

	1994 current prices billion Sch	1995	1996	1997	1998	1999
Private consumption	1 254.6	2.9	2.4	0.6	1.7	2.2
Government consumption	455.0	0.0	0.1	0.5	0.6	0.9
Gross fixed capital formation	533.3	1.9	2.4	3.8	4.4	4.8
Final domestic demand	2 242.9	2.1	2.0	1.4	2.2	2.7
* stockbuilding	0.8[a]	0.2	–0.6	0.1	0.1	0.0
Total domestic demand	2 243.7	2.3	1.4	1.5	2.3	2.7
Exports of goods and services	838.8	6.5	9.3	9.0	7.3	6.8
Imports of goods and services	843.0	7.0	8.7	7.7	6.5	6.5
* net exports	–4.1[a]	–0.3	0.2	0.6	0.5	0.2
GDP at market prices	2 239.6	2.1	1.6	2.1	2.7	2.9
GDP deflator	–	2.1	2.1	1.4	1.2	1.3
Memorandum items						
Private consumption deflator	–	1.5	2.5	1.5	1.4	1.5
Industrial production	–	5.3	1.4	4.0	4.5	4.2
Unemployment rate[b]	–	5.9	6.3	6.2	6.1	5.9
Household saving ratio[c]	–	10.2	8.5	8.0	8.1	8.6
General government financial balance[d]	–	–5.1	–3.9	–2.5	–2.2	–2.3
Current account balance[d]	–	–2.0	–1.8	–1.9	–1.7	–1.7

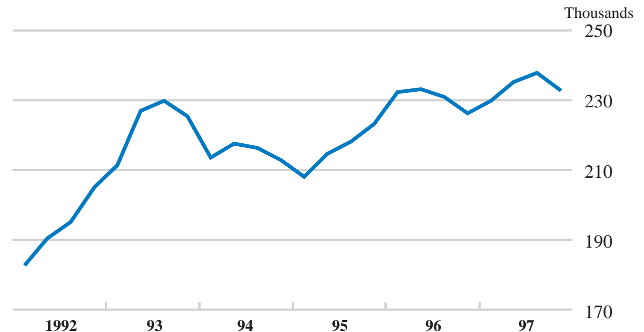
* Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
a) Actual amount.
b) See data annex for details.
c) As a percentage of disposable income.
d) As a percentage of GDP.

Austria

Employment[1] is expanding



Unemployment is not yet declining



1. Dependent employment.

Goods markets need to be further liberalised and labour markets made more flexible

With respect to product markets, market opening following accession to the European Union has substantially increased competitive pressures, increasing efficiency and lowering prices. But competition has not yet been extended to certain sectors such as telecommunications and electricity. Labour market flexibility has improved, especially with respect to working time, but further steps are needed towards a framework that encourages the social partners to expand labour market flexibility.

Growth is projected to accelerate, the main risk being a spread of financial-market turbulence

While the construction sector is likely to remain a brake on activity for some time to come due to excess supply in some branches, surveys of business confidence point to a continuation of buoyant investment activity, partly based on strong exports to the European Union and to Central and Eastern Europe. With fiscal policy becoming more neutral, per capita real disposable incomes should have room to expand, and in conjunction with slowly expanding employment this should allow consumption to increasingly support domestic demand. These trends are projected to underpin GDP growth of around 2¾ per cent in 1998, increasing to around 3 per cent in 1999. Growth of this order should lead to a significant reduction of excess capacity and some increase in employment. It will also support robust import growth. Despite strong exports, the current account deficit could therefore remain at around 1¾ per cent of GDP. Inflation should continue to remain low. With respect to risks, Austria has important trade and financial links to emerging markets so that any volatility could have a significant effect on growth prospects. In addition, any moves by the Bundesbank to raise interest rates significantly in the run up to European Monetary Union could affect growth negatively as the Austrian authorities would be compelled to follow. With the output gap projected to narrow and unemployment to decline, there is some uncertainty about the degree of prospective pressure in the labour market.

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

The 1998 federal budget has been incorporated in the projections, together with additional revenues arising from the widening of the pension contribution base. A large credit of Sch 15 billion in the federal budget for 1998, which arises from changing the timing for recognising the liability for tax reimbursements, is assumed not to affect the budget on a national accounts basis. Although lower levels of government intend to move a number of entities off-budget, the potential budgetary and debt effects remain unclear and have not been incorporated in the projection. State and local governments are assumed to remain in budget balance throughout the period. The 1999 outline federal budget serves as the basis of the projection but the lower than expected deficit in 1997 is not projected to carry through to a lower deficit/GDP target. Increased family allowances are assumed to lead to additional transfers in 1999 of some Sch 6 billion.

Belgium

Economic activity has been robust in the recent period. Real GDP growth is projected to continue at around 2³/₄ per cent a year, in both 1998 and 1999, with net exports losing some buoyancy but domestic demand gaining strength. Job creation has already accelerated, and the unemployment rate is expected to approach the structural rate – estimated at 11¹/₂ per cent – in 1999. Inflation is set to remain low, partly as a result of subdued import prices. The general government deficit, which fell markedly in 1997 reflecting the rebound of the economy, is expected to decline further – to a little over 1¹/₂ per cent of GDP in 1999. The debt-to-GDP ratio, though still very high, is on a firmly declining trend.

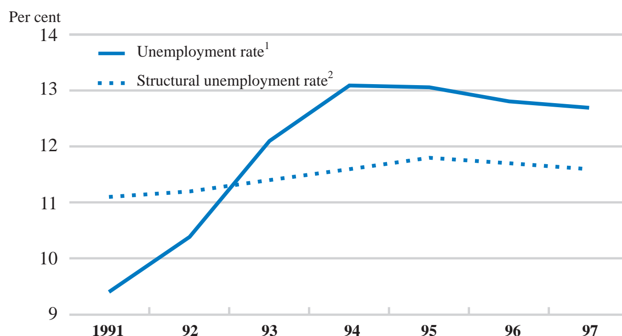
There is a continuing need to step up structural reform in order to make the economy more flexible and reduce the high structural rate of unemployment. Special consideration should be given to measures enhancing the return to the active labour force of older unemployed and persons of working age on social assistance and other welfare programmes. Over the longer term, the wage determination process should be liberalised and government involvement reduced.

Activity has picked up, but unemployment remains high

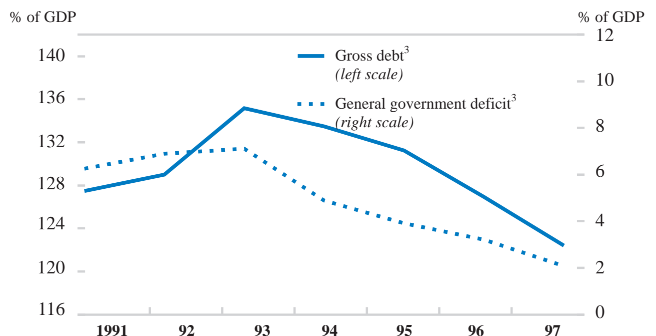
Led by exports and private consumption, economic activity picked up in 1997. Real GDP growth was an estimated 2.7 per cent – broadly in line with the European Union (EU) average. Private consumption has benefited from stepped-up job creation and, in early 1998, from the biennial Brussels "car show". Business fixed investment has shown some volatility but has continued to support growth. Despite an acceleration in employment, the number of unemployed has declined only moderately and the unemployment rate – at around 12¹/₂ per cent – remains about 1 percentage point above the OECD Secretariat's estimate of the structural rate. This, combined with the restraining influence of the law on employment and competitiveness,[1] has contributed to maintaining a generally

Belgium

Unemployment is edging down



Public finance is improving



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

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.

favourable wage-cost performance – although the 1995-96 real wage freeze has been followed by an acceleration in the wage rate and in compensation per employee. Consumer price inflation fell to less than 1 per cent year-on-year in early 1998 – one of the lowest rates in the European Union.

Macroeconomic policy is likely to be broadly neutral in 1998-99, and net exports may lose some buoyancy…

Interest rates are expected to increase only moderately, as a result of robust economic growth in EU countries generally, with long-term rates remaining historically low. The general budget deficit fell markedly in 1997 – to an estimated 2.1 per cent of GDP, from 3.2 per cent in 1996 – largely as a result of stronger receipts on account of both direct and indirect taxes, some of this reflecting stepped-up efforts to fight fiscal fraud and evasion. Also, interest payments decreased, due to a lower average interest rate paid on the public debt. The 1998 Budget introduced only a few additional corrective measures, but tax receipts are likely to remain buoyant over the projection period and the deficit is expected to decline further – to a little over 1½ per cent of GDP in 1999. On a cyclically adjusted basis, however, the deficit may increase slightly; this reflects the ending of a number of one-off corrective measures taken in 1997 and 1998. The debt-to-GDP ratio is slated to decline to 115½ per cent in 1999, reflecting, among other factors, the recent sale of gold by the National Bank of Belgium (see box). Although Belgium does not seem to be particularly exposed to it, the Asia crisis may curb economic growth somewhat – mainly through weaker net exports. Nonetheless, as a result of the 1996-97 depreciation of the Belgian franc in effective terms, the continuing good cost-price performance of domestic firms relative to foreign competitors, and the projected sustained expansion in neighbouring countries, net exports should continue to support growth.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1994 current prices billion BF	1995	1996	1997	1998	1999
Private consumption	4 920.3	1.1	1.3	1.6	2.1	2.1
Government consumption	1 135.6	0.9	1.8	1.2	1.3	1.2
Gross fixed capital formation	1 348.9	3.2	0.6	4.5	4.1	4.1
Final domestic demand	7 404.8	1.5	1.2	2.1	2.4	2.4
* stockbuilding	25.3[a]	0.0	–0.1	0.1	0.0	0.0
Total domestic demand	7 430.0	1.4	1.1	2.1	2.4	2.4
Exports of goods and services	5 042.6	6.8	3.2	6.2	6.0	5.8
Imports of goods and services	4 710.3	6.1	2.8	5.6	5.8	5.7
* net exports	332.3[a]	0.7	0.4	0.7	0.4	0.4
GDP at market prices	7 762.3	2.1	1.5	2.7	2.7	2.8
GDP deflator	–	1.7	1.6	1.4	1.2	1.4
Memorandum items						
Private consumption deflator	–	1.7	2.3	1.6	1.0	1.2
Industrial production	–	6.6	1.0	4.2	2.6	2.7
Unemployment rate	–	13.1	12.8	12.7	12.3	11.9
Household saving ratio[b]	–	17.7	16.5	15.6	15.8	16.0
General government financial balance[c]	–	–3.9	–3.2	–2.1	–1.7	–1.6
Current account balance[d]	–	5.4	5.4	5.5	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 disposable income.
c) As a percentage of GDP.
d) As a percentage of GDP. Balance for BLEU.

... but domestic demand is expected to strengthen and GDP growth to remain robust, leading to a decline in unemployment

Despite some short-term volatility, the conjunctural indicators of the National Bank of Belgium – which lead economic activity by only a few months – have risen markedly in the recent period, pointing to broadly based strength in the economy and the continuation of the expansion in coming months. Beyond that, the latest survey shows that business fixed investment in manufacturing is expected to remain buoyant in 1998; and private consumption is projected to strengthen, as a result of a further improvement in labour market conditions and a pick-up in real disposable income. With this stronger picture for domestic demand, real GDP growth is projected to be around 2¾ per cent in both 1998 and 1999. With the usual lag, the unemployment rate may react to stepped-up economic growth and job creation, falling below 12 per cent in 1999 and approaching the estimated structural rate (NAWRU). With a declining but still significant output gap, the restraining effect of the law on employment and competitiveness, and subdued import prices, serious inflationary pressures are unlikely to arise. The increase in compensation per employee may remain below 2¾ per cent and private consumption inflation may decline from 1.6 per cent in 1997 to a little over 1 per cent in 1999. The current-account surplus of the Belgian-Luxembourg Economic Union is projected to widen moderately – from an estimated 5½ per cent of GDP in 1997 to 6¼ per cent in 1999. The main risks and uncertainties concern, on the external side, the impact of the Asia crisis and, on the domestic side, the possibility that improved labour market conditions might induce households to reduce the saving ratio and spend more than projected.

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

The 1998-99 projections are based on the 1998 budget. It introduced new corrective measures – entailing both expenditure cuts and additional receipts – totalling BFr 17 billion (or 0.2 per cent of GDP). The measures included the extension of levies imposed in 1997 on pharmaceutical companies and electricity producers, and one-off initiatives such as the sale of a licence for a third mobile phone operator. In addition, multi-annual measures presented in the 1997 budget have been included, notably: the effects of pension reform in the private sector; and changes in the financing of the Post Office. The sales of publicly owned real-estate continue, but at a slower pace. Income tax brackets are frozen in 1998, but are assumed to be adjusted to inflation in 1999. In March 1998, the National Bank of Belgium announced that it had sold 9.6 million ounces of gold, realising a capital gain of BF 92 billion. It is assumed that the Government will use this amount to retire foreign currency denominated public debt – as it has done in the case of previous gold sales.

Czech Republic

Recent economic developments in the Czech Republic were dominated by the May 1997 currency crisis and the macroeconomic imbalances that provoked it. The depreciation of the Koruna reversed the trend in foreign trade as exports accelerated and imports slowed, with the trade and current account deficits shrinking somewhat. A tightening of fiscal policy led to a fall in investment and government demand, while consumption slowed in the face of lower real-wage growth. Unemployment began to rise, but inflation has been accelerating under the dual influence of the depreciation and hikes in administered prices. Assuming no further depreciation, output growth should continue to be moderate this year and next, allowing for some limited progress on disinflation and reduction of the external balance, despite mediocre productivity performance.

Domestic demand growth needs to be kept moderate to allow external adjustment to continue. While currently not large, the fiscal deficit should be reduced in support of monetary policy, while an even tighter fiscal stance may be warranted to guard against the risk of slippage if additional state aid to the banking sector is required. Better co-ordination of fiscal and monetary instruments will also facilitate achievement of the central bank's recently-announced inflation target. To underpin stronger medium-term performance and to reduce vulnerability to shocks, high priority should be given to further strengthening the financial system, inter alia through rapid bank privatisation.

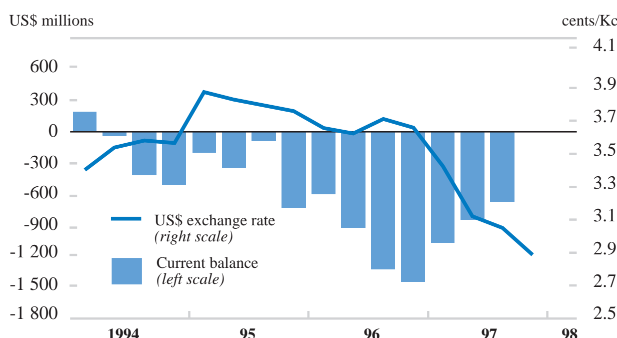
Following the devaluation GDP slowed, unemployment rose and the external balance improved somewhat…

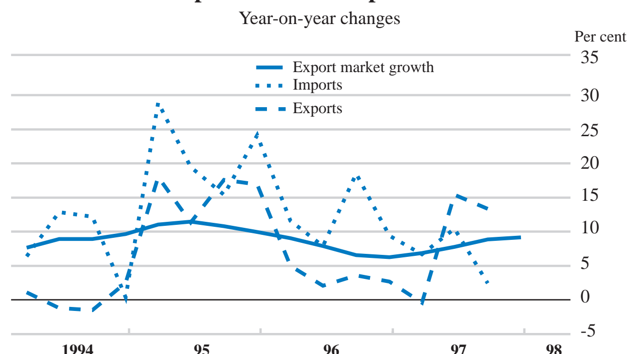
Economic growth was already slowing in the first half of 1997, but this process intensified following the exchange rate depreciation in May, so that, for the whole year, output increased by only 1 per cent. Both government and private sector activity fell as a result of tight fiscal and monetary policy, while slower real-wage growth adversely affected private consumption. Reflecting these developments, unemployment rose to 5.6 per cent of the labour force in early 1998. The economic slowdown and the depreciation of the currency, now under a managed float, slowed imports and raised exports in the second half of the year. As a result, the trade and current account deficits narrowed, although they remain sizeable at 8.3 and 6.0 per cent of GDP, respectively.

…while inflation accelerated

Large increases in administered prices and indirect taxes in July 1997 and January 1998, combined with the inflationary impact of the depreciation, reversed the earlier

Czech Republic





Demand, output and prices

Percentage changes, volume (1992 prices)

	1994 current prices billion Kc	1995	1996	1997	1998	1999
Private consumption	564.0	6.9	7.0	1.6	0.9	2.1
Government consumption	263.0	–1.6	4.3	–1.8	–0.8	0.0
Gross fixed capital formation	335.1	21.0	8.7	–4.9	–1.5	3.0
Final domestic demand	1 162.1	9.4	7.1	–1.2	–0.2	2.0
* stockbuilding	5.4[a]	2.6	3.4	1.2	0.0	0.0
Total domestic demand	1 167.5	10.9	9.3	–0.1	–0.2	1.7
Exports of goods and services	608.0	16.1	5.4	10.2	6.5	4.1
Imports of goods and services	632.5	22.0	12.9	6.7	4.0	4.3
* net exports	–24.5[a]	–5.4	–6.6	1.1	1.1	–0.8
GDP at market prices	1 143.0	6.4	3.9	1.0	0.9	1.2
GDP deflator	–	10.6	9.4	8.5	10.3	9.2
Memorandum items						
Private consumption deflator	–	9.1	7.8	8.8	11.5	9.6
Industrial production	–	9.2	7.1	4.5	3.5	4.0
Unemployment rate	–	3.1	3.5	4.4	5.8	6.6
General government financial balance[b]	–	–2.2	–1.2	–2.2	–2.2	–2.5
Current account balance[b]	–	–2.7	–7.6	–6.0	–3.9	–4.1

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

trend towards disinflation. By February 1998, inflation had reached 13.4 per cent (year-over-year) although net inflation (inflation, corrected for hikes in administered prices and indirect taxes) rose by only 7.9 per cent. Inflation for 1997 as a whole was 8.5 per cent.

Despite unexpected expenditures the fiscal deficit remained small…

Despite spending cuts of more than 2 per cent of GDP following the two spring stabilization packages, the general government deficit in 1997 was slightly larger than 2 per cent of GDP, due in part to exceptional expenditures associated with the summer floods and a last minute transfer from the state budget to Konsolidacni banka, a state-owned institution created to assume some of the bad loans made during the communist era. Parliament approved a balanced state budget for 1998, but pension expenditures and new transfers to Konsolidacni banka and other extra-budgetary agencies may exceed initial estimates and cause a deficit.

…while monetary policy began to target inflation directly

Since monetary policy could no longer rely on the fixed exchange rate as a nominal anchor, in December 1997 the central bank decided to directly target net inflation and to limit interventions in the currency market to smoothing economically-unjustified swings in the exchange rate. Its target of a 6 per cent (±0.5 percentage points) increase in market prices over the 12 months to December 1998 is estimated to correspond to a 9 per cent rate of "headline" (total consumer price index) inflation.

Structural reform proceeds slowly so that…

The pace and extent of structural reform remains slow. The full privatisation of Investicni a Postovni Banka (the third largest bank) took longer than expected, and that of the other main banks has only just started. At the same time, the government's plans to sell the remaining so-called strategic enterprises remain unclear. Although steps have been taken to improve transparency in financial markets, the newly-established Security and Exchange Commission was stripped of most of its independence and rule-making authority. Similarly, while the new banking law separates the commercial and investment activities of banks, it does not prevent them from

operating investment funds and, therefore, does not eliminate the risk that these could be managed in the banks' rather than shareholders' interest.

… productivity improvements and output growth will remain subdued

GDP growth is projected to remain subdued in 1998 and to accelerate slightly in 1999. Household consumption should grow only moderately due to slower wage increases (which may fall to zero in real terms), while a pick-up in public-sector projects is expected to contribute to a small overall rise in investment. The stagnation in real incomes and slow domestic demand should keep import growth moderate which, with an expected slight improvement in export performance, should lead to a stabilization of the current account deficit as a share of GDP.

Better performance will depend on the pace of structural reform and policy co-ordination

These projections are surrounded by several uncertainties. A further depreciation could, by boosting exports and reducing imports, lead – for a time – to faster growth than projected here. However, this would imply even higher inflation and, by temporarily improving corporate profitability, could reduce the incentives to restructure, thereby eroding the competitiveness gains associated with the depreciation. Another risk is that domestic demand expands more quickly than projected. In either case, there could ultimately be a stagnation or worsening of the trade and current account deficits, leaving the currency and the economy very sensitive to external shocks. A further risk relates to the extent of co-ordination between monetary and fiscal policies. Should fiscal policy not be sufficiently supportive of monetary policy, more tightening of the latter would be necessary, with potentially significant impacts on banking-sector and enterprise health. On the other hand, faster progress in implementing structural measures could result in a more rapid and marked improvement in productivity growth which would allow exports and output to expand more quickly than projected here.

FISCAL POLICY ASSUMPTIONS
UNDERLYING THE PROJECTIONS

These projections incorporate measures introduced in the 1998 State Budget. The most important of these are: *i)* the lowering of the profit tax rate; *ii)* the increase in indirect taxes, especially the value-added tax on utility rates; *iii)* a nominal freeze of the government wage bill; *iv)* an increase in subsidies to low-income households; *v)* continuation of subsidies to enterprises due to the floods of summer 1997; and *vi)* a small increase in capital expenditures, mostly infrastructure related. They also incorporate indexation-based increases in pension payments (estimated at 0.75 per cent of GDP in 1998) and a Kc 5 billion transfer (0.2-0.3 per cent of GDP) to Konsolidacni banka and exclude privatisation revenues.

Denmark

Economic growth has been sustained by strongly expanding private consumption, stemming from continued employment and real-wage growth and supported by substantial real wealth gains emanating from rapid house price increases. The output gap has been virtually closed, but price inflation remains low and long-term interest rates have fallen. The pace of domestic demand growth remains strong, but it should become more sustainable as tighter fiscal policies take hold: the surplus on the general government account achieved in 1997 should increase over the projection period as a result of restrained fiscal policy.

The present labour market outlook suggests that actual unemployment could already be below the estimated structural rate, even incorporating the effects of recent labour market reforms, so that the continued fall in unemployment points to a risk of rising wage pressures. While Danish interest rates are expected to edge upwards along with European rates, given the fixed exchange rate strategy, this may be less than required on domestic grounds. An additional tightening of fiscal policy and further labour market reforms would seem to be required to avoid a possible deterioration in competitiveness and hence of the external account.

Domestic demand sustains the upswing…

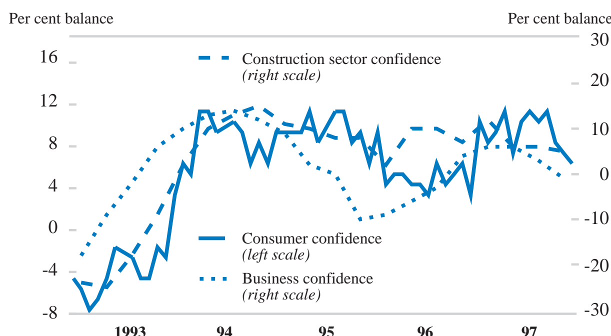
The economic upswing continues to be driven by resilient domestic demand and high levels of confidence in the household and business sectors. Private consumption and housing investment have been bolstered by buoyant employment and real wage growth and compounded by wealth effects arising from double-digit house price increases. Spurred by the favourable demand situation – and exploiting a still healthy profit situation and declining interest rates – private enterprises have continued to expand capacity, although there was also a shift towards capital-deepening investment during 1997. The growth of imports has been more than twice as rapid as that of domestic supply, while exports have lost market share. Total domestic demand expanded by almost 5 per cent in 1997, while real GDP growth remained at around 3 per cent.

… unemployment continues to fall and inflation remains stable…

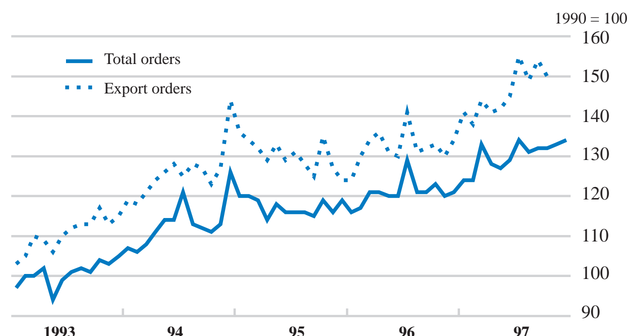
During 1997, the registered unemployment rate fell by almost 1 percentage point to 7½ per cent, reflecting employment growth of almost 2½ per cent. Job creation has been as fast in the public sector as in the private sector. The favourable employment outlook and

Denmark

Strong confidence[1]



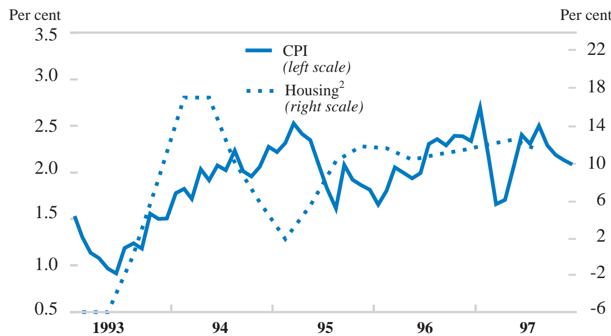
Favourable demand situation[2]



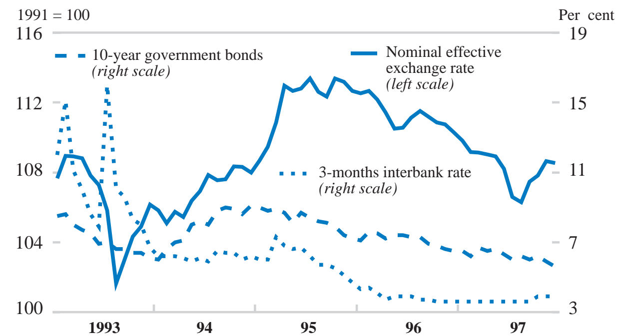
1. Seasonally adjusted. Balance between positive and negative answers.
2. Volume indices, s.a.
Sources: OECD; Danmarks Statistik.

Denmark

Low inflation but rising house prices[1]



Supportive monetary conditions



1. Year-on-year percentage changes.
2. Price of one family dwelling.
Sources: OECD; Danmarks Statistik.

the reduction in scope of some active labour-market policies have led to an expansion of over 1 per cent in the labour supply. Despite the tighter labour market, overall wage inflation has remained stable at around 4 per cent, although the business service sector – where wage links with the rest of the economy are weak – has registered wage increases well above average. Increasing product market competition – as a result of the ongoing deregulation process and European integration – is helping to keep price inflation under control; it is currently around 2 per cent after reaching $2^1/_2$ per cent in mid-year.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1994 current prices billion Dkr	1995	1996	1997	1998	1999
Private consumption	492.8	2.2	2.8	4.1	3.1	2.8
Government consumption	250.3	2.0	2.4	2.9	1.0	1.0
Gross fixed capital formation	167.0	11.5	7.2	7.2	6.8	5.5
Final domestic demand	910.1	3.9	3.6	4.4	3.4	3.0
* stockbuilding	0.1[a]	0.6	–0.3	–0.2	0.0	0.0
Total domestic demand	910.2	4.6	3.3	4.2	3.4	3.0
Exports of goods and services	341.8	5.3	4.1	4.5	3.9	3.9
Imports of goods and services	291.0	9.8	3.7	7.0	4.9	4.4
* net exports	50.8[a]	–1.3	0.3	–0.7	–0.3	–0.1
GDP at market prices	961.1	3.1	3.5	3.4	3.0	2.8
GDP deflator	–	2.1	1.6	1.7	2.6	2.9
Memorandum items						
Private consumption deflator	–	1.9	1.9	1.7	2.3	2.6
Industrial production	–	4.5	1.0	3.0	3.4	3.5
Unemployment rate	–	10.1	8.6	7.6	6.7	6.2
Household saving ratio	–	5.7	4.3	4.3	5.7	6.0
General government financial balance[b]	–	–2.2	–0.9	0.4	1.1	1.9
Current account balance[b]	–	0.9	1.6	0.4	0.6	0.7

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

… on the back of supportive monetary conditions…

Monetary policy has continued to focus on exchange rate stability vis-à-vis the Deutschemark. During the first part of 1997 there was a 4 per cent depreciation in the effective exchange rate primarily reflecting a stronger US dollar and pound sterling, although about half of this effective depreciation has since been reversed. Interest rates fell during 1997 and in particular following the Southeast Asian crisis. The spread between Danish and German short-term interest rates narrowed from slightly less than 1/2 percentage point to 1/4 per cent in early 1998. Concurrently, Danish long-term yields declined by almost 1 1/4 percentage points, halving the differential *vis-à-vis* Germany to around 30 basis points.

… and a surplus on the general government balance

Despite higher than envisaged growth in local government expenditures, brisk economic growth produced a surplus on the general government account of almost 1/2 per cent of GDP in 1997, which is projected to double in each of the following two years, in spite of the reduction of income taxes embodied in the 1993-98 tax reform. The fiscal stance adopted in 1998 should have a restraining effect of around 1/2 percentage point of GDP. In the absence of any policy announcement a neutral stance is assumed in the projection for 1999.

GDP growth should fall to a sustainable rate but inflation remains a risk

The configuration of demand and supply is expected to remain basically unchanged. Household demand should continue to be underpinned by the positive employment outlook and higher real wage growth, as well as the continued recovery in house prices. Business investment growth should remain strong as a result of the need for expansion of production capacity. Exports are not projected to keep pace with export market growth because of past high cost inflation and as producers remain focused on the strong domestic market. The positive effects on domestic demand from the lower long-term interest rates should be stronger than the direct negative effects on trade from the East Asia crisis, as trade with the region accounts for less than 3 per cent of Danish exports. GDP growth should remain at around 2 1/2 per cent throughout the projection period. The output gap should be fully closed by the end of the projection period and unemployment is projected to fall further below the OECD Secretariat's estimate of the structural rate. This is expected to push up unit labour cost somewhat, which together with higher indirect taxes could take consumer price inflation to around 2 1/4 per cent in 1998 and above 2 1/2 per cent in 1999. The inflation outlook could be further at risk if demand growth is more rapid than projected and resources more fully utilised, though much of the effect would probably show up in rising imports and a shrinking current account surplus.

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

The projections incorporate the approved Finance Bill for 1998. The implied structural budget improvement of 1 1/4 percentage points in 1998 will be obtained through moderate expenditure growth and a lowering of income tax rates, offset by an expanding tax base through growing personal incomes. Compared with official forecasts, the OECD Secretariat projections assume faster growth in public salaries, partly due to higher local government employment growth, again offset by higher revenues through a more rapidly expanding tax base. As no specific fiscal policy measures have been announced for 1999, the projection assumes an unchanged discretionary fiscal stance and modest reductions in expenditure and tax ratios.

Finland

The brisk recovery from the forestry-related downturn in early 1996 continued in 1997, with GDP expanding by a robust 6 per cent. Exports grew at a double-digit rate, while domestic demand gained further momentum as monetary conditions remained easy and household and business sentiment improved. The unemployment rate is steadily declining, and economic prospects remain bright, particularly as inflation risks have decreased with the conclusion of a new centralised pay agreement.

Although the authorities need to remain vigilant to possible signs of overheating, the main policy focus should now be on key measures proposed in the OECD Jobs Strategy to rein in structural unemployment. Work incentives for older unemployed workers need to be strengthened, while the growing importance of high-tech activities in the economy makes it imperative that skills be enhanced. Hence, a more active stance of labour market policies should be adopted, including a shift from unconditional income support towards a strict enforcement of eligibility rules, improved job brokerage by the public employment service, better targeted re-training and increased tax credits for low-paid work.

The economic upswing continues unabated…

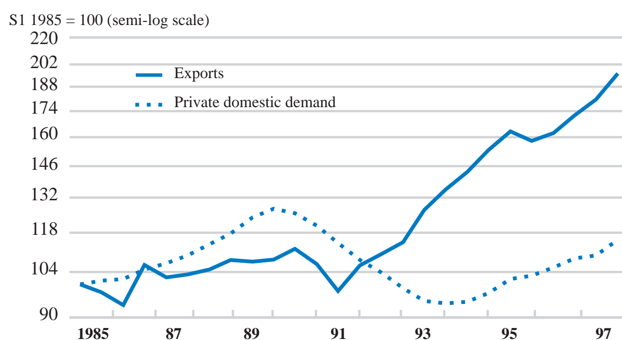
GDP expanded by a robust 6 per cent in 1997 with few, if any, signs of a slowdown. The appreciation of the dollar, the rapid development of eastern European economies, the boom in the international telecommunication equipment market, and the upswing in the forestry cycle all served to boost exports after the brief downturn in early 1996. Moreover, with the terms of trade rebounding towards the end of the year, the external current account surplus has reached a historic high. At the same time, domestic demand conditions have remained favourable, with residential investment and durables consumption particularly buoyant. As job creation accelerated, unemployment dropped below 13 per cent of the labour force in recent months. Wage increases eased markedly to average $2^1/_2$ per cent in 1997, in line with the two-year incomes policy deal concluded in late 1995. However, a significant increase in the cost of housing, related to the recovery of the housing market, served to lift consumer price inflation to around 2 per cent by the end of the year.

… supported by credible policies

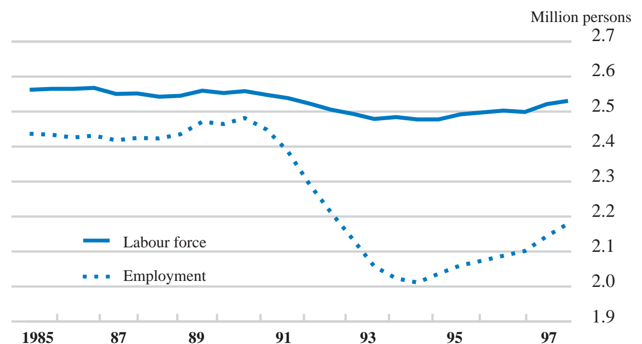
The striking recovery of the Finnish economy from the crisis of the early 1990s has been based on successful industrial restructuring, moderate wage developments, positive household and business sentiment, and sustained efforts by the authorities to

Finland

The expansion is export-led



It has boosted employment



Demand, output and prices

Percentage changes, volume (1990 prices)

	1994 current prices billion Mk	1995	1996	1997	1998	1999
Private consumption	284.4	4.6	3.8	3.0	3.2	3.0
Government consumption	114.0	1.9	3.5	–0.3	0.6	0.4
Gross fixed capital formation	74.2	11.3	8.4	11.2	10.3	9.0
Final domestic demand	472.6	5.1	4.6	3.8	4.1	3.8
* stockbuilding	7.9[a]	–0.2	–0.7	0.3	0.1	0.0
Total domestic demand	480.5	4.8	3.8	4.1	4.1	3.7
Exports of goods and services	182.5	8.2	3.9	12.8	7.5	3.8
Imports of goods and services	150.0	6.9	4.3	9.3	7.9	5.9
* net exports	32.5[a]	0.9	0.2	1.9	0.6	–0.3
GDP at market prices	511.0	5.1	3.6	5.9	4.2	3.0
GDP deflator	–	2.4	1.3	1.1	1.9	2.3
Memorandum items						
Private consumption deflator	–	0.3	1.6	1.4	1.9	2.0
Unemployment rate	–	17.2	16.3	14.5	12.4	11.0
General government financial balance[b]	–	–5.2	–3.4	–1.0	0.6	1.1
Current account balance[b]	–	4.1	3.8	5.4	5.8	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 GDP.

enhance policy credibility. The fiscal austerity programme started in 1993 is now nearing its completion, and has secured the achievement of the fiscal requirements of the Maastricht Treaty in 1997. Whereas the 1998 budget points to some further fiscal consolidation this year, tax cuts may lead to a less restrictive stance of fiscal policy in 1999 (although their implementation is uncertain and has not been incorporated in the projections: see box). Monetary conditions are already easy, although concerns over demand-pull and asset price inflation prompted the Bank of Finland to raise official interest rates in September last year, by 25 basis points to 3¹/₄ per cent, and by a further 15 basis points in March 1998. Nevertheless, after a new incomes policy agreement for the years 1998 and 1999 was signed in December 1997, the Bank has expressed confidence that the official target of 2 per cent "underlying inflation" (consumer prices excluding indirect taxes, subsidies and housing capital cost) will be achieved in the years ahead. Moreover, with long-term interest rates close to corresponding German rates and the markka exchange rate broadly stable since it was linked to the European Exchange Rate Mechanism in October 1996, Finland is well placed for its entry into the European Economic and Monetary Union from the outset.

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

Projections for 1998 are based on the budget presented to parliament last autumn, which includes a 2 per cent of GDP reduction in public expenditure, with the bulk of the savings in the area of social security and the remainder reflecting the completion of public works programmes initiated in 1996. Tax proceeds also fall relative to GDP, as a cut in income tax rates was not fully offset by a rise in petrol excises. As regards 1999, tax and social security contribution rates are assumed to remain unchanged and expenditure restraint to continue in line with the medium-term expenditure framework agreed in 1997. As the budget negotiations for 1999 have yet to begin, a 2 per cent of GDP tax cut envisaged in the incomes policy agreement has not been incorporated in the projections.

Economic prospects remain favourable

Although both private consumption and residential investment should remain buoyant, economic growth is projected to ease to around 4¹/₄ per cent in 1998 and 3 per cent in 1999 due to slower export growth in the wake of the Asian crisis (in particular in the forestry equipment industry), the unwinding of public works programmes and the completion of major investment projects in the forestry industry. Further robust

employment growth should push the unemployment rate to 11 per cent by the end of the projection period, but wage and price increases are expected to remain moderate, at close to 3 and 2 per cent on average, respectively. While inflation risks have considerably eased with the recent incomes policy agreement, wages might increase somewhat faster than projected as emerging shortages in several trades (notably construction workers and professional engineers) could lead to wage over-bidding by employers.

Greece

The performance of the economy has continued to improve though a rising external disequilibrium necessitated an exchange rate realignment. Inflation has fallen to within 2 percentage points of the European Union (EU) average, while investment-led output growth has accelerated to a record high for the 1990s. However, large wage increases deterred employment growth. Looking forward, output growth should be more balanced as the negative external contribution to output growth abates. Tighter policies and losses of purchasing power will slow the recovery in activity in 1998 but it is expected to regain steam in 1999. In parallel, inflation should converge further towards the EU average once the effect of the currency depreciation has worked through, and the 1998 and 1999 current account deficits should stabilize as a percentage of GDP at the 1997 level.

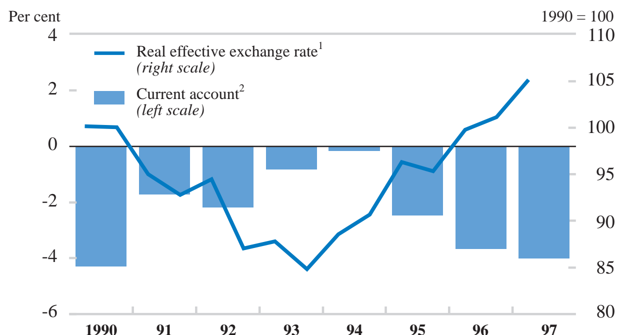
A balanced policy strategy is necessary to realise sustainable non-inflationary output growth and support employment creation. To ensure the credibility of the new level of the exchange rate, it is essential to implement fully the announced additional tightening of fiscal policy and the supportive package of structural measures. The latter need to be accompanied by reforms which target deep-rooted structural problems in labour markets, the pension and health systems, and the deficit-ridden public sector (central government, public enterprises, and some state-owned banks). In the short run, the timely introduction of tangible policy changes will be critical to enhancing confidence and abetting a reduction of interest rates. Over the medium term, such policies should reduce the high structural unemployment rate and the large public debt, and improve international competitiveness while maintaining a stable exchange rate.

A stable nominal exchange rate has been the key to a noteworthy reduction in inflation but also a source of the widening of the current account

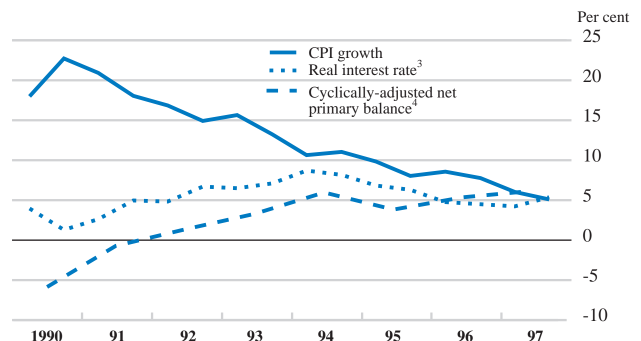
In 1997, output growth is estimated to have accelerated to near 3½ per cent, a rate not attained since the late 1980s and one that was significantly above the EU average. The main stimulus was a 50 per cent expansion in the EU-supported public investment programme. Private consumption and residential investment improved on their solid 1996 performance, and were supported by real wage gains of the order of 4½ per cent in 1997. The strengthening of activity did not result in any sizeable pick-up in employment, nor did it hamper the rapid decline in underlying inflation, with the 12-month rate falling below 4½ per cent in early 1998, some 2½ percentage points less than a year earlier. The disinflation process continued to rely heavily

Greece

The current account moves into sizeable deficit



Inflation slows sharply



1. Deflated by relative unit labour costs.
2. As a per cent of GDP. Bank of Greece data on a settlements basis.
3. Twelve-month Treasury-bill, deflated by the consumer price index.
4. As a per cent of GDP, excluding payments on called government guarantees.

on the stability of the nominal exchange rate; however the resulting significant appreciation of the real effective exchange rate has been a major factor behind a poor merchandise export performance and a widening of the current account to about 4 per cent of GDP in 1997.

The policy mix improved in 1997 with a stringent monetary policy…

The policy mix improved in 1997 as fiscal adjustment supported a tight monetary policy in reducing inflation. However, incomes policy remained lax and little progress was made in tackling the economy's structural problems. Monetary policy continued to use the exchange rate as a nominal anchor. This policy was sometimes under pressure during past years because of large capital inflows; but during the second half of 1997 the capital account turned around with significant net outflows. This development may have been triggered by financial developments in Southeast Asia, but vulnerability was increased by reductions in administratively-set interest rates on Government securities that exceeded the pace of disinflation. The Bank of Greece had to temporarily raise its intervention rate to very high levels in late October 1997, and short-term interbank rates eventually settled near 15 per cent at the beginning of 1998, but showed no signs of further abatement. In mid-March, the drachma entered the European Exchange Rate Mechanism and, as a result of the agreement on the central rate, the currency was devalued by 12 per cent in foreign currency terms. For the remainder of 1998, monetary policy will aim to keep the drachma near its central rate. The OECD Secretariat projections assume that interest rates gradually move back toward their pre-crisis levels with the timing of reductions from their still high level depending on improvements in both the balance of payments and the underlying inflation rate.

Demand, output and prices

Percentage changes, volume (based on previous year prices)

	1994 current prices billion Dr	1995	1996	1997	1998	1999
Private consumption	17 938.2	2.2	2.3	2.5	1.8	2.1
Government consumption	3 324.2	8.0	0.5	–0.1	0.8	0.9
Gross fixed capital formation[a]	4 491.4	7.3	9.4	10.9	6.1	7.0
Final domestic demand	25 753.8	3.9	3.5	3.9	2.6	3.1
* stockbuilding[b]	45.9[c]	–0.5	0.0	0.0	0.0	0.0
Total domestic demand	25 799.7	3.4	3.5	3.9	2.6	3.1
Exports of goods and services	3 909.9	1.0	0.2	5.2	6.5	7.5
Imports of goods and services	5 776.0	6.1	3.9	5.9	4.0	5.0
* net exports	–1 866.1[c]	–1.7	–1.2	–0.9	–0.1	–0.2
GDP at market prices	23 933.6	2.1	2.7	3.5	3.0	3.4
GDP deflator	–	9.8	8.1	6.9	4.3	3.2
Memorandum items						
Private consumption deflator	–	8.6	8.5	5.5	4.9	3.4
Industrial production	–	2.1	0.5	0.5	1.5	2.0
Unemployment rate	–	10.0	10.3	10.4	10.6	10.6
General government financial balance[d]	–	–10.3	–7.5	–4.0	–3.0	–2.9
Current account balance[d]	–	–2.5	–3.7	–4.0	–4.1	–4.1

* 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.

... supported by an improved fiscal performance

The Government has announced that it has exceeded the ambitious 1997 fiscal policy objective to reduce the general government deficit to 4.2 per cent of GDP from 7.5 per cent in 1996. The bulk of the adjustment was achieved through the implementation of a package of tax measures that raised revenues by about 1 per cent of GDP and, on the expenditure side, by a reduction in interest payments equivalent to 2 per cent of GDP. A large increase in investment expenditure was more than fully financed through the use of EU funds and by equity injections to public enterprises in lieu of capital transfers. The 1998 Budget aims to reduce the general government deficit to 2.4 per cent of GDP and to balance the adjustment more evenly between revenues and primary expenditures (see box). Most importantly, civil servants' pay increases will be curtailed sharply following cumulative increases of about 30 per cent during 1996-97. At the time of the devaluation, the Government made the commitment to make cuts in expenditure equivalent to about 1 per cent of GDP in order to meet the existing fiscal targets and speed up the implementation of structural reform. The cuts fall mainly on investment spending, public enterprise subsidies, and the social security budget. The OECD Secretariat projections do not take account of the forthcoming reform to the social security system, as it is not yet specified, and therefore show a deficit above the official target.

FISCAL POLICY ASSUMPTIONS
UNDERLYING THE PROJECTIONS

For 1998, the main factors affecting current expenditure are: *i)* civil service wage increases of 2.5 per cent; *ii)* public pension adjustments of 5.5 per cent; *iii)* replacement of only one in five retiring civil servants, except in education, health services, and the security forces, where the replacement rate will be one for one; and *iv)* the introduction of two-year zero-coupon bonds from 1997. Public investment's budgetary impact is partially offset by EU funds and the use of equity injections in lieu of capital transfers to public enterprises. New revenue measures equivalent to approximately 1 per cent of GDP include, *inter alia*, increases in: *i)* withholdings on corporate and personal incomes; *ii)* the corporate income tax rate from 35 per cent to 40 per cent for unlisted companies and *iii)* the tobacco excise tax. For 1999, indirect taxes grow faster than the tax base reflecting gains in fighting tax evasion, while the direct tax elasticity is tempered by increased tax withholdings in 1998. Expenditure is mainly affected by the maintenance of the government employment policy, civil service wage awards in line with those in the private sector, and the indexation of pensions to prices.

Continuation of a good economic performance will require structural reforms to influence expectations and return rates to their pre-crisis level

Output is expected to decelerate in 1998, before recovering in 1999 when the beneficial effects of the exchange rate depreciation feed through the economy. Output growth will be more balanced, as the depreciation brakes import demand and gradually provides an impetus to export growth. Moreover, with monetary and fiscal policies remaining tight, the pace of domestic demand is expected to slow. Thus, households' reduced purchasing power should temporarily restrain consumption, while private investment activity is expected to moderate as profit margins are squeezed by rising imported input and financial costs. Public investment will continue to provide a critical, yet diminished, impetus to activity. The depreciation is expected to add about 1 percentage point to 1998 inflation and thus delay significant further progress in price convergence. Nevertheless, by 1999 inflation should resume its downward trend as world commodity prices are expected to remain moderate and labour cost increases slow, in part through continued productivity gains bought at the expense of slow employment growth. The depreciation will stabilize the current account deficit near 4 per cent of GDP during the projection period. The first important risk to the projections is that interest rates will not come down as fast as projected, with output then liable to suffer. Expectations will play a critical role, and progress in the recent effort to restructure public enterprises will provide important signals in this regard. The other main risk is that the devaluation will set off a wage-price spiral. The likelihood of this would be greatly reduced by the successful implementation of the 1998 Budget and moderation in 1998 national collective wage negotiations.

Hungary

Economic growth in Hungary accelerated during 1997, led by a surge in investment demand and, towards the end of the year, a recovery in private consumption. Despite a significant expansion in exports, the external sector's contribution to overall growth was negative, as was that of government expenditures. At the same time, disinflation continued throughout the year and the unemployment rate fell to 7.8 per cent in the fourth quarter. Supported by fiscal stimulus, domestic consumption and investment are expected to be the principal sources of growth this year and next. Employment is projected to rise, and unemployment to fall, while the trade and current account deficits should increase somewhat.

The stronger output growth raises the spectre of demand outstripping supply in 1998 or 1999 and could see the current account deficit reaching uncomfortable levels. In such circumstances, additional spending restraint and a tight monetary policy would be necessary if international confidence and external balance were to be preserved and inflation is to be kept on a steady downward path.

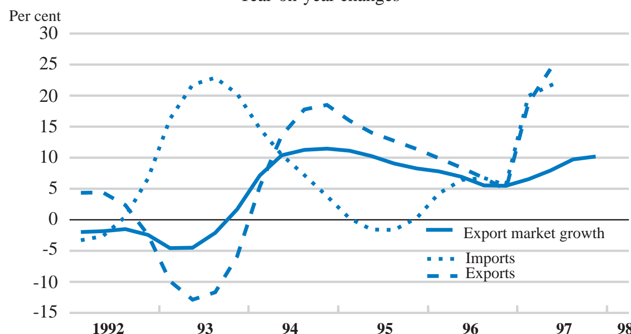
Investment and substantial exports spurred growth…

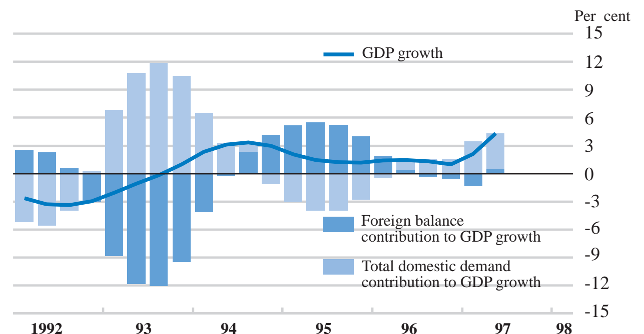
GDP is estimated to have increased by 3.8 per cent in 1997, propelled by very strong investment growth and stock building and by a pick-up in private consumption towards the end of the year. Although sales abroad grew by a spectacular 26.4 per cent, the contribution of net exports to overall growth was slightly negative as imports also rose rapidly. Nonetheless, the current account deficit fell to 2.2 per cent of GDP. Despite the rapid expansion in aggregate supply, employment remained flat, with increases in the manufacturing sector offset by losses elsewhere. Falling participation rates permitted the unemployment rate to fall to 7.8 per cent by the fourth quarter of 1997. At the same time, the annual rate of consumer price inflation declined by 5 percentage points, but remains high at 18.4 per cent.

… while exchange rate policy and moderate wage growth have supported disinflation…

To achieve further disinflation, the central bank and the Ministry of Finance jointly set a goal of reducing year-over-year price increases to 13.5 per cent by the end of 1998. The target, and the previous year's success in reducing inflation, convinced the social partners

Hungary





Demand, output and prices

Percentage changes, volume (1991 prices)

	1994 current prices billion HUF	1995	1996	1997	1998	1999
Private consumption	3 151.7	–6.6	–3.1	2.0	3.6	3.4
Government consumption	527.1	–3.0	–5.4	–1.0	2.0	2.0
Gross fixed capital formation	878.5	–4.3	6.3	9.6	12.9	11.0
Final domestic demand	4 557.3	–5.7	–1.3	3.5	5.8	5.3
* stockbuilding	90.1[a]	2.7	2.2	1.4	0.0	0.0
Total domestic demand	4 647.4	–3.1	0.9	4.6	5.4	4.9
Exports of goods and services	1 262.5	13.4	7.4	26.4	14.2	13.5
Imports of goods and services	1 545.1	–0.7	5.7	26.0	15.2	13.0
* net exports	–282.6[a]	4.9	0.4	–1.1	–1.3	–0.6
GDP at market prices	4 364.8	1.5	1.3	3.8	4.3	4.6
GDP deflator	–	26.7	20.4	18.6	15.0	13.0
Memorandum items						
Private consumption deflator	–	26.5	21.7	18.1	15.6	13.1
Industrial production	–	4.6	3.4	11.1	7.1	8.6
Unemployment rate	–	10.3	10.0	8.7	7.8	7.3
Household saving ratio[b]	–	12.1	14.6	13.4	13.7	13.0
General government financial balance[c]	–	–6.3	–3.1	–4.5	–4.9	–4.9
Current account balance[c]	–	–5.5	–3.8	–2.2	–2.3	–2.6

* 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.

to agree to a forward-looking 16 per cent wage increase, which, if the target is met, would allow for gains in real wages. The disinflationary impulse provided by the wage bargain is being supported by the exchange rate, whose rate of crawl has been reduced to 0.9 per cent per month or 11 per cent for the year, implying additional downward pressure on inflation from tradeables.

… despite an expansionary fiscal stance

Despite cost overruns in the social-security account, the consolidated budget deficit came in below target at 4.6 per cent of GDP, with both revenues and expenditures of the central budget exceeding initial projections. Privatisation revenues, in particular, proved three times stronger than expected and were used to reduce further the general government outstanding debt, which fell to 64 per cent of GDP. Net external debt fell 10 per cent and is now $12.9 billion (including inter-company loans). The 1998 budget envisions substantial declines in taxes, which will be partially offset by lower debt servicing charges. As a result, the fiscal deficit is expected to rise to 4.9 per cent of GDP.

Rising household consumption should sustain output growth

Output is projected to expand by 4.3 per cent in 1998, supported by an increase in private consumption, associated with some real wage growth, and by a further modest rise in investment. Moderate increases in unit labour costs together with new capacity will ensure that exports continue to expand rapidly. But imports will also rise strongly, so

FISCAL POLICY ASSUMPTIONS
UNDERLYING THE PROJECTIONS

The fiscal projections incorporate the following measures in 1998: *i)* a 17 per cent increase in the public-sector wage bill; *ii)* a social-security budget overrun of 35 billion forints; *iii)* an increase in public-sector investment expenditures; and *iv)* is an increase in personal income tax and business sector tax exemptions. For 1999, the projections assume that: *i)* tax elasticities remain broadly constant; *ii)* wages in the government sector grow somewhat faster than in the private sector; and *iii)* that public sector investment represents about the same share of GDP as in 1998.

that the trade deficit will increase, though it seems unlikely to exceed $4 billion, and the current account deficit is projected to remain below 3 per cent of GDP. Progress on disinflation should continue to be made in 1998 and 1999 although the price increase projected for 1998 is consistent with an end of year inflation rate of about 15 per cent, somewhat higher than the authorities' target. The projection anticipates a tightening of monetary policy in 1998 and assumes that the rate of crawl of the exchange rate will fall further, from 0.9 per cent a month currently to 0.6 per cent at the end of 1999.

Tight monetary and incomes policies yield further disinflation but wage drift and fiscal stimulus might overheat the economy

The risks surrounding the outlook relate to the extent to which actual wage increases will, in effect, remain moderate, as well as to the strength of consumption demand and the size of the government deficit. In principle, labour supply should not constrain growth, but the current account deficit and inflation could be higher if demand grows much faster than projected.

Iceland

Economic activity continued to expand rapidly in 1997. Solid real income gains pushed up personal consumption expenditures while fixed investment increased substantially again. Inflation remained muted because of weak import prices. In 1998, accelerating wage costs will probably begin to put upward pressure on prices. The outlook is for output to decelerate somewhat, but the unemployment rate should edge down further and the current account deficit widen.

A rise in interest rates might be needed to reduce the likelihood of the economy overheating. This could put upward pressure on the krona, but concerns over the exchange rate should not jeopardise efforts to keep inflation low. Fiscal policy could alleviate some of the burden by increasing budget surpluses in the near term. To promote the development of the financial markets, majority stakes in the newly formed investment bank and the two publicly-owned commercial banks should be sold to the private sector.

The upswing in activity continued in 1997…

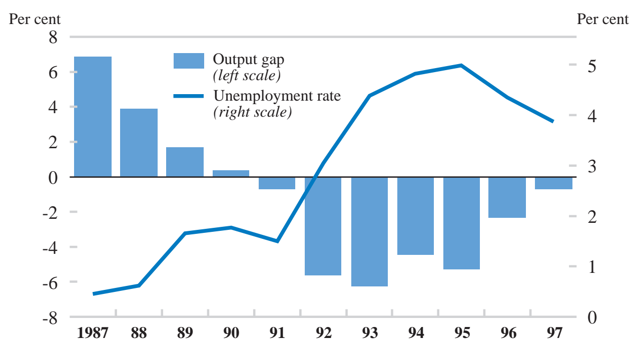
The upswing in activity continued in 1997, with GDP growing about 5 per cent. The major factors behind this buoyant performance were personal consumption and continued foreign investment in the energy-intensive sectors. The labour market improved, and the unemployment rate fell to an average of 3.9 per cent, more than a percentage point below the cyclical peak. Such tightness, together with the new pay settlements reached in the spring, generated rapid wage growth, but price inflation remained muted, with the consumer price index increasing only 2.0 per cent in the twelve months to January 1998. Fishermen agreed to return to work in the middle of February, ending a nine-day strike during the important capelin season.

… and with policy not significantly tighter…

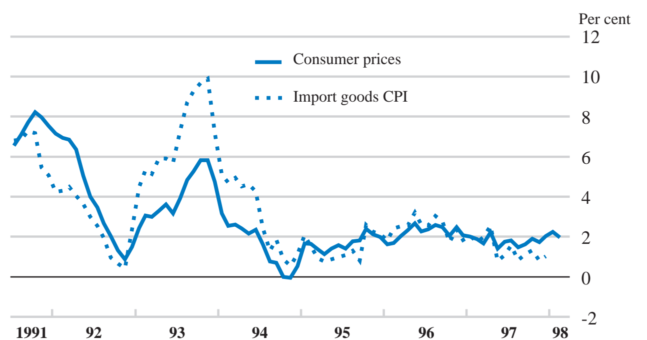
Government policy has apparently not been tightened significantly to ward off the risk of overheating. With the krona depreciating and the inflation outlook deteriorating, the central bank raised short-term interest rates 30 basis points in November; the krona subsequently appreciated. The 1998 Treasury budget calls for a slight surplus in spite of a further cut in marginal tax rates. Indeed the surplus may be somewhat larger as revenue collections in 1997 were stronger than expected, more than offsetting expenditure overruns. The government declared its intention to sell a minority stake in the newly formed Investment Bank in 1998, providing a one-off boost to revenue.

Iceland

The economy moves close to capacity



Inflation edges up



Demand, output and prices

Percentage changes, volume (1990 prices)

	1994 current prices billion Ikr	1995	1996	1997	1998	1999
Private consumption	256.9	4.2	6.4	6.0	5.8	3.9
Government consumption	89.4	1.3	1.0	1.5	2.9	1.8
Gross fixed capital formation	65.9	–2.8	26.5	9.9	8.7	1.5
Final domestic demand	412.3	2.5	8.3	5.8	5.8	3.0
* stockbuilding	0.0[a]	0.6	–0.7	0.0	0.1	0.0
Total domestic demand	412.3	3.1	7.5	5.8	5.9	3.0
Exports of goods and services	157.4	–2.1	9.6	5.6	5.3	6.7
Imports of goods and services	134.6	3.8	16.6	8.0	9.0	5.6
* net exports	22.8[a]	–1.9	–1.7	–0.6	–1.2	0.5
GDP at market prices	435.1	1.1	5.5	5.0	4.6	3.4
GDP deflator	–	2.8	1.9	3.5	3.9	3.6
Memorandum items						
Private consumption deflator	–	1.8	2.3	1.8	2.4	3.2
Unemployment rate	–	5.0	4.4	3.9	3.5	3.4
General government financial balance[b]	–	–2.8	–0.5	0.6	0.0	–0.2
Current account balance[b]	–	0.8	–1.6	–1.5	–1.8	–1.7

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

Fishing quotas for the 1997-98 season suggest a small decline in the catch on a constant-dollar basis.

… output should continue to grow above trend

Output is projected to grow above trend, pushing GDP well above its potential level, and unemployment is expected to continue to fall, leading to substantial wage drift. With available slack taken up, prices are set to accelerate. Meanwhile, the current account is projected to move further in deficit, reaching 1¾ per cent of GDP in 1998 and 1999. The biggest risk to the forecast is that activity will accelerate further, leading to an overheated economy and significant tightening by monetary authorities. On the other hand, if activity in Europe falls off and commodity prices drop precipitously, the economy could slow.

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

The projection includes the recently announced tax cuts for 1998 and 1999, as well as the boost to social security payments. Spending is expected to run a little higher than official projections due to usual cost overruns.

Ireland

The Irish economy continues to perform exceptionally well. In 1997, it once again had output increases unsurpassed elsewhere in the OECD area, combined with steadily declining unemployment and still modest price inflation. Real incomes are rising strongly; expenditure growth is well balanced; and the budget is now in surplus, as is the current account. The projection calls for a continuation of most of these trends, albeit with some moderation of growth outcomes. The chief risk is clearly that of overheating, signs of which are spreading.

The challenge confronting the authorities is how to head off the risk of overheating with a shrinking number of tools at their disposal. The budget has already been set, and promises to the social partners of substantial tax cuts and social spending increases were met, with limited efforts to restrain current spending, public or private. Given the near certainty that Ireland will be an initial member of the Economic and Monetary Union, interest rates will have to converge with lower European rates over the course of the year. Fortunately, a final element of unwanted stimulus in the form of additional currency depreciation when exchange rates for EMU are set in May, has just been largely headed off, though the pound remains at its lowest level in effective terms in many years. It is crucial that the recent commitment not to overspend this year be honoured and that spending restraint be the hallmark of the budget for 1999.

The economy is still growing very rapidly…

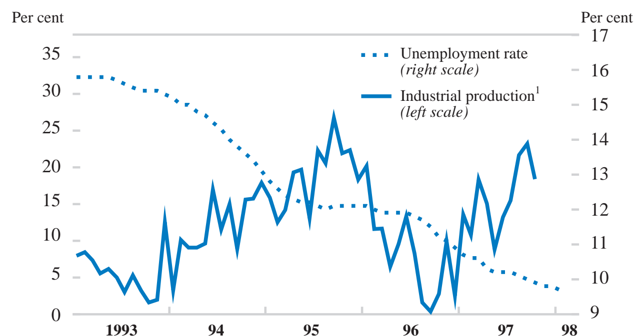
Ireland enjoyed another year of exemplary economic performance in 1997. At over 10 per cent, real GDP growth was the fastest in the OECD area for the third year in succession, and industrial production has been rising nearly twice as fast. The standardised unemployment rate has continued to fall rapidly, reaching 9.6 per cent in February, down nearly six points from the 1993 peak. Ireland has become a net importer not only of direct investment capital (as it has long been) but since 1995 of labour as well: net migration picked up to an annual rate of 15 000 (0.4 per cent of the population) in the year to April 1997.

… with a healthy mix of spending

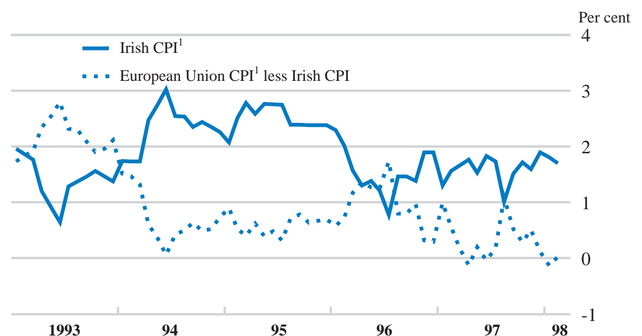
The mix of demand components remains fairly healthy, with growth led by investment and exports, government spending tilted towards capital outlays, the saving ratio apparently fairly stable at a high level and the external accounts showing a continuing surplus. The current account balance for the first three quarters of 1997 was 287 million pounds (0.8 per cent of GDP), down from 407 million in the previous year; a steep increase in the merchandise surplus has been more than offset by a burgeoning services deficit.

Ireland

A surging economy

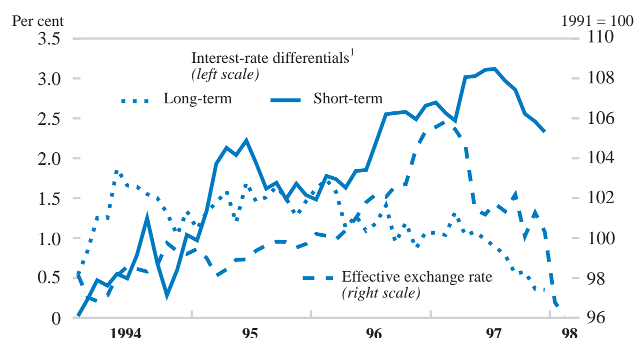


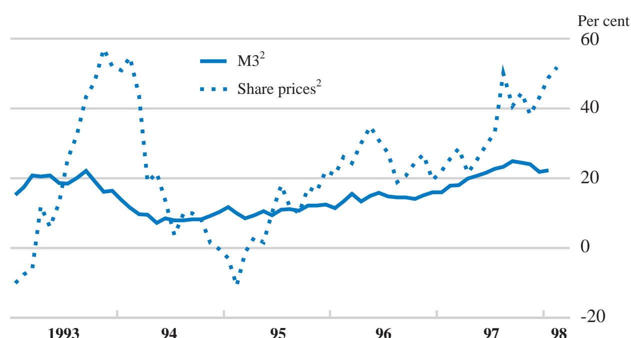
An end to disinflation?



1. Year-on-year percentage change.

Ireland





1. Irish rate less equivalent German rate.
2. Year-on-year percentage change.

Inflation remains low, but signs of overheating are spreading

But the beginnings of the classic signs of overheating can be seen. Labour shortages are reported for a number of skilled trades and professions, and housing and other asset prices are undergoing a definite boom fuelled by accelerating growth in money and credit: equity prices have risen by around half over the past year, well above gains recorded on other equity markets. Consumer price inflation reached a trough of 1.0 per cent (year on year) in August 1997, with a pick-up to 1.7 per cent most recently.

Interest rates and the pound have fallen and the budget too is stimulative

Despite the risks of overheating, the macroeconomic policy settings are shifting to a decidedly expansionary stance overall. The pound has again fallen sharply in effective terms since the autumn and has recently been at its lowest level in modern times, down over 10 per cent since the beginning of 1997. However, the possibility of further depreciation was avoided when the authorities agreed to boost the pound's central rate (the rate widely expected to be chosen when Euro rates are set in May) by 3 per cent in March. Nevertheless, the Central Bank is no longer able to maintain interest rates at their previous high levels for any terms other than the shortest, and margins over German rates have continued to fall, with the ten-year yield spread less than 1/4 percentage point, about 1 1/2 points less than in early 1997. Sharp declines in short rates are projected over the remainder of this year.

Adding to the risk of overheating is a fiscal stance which has exerted no restraint. Honouring commitments made in the earlier tripartite wage agreements, the 1998 budget, presented in December, included a number of tax cuts (worth over half a billion pounds on the personal side) and spending increases, reducing the general government surplus even in the official projection. Nevertheless, government debt will continue to fall quickly, with the 60 per cent target in relation to GDP (Maastricht definition) achieved this year. The budget targets should be easily attained, given that they were based on prudent GDP growth rate assumptions (8.3 and 8.0 per cent, respectively, in 1997 and 1998). While the authorities promised to adhere to the budget's spending targets, any overspending would further limit the effectiveness of the automatic stabilizers.

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

The 1997 budget outturn is based on the figures provided in the 1998 budget, presented in December 1997, modified for higher-than-budgeted revenues, consistent with stronger-than-expected GDP growth. For 1998 budget targets for revenues are projected once again to be easily surpassed, as has been the pattern in recent years when output has expanded at rates well beyond expectations. The government's recent commitment to avoid overspending this year is assumed to be met, thereby boosting the projected surplus by 0.3 percentage points of GDP. Official projections for 1999 form the basis for the figures provided for that year. However, they have been modified: to remove the possible tax cuts and spending increases (worth nearly 0.7 per cent of GDP) over and above the costs of maintaining the existing level of services mentioned in the budget documentation; to reflect the stronger rise in nominal and real output and incomes; and to allow for lower interest rates, especially at the short end of the maturity spectrum.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1994 current prices million Ir£	1995	1996	1997	1998	1999
Private consumption	20 400	4.2	6.3	7.0	6.8	6.0
Government consumption	5 579	3.9	2.9	4.9	1.9	2.2
Gross fixed capital formation	5 575	9.6	15.9	13.2	14.2	9.9
Final domestic demand	31 554	5.1	7.5	7.9	7.6	6.3
* stockbuilding	–128[a]	1.0	0.8	0.2	0.1	0.1
Total domestic demand	31 427	6.4	8.4	8.0	7.6	6.3
Exports of goods and services	25 308	19.6	10.0	17.5	13.5	10.1
Imports of goods and services	21 891	15.8	11.4	16.0	13.5	10.6
* net exports	3 418[a]	4.9	0.6	3.7	2.3	1.4
GDP at market prices	34 844	10.4	7.7	10.5	8.6	6.6
GDP deflator	–	0.4	1.2	1.6	3.4	3.2
GNP at market prices	31 269	8.8	6.9	8.7	7.4	6.4
Memorandum items						
Private consumption deflator	–	2.0	1.1	1.2	3.1	3.3
Industrial production	–	18.9	7.9	15.5	12.0	10.0
Unemployment rate	–	12.2	11.9	10.2	9.3	8.2
Household saving ratio[b]	–	9.8	9.7	10.0	9.6	9.2
General government financial balance[c]	–	–1.9	–0.9	0.9	1.5	1.6
Current account balance[d]	–	3.1	2.3	1.9	1.2	0.4

* 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.

Unsustainable growth rates could continue…

With a stimulative policy environment and no sign of any let-up in inward investment, the economy is expected to continue to expand at what is almost certainly an unsustainable pace. Even though the Partnership 2000 wage agreement is likely to hold rapid, increases in employment, in conjunction with a pickup in transfer income and a cut in direct taxes, may allow substantial real disposable income gains, which, in the current environment, are sure to be spent. With housing needs unabating, given the migratory expectations, and with further increases in inward direct investment, private investment growth looks set to stay in the double-digit range. Although export market growth is projected to be a bit slower because of the crisis in Asia, continuing market share gains are expected because of the favourable product structure of Irish exports and their supply-determined nature, as well as the competitiveness gains resulting from currency depreciation. Nevertheless, the current external surplus is expected to narrow, as rises in the trade surplus fail to keep pace with those in the deficits on both factor income and non-factor services.

… leading to a pickup in inflation

GDP growth is expected to again exceed potential rates, leading to further pressures on capacity. In such a scenario inflation is likely to increase, but the size of the pick-up may continue to be held down by growing competition in the retail sector, modest increases in unit labour costs attributable to both substantial adherence to the wage agreement through 1999 and to robust trends in productivity growth, and even greater import supply. Nevertheless, the inflation rate could well move even higher if the retail competition effects are of a once-off nature, asset price gains spill over into further spending growth or wage increases diverge further from rates stipulated in the accords.

Korea

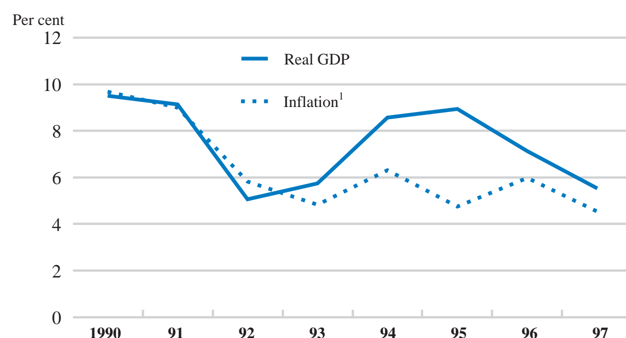
Although the Korean economy has grown rapidly in recent years, while appearing to maintain sound macroeconomic fundamentals, it experienced a foreign exchange crisis at the end of 1997 in the wake of severe financial turbulence in several South-East Asian economies. Faced with the threat of a default on its external debt, Korea received a $57 billion rescue package led by the International Monetary Fund (IMF) at the beginning of December 1997. Despite this package, the exchange rate continued to decline, while interest rates doubled to 30 per cent by the end of the year. Although financial markets have stabilized somewhat since the beginning of the year and some of the exchange-rate overshooting has been reversed, the impact of the crisis is now being felt in the real economy. Given the loss of purchasing power and the restrictive macroeconomic policies in place, total domestic demand is projected to drop by almost 10 per cent in 1998, while inflation accelerates. Despite a large increase in net exports, total output may decline slightly. With domestic demand expected to stabilize in 1999, economic growth is likely to resume, though at well below past rates. These developments are likely to result in a substantial current account surplus both this year and next.

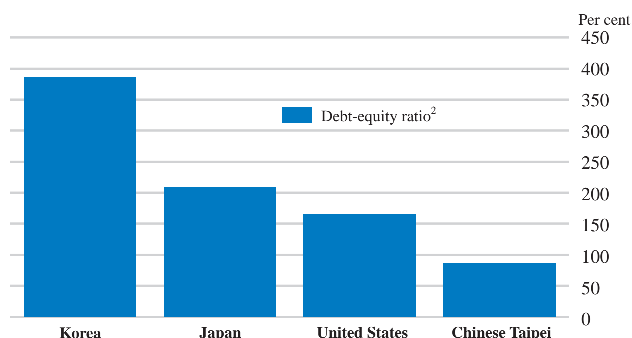
The government has taken a number of steps intended to open capital markets, restructure the financial system and strengthen prudential supervision, increase labour market flexibility and encourage corporate restructuring. Additional steps to improve corporate governance practices and further open the product market are planned. Rapid and effective implementation of these measures should help to boost confidence in the Korean economy, laying the groundwork for a recovery of the exchange rate and a decline in interest rates to more normal levels. Despite the substantial costs to the budget of bank re-structuring, there also appears to be some scope for fiscal policy to play a role in counterbalancing the negative impact of the crisis.

Strong growth in 1997 masked financial problems that led to the crisis…

The favourable macroeconomic conditions in 1997 – real output growth of 5.5 per cent and the deceleration of inflation to 4.5 per cent – masked financial vulnerability stemming from highly-leveraged firms and a weak, poorly-supervised financial system. Firms had financed a rapid increase in capacity using short-term debt, much of it incurred abroad, either directly or through domestic banks. The deterioration in corporate balance sheets and the mounting bad loan problem during 1997 led to the foreign exchange crisis, which erupted towards the end of the year when foreign banks shut off their credit lines to Korea.

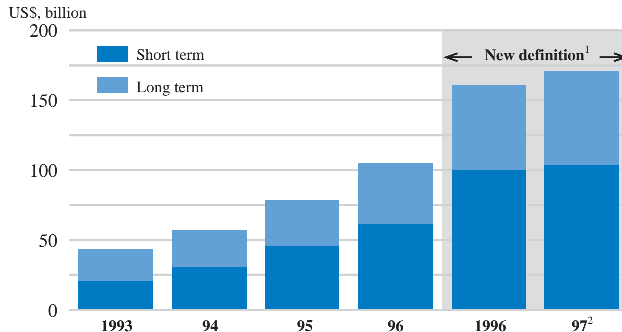
Korea

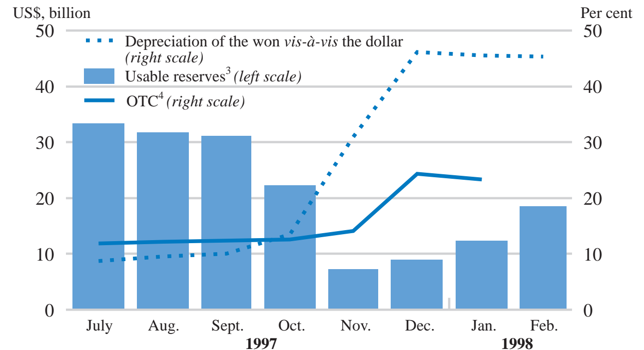




1. Private consumption deflator.
2. Top 30 business groups in Korea in 1996. 1994 for other countries.
Sources: OECD; FTC; Bank of Korea.

Korea





1. As part of its agreement with the IMF, Korea changed its definition of external liabilities to include: *i)* the foreign borrowings of overseas branches and subsidiaries of Korean financial institutions and *ii)* offshore borrowings of Korean financial institutions. This boosted total liabilities at the end of 1996 from $104.7 billion to $160.7 billion.
2. September 1997.
3. Usable official reserves from October 1997; prior figures refer to total reserves.
4. Over-the-counter 3-year corporate bond rates.

Sources: OECD; FTC; Bank of Korea.

… which is now having a severe impact on demand and employment

The impact of the crisis is likely to be most severe in the first half of 1998. Tight credit conditions doubled the number of bankruptcies, while the dishonoured bill[1] ratio rose to an all-time high in December. Already in January, the unemployment rate was 2 percentage points higher than before the crisis. Imports were down 30 per cent year-on-year in dollar terms in February, reflecting falling demand and the reluctance of banks to accept letters of credit. With exports continuing to increase, the current account recorded a substantial surplus for the fourth consecutive month. The sharp rise in the price of imported goods boosted the 12-month increase in the consumer price index, which had been running at a 4 per cent rate, to 9.5 per cent in February.

Capital inflows appear to have resumed following the agreement with international banks

At the end of January, the government reached an agreement with international banks to lengthen the maturity of Korea's commercial bank loans.[2] The agreement converted $21.8 billion of short-term debt into one to three-year loans guaranteed by the government. The favourable interest rates on these loans – 2.25 to 2.75 percentage points above Libor (depending on the maturity) – helped boost the exchange rate and raised Korea's sovereign credit rating to just one step below investment grade, thus helping to reopen commercial bank credit lines. The agreement, combined with additional loans from international financial institutions, will help Korea meet its target of boosting its useable foreign exchange reserves from $9 billion at the end of 1997 to $30 billion by the end of June 1998. Private inflows have already begun: in the month after the limit on foreign investment in a company's shares was doubled to 50 per cent, foreign inflows totalled $625 million, helping to boost the stock market index by almost 50 per cent since mid-December.

Macroeconomic policies are restrictive…

Restrictive macroeconomic policies were put in place as stipulated by the IMF agreement. Monetary policy was tightened in an effort to limit inflation to below 9 per cent. The growth of the broad money supply (M3) has been targeted to slow from

1. The value of dishonoured bills (promissory notes and cheques) divided by the value of cleared bills.
2. With the easing of controls on foreign borrowing, external liabilities had tripled between December 1994 and September 1997 to $170.6 billion (66 per cent of GDP at the current exchange rate). About $104 billion was short-term, with a maturity of less than one year.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1994 current prices trillion won	1995	1996	1997	1998	1999
Private consumption	164.4	8.3	6.9	3.1	4.0	0.3
Government consumption	32.4	1.0	7.1	5.7	–5.0	–0.5
Gross fixed capital formation	109.4	11.7	7.1	–3.5	–18.7	–2.4
Final domestic demand	306.2	8.8	7.0	0.8	–9.4	–0.6
* stockbuilding	0.9[a]	–0.5	0.9	–4.0	0.0	0.0
Total domestic demand	307.1	8.3	7.9	–3.1	–9.8	–0.7
Exports of goods and services	92.1	24.0	14.1	23.6	12.0	10.0
Imports of goods and services	94.4	22.0	14.8	3.8	–6.0	3.0
* net exports	–2.2[a]	0.5	–0.3	8.7	8.9	4.6
GDP at market prices	306.0	8.9	7.1	5.5	–0.2	4.0
GDP deflator	–	5.6	3.4	2.3	6.7	4.4
Memorandum items						
Private consumption deflator	–	4.8	6.0	4.5	10.5	6.6
Industrial production	–	11.9	8.4	6.7	2.0	5.0
Unemployment rate	–	2.0	2.0	2.6	5.7	6.3
Household saving ratio[b]	–	18.0	17.1	19.2	13.3	10.7
General government financial balance[c]	–	4.7	4.9	3.0	1.6	1.1
Current account balance[c]	–	–1.8	–4.8	–1.8	4.8	7.3

* 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.

15.6 per cent in 1997 to 12.5 per cent in 1998, while the three-year bond rate and the overnight call rate, which had both averaged about 12 per cent in the first half of 1997, remain around 20 per cent. The prospects for lower rates will depend primarily on exchange rate developments. The requirement that the commercial banks meet the Bank for International Settlements (BIS) capital-asset ratios by June 2000 is also likely to restrict credit growth. At the end of 1997, 14 of the 26 commercial banks did not meet the recommended ratio of 8 per cent.[3] In addition, 12 of the 30 merchant banks have already been shut down, with more closures likely. Fiscal policy is also restrictive (see box). Despite increased spending to deal with the bad loan problem and higher unemployment, cuts in other expenditures will limit the rise in total government outlays to under 4 per cent in nominal terms. As for revenues, a large share of the cyclical slowdown in tax receipts is to be offset by higher tax rates and broader coverage. The OECD Secretariat estimates that these measures will limit the deterioration in the general government surplus, which is accordingly projected to decline from 3 per cent in 1997 to about 1½ per cent in 1998.

… and may contribute to a sharp contraction in domestic demand in 1998

The economy is expected to contract slightly in 1998, reflecting a sharp decline in domestic demand, particularly investment. The business sector is likely to scale back its investment plans in reaction to extraordinarily high borrowing costs, excess capacity and balance-sheet problems. In addition, firms will attempt to limit labour costs by reducing total wages, notably through cuts in bonus and overtime payments, which account for a third of employee compensation. Employment is also projected to

3. However, according to the previous Korean definition, which included 50 per cent of securities losses, 22 banks met the BIS ratio. To meet the 8 per cent standard, banks will be able to revalue their land holdings over the period 1998 to 2000 and a large number have announced plans to issue new equity and subordinated debt.

decline, with the unemployment rate more than doubling to around 5½ per cent in 1998. Household disposable income will be further eroded by an acceleration of consumer prices to double-digit levels, making a sharp contraction in private consumption likely despite a fall in the saving rate. However, the collapse of domestic demand should be largely offset by a massive positive swing in the foreign balance. A significant decline in imports is projected, while the competitiveness gains of Korean firms should enable them to boost exports despite the economic crisis in South-East Asia. Consequently, at current exchange rates the current account surplus may be as large as $15 billion (5 per cent of GDP) in 1998.

A moderate economic recovery is projected for 1999, but the risks attached are large

Economic growth is projected to recover in 1999 to around 4 per cent. Domestic demand is likely to stabilize while net exports should again increase significantly as the competitiveness gains continue to boost exports. Moreover, inflation is expected to moderate in 1999, reflecting the large degree of slack in the economy. Unemployment is projected to rise further as a result of on-going restructuring efforts by firms. As the size of the exchange rate shock is unprecedented in Korean history, there are very large risks attached to these projections. On the upside, a recovery in the exchange rate, which was W 1 164 to the dollar prior to the IMF agreement and W 1 484 at the time the projections were made, would allow interest rates to fall to more normal levels and moderate the decline in domestic demand, resulting in positive output growth in 1998. Such an appreciation would also limit the rise in inflation and reduce the size of the current account surplus. Such an outcome, though, depends on a restoration of international confidence in the Korean economy that would encourage more capital inflows. One key to restoring confidence is the rapid restructuring of the financial system that now appears to be in train. However, the potential for further large-scale bankruptcies that would exacerbate the problems of the financial system poses a major downside risk to the projection. International confidence could also be weakened if labour unions, or the courts, prevent the easing of legal constraints on laying off workers from working effectively, or if social unrest increases in the presence of sharply higher unemployment. Another downside risk would be protectionist measures abroad that limit the rise in exports and could in turn undermine confidence in Korea's capacity to overcome the crisis rapidly.

FISCAL POLICY ASSUMPTIONS
UNDERLYING THE PROJECTIONS

The rise in total government expenditure in 1998 is to be limited to under 4 per cent, the lowest since 1974, with increased spending related to the economic crisis being roughly offset by cuts elsewhere. *First*, W 3.6 trillion is to be spent on the interest charges of the Korea Asset Management Corporation and the Korea Deposit Insurance Corporation, which is addressing the banks' non-performing loan problem. *Second*, the unemployed are to receive an additional W 2 trillion of assistance. *Third*, the sharp rise in interest rates will boost borrowing costs. This additional spending is to be partially offset by expenditure cuts, primarily in public investment. On the revenue side, the cyclical decline in tax receipts, estimated at 1.6 per cent of GDP by the OECD Secretariat, will be partially offset by higher tax rates and coverage. The tax rates on interest income and oil were increased. In addition, the government has raised special excise taxes. Such measures are expected to generate about W 4 trillion in revenue. As for 1999, no budget plans have been announced. The projections assume a pick-up in the growth of spending from its very modest pace in 1998 to about 6 per cent and no further changes in taxation.

Luxembourg

Real GDP growth is projected to decline slightly in 1998-99 – to around 3½ per cent – despite continued buoyancy in the service sector. Tensions in the labour market are unlikely to arise due to an elastic supply of cross border workers, and unemployment may edge down only a little. The surplus in the general government budget is expected to fall slightly.

It would be desirable to improve public finance management by a stricter application of the expenditure norm. Furthermore, the flexibility of the budget might be improved by reducing the widespread use of indexation. Such measures would also enhance the adaptability of the economy and notably the labour market.

Activity picked up in 1997…

Output increased rapidly in 1997 – by an estimated 3¾ per cent – in line with the cyclical recovery in surrounding countries. Domestic demand was buoyant and the external sector was again a driving force, as steel shipments picked up and export-oriented financial services continued their robust expansion. However, with investment strengthening due to two satellite launches and purchases of several aircraft, imports surged and the contribution of the foreign balance to growth became slightly negative. Owing to stepped-up activity in the manufacturing sector, the number of workers affected by part-time unemployment has steadily come down. Nevertheless, full-time unemployment has continued to edge up, as most newly created jobs have been filled by cross-border workers. After an acceleration in mid-1997, consumer price inflation has abated, falling to less than 1½ per cent year-on-year at the beginning of 1998.

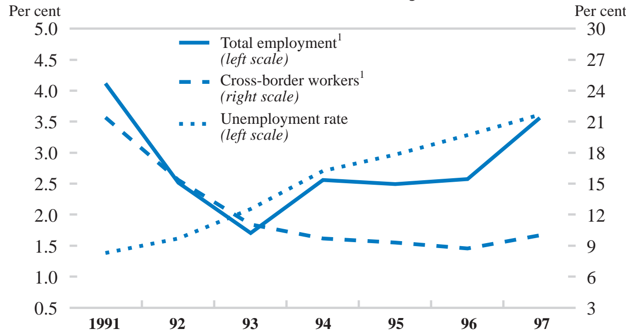
Demand, output and prices

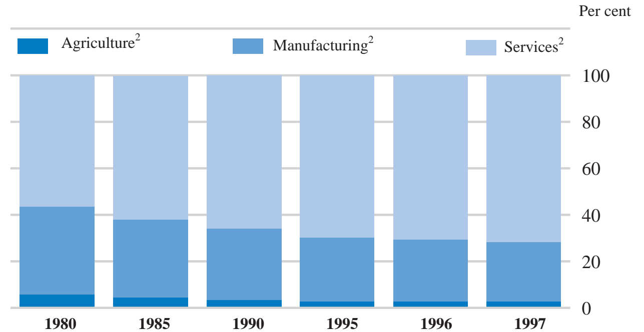
Percentage changes, volume (1990 prices)

	1994 current prices billion LF	1995	1996	1997	1998	1999
Private consumption	266.6	2.4	1.9	2.8	2.4	2.4
Government consumption	60.9	2.2	3.3	3.9	1.5	2.0
Gross fixed capital formation	99.6	3.5	–1.7	8.0	4.0	4.0
Final domestic demand	427.1	2.7	1.1	4.3	2.7	2.8
* stockbuilding	4.5[a]	0.5	0.7	–0.1	0.1	0.1
Total domestic demand	431.6	3.2	1.8	4.1	2.8	2.9
Exports of goods and services	457.2	4.4	2.3	4.6	4.3	3.9
Imports of goods and services	401.2	3.8	1.0	5.2	3.7	3.3
* net exports	56.0[a]	0.8	1.3	–0.1	0.9	0.8
GDP at market prices	487.6	3.8	3.0	3.7	3.4	3.5
GDP deflator	–	1.0	1.0	1.8	1.5	1.7
Memorandum items						
Private consumption deflator	–	0.7	1.4	1.4	1.1	1.3
Industrial production	–	1.4	–1.9	7.1	2.5	2.6
Unemployment rate	–	3.0	3.3	3.6	3.6	3.5

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

Luxembourg





1. Annual growth rates.
2. As a percentage of total employment.

… and, with continued buoyancy in the service sector and supportive fiscal policy, it is expected to remain strong in 1998-99

The shift in employment from manufacturing to services is likely to continue. Despite growing foreign competition and the introduction of the euro, the export-oriented financial sector should keep on growing, supported by the expansion of fee-earning activities and the development of new products. The ongoing restructuring of the steel industry will result in a further decline in employment in this sector – mainly by early retirement – but in the economy as a whole job creation is expected to remain strong. Nonetheless, given the elastic labour supply from surrounding countries, tensions in the labour market are unlikely to arise. Economic policy remains directed at preserving the attractiveness of Luxembourg for foreign direct investment by progressively reducing corporate income taxes and improving the physical infrastructure. Given these initiatives, the general government budget surplus is expected to decrease somewhat. Real GDP is projected to grow by around 3$^1/_2$ per cent in both 1998 and 1999. Exports are expected to stay buoyant, but domestic demand is likely to decelerate as investment growth is returning to more sustainable rates. While job creation is projected to remain robust, the unemployment rate may decline only slightly. With little tension in the labour market and the increase in import prices slowing down, consumer price inflation is expected to remain subdued. The major uncertainty for the projections concerns the impact of European Economic and Monetary Union (EMU) on the large financial sector, and whether the economic expansion in neighbouring countries continues as projected.

> FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS
>
> The OECD Secretariat's projections for 1998 include tax reductions for households and enterprises announced in the 1998 Budget. Current central government expenditure is projected to grow by almost 5 per cent, compared with the medium-term guideline (or expenditure norm) of 4.25 per cent for total central government expenditure in 1998. Central government investment, mainly financed by special investment funds, is projected to grow by more than 17 per cent due to the start of some important road projects. In 1999, government expenditure is projected to grow more or less in line with the medium term guideline, *i.e.* by around 4$^1/_2$ per cent.

Mexico

Real GDP accelerated to 7 per cent in 1997, boosted by buoyant private domestic demand and persistently strong exports. The expansion is expected to be less rapid over the projection period, as the process of recuperating from the 1995 trough comes to an end. Notwithstanding strong job creation in the formal sector, real wage increases are expected to be moderate, due to large overall labour market slack, and inflation should continue to come down. Sustained import growth and lower oil export prices this year are expected to translate into a widening current-account deficit.

Monetary policy, as described in the monetary programme for 1998, continues to focus on reducing inflation, while at the same time aiming at maintaining stable conditions on financial markets. With the recovery of demand well established, a cautious stance is required for fiscal policy. The decision to cut public spending relative to budget plans for 1998 seems an appropriate response to reduced oil revenues. Structural reform should be stepped up, with emphasis on strengthening tax revenue, while improving the effectiveness of public spending in order to achieve social policy objectives and to improve basic infrastructure.

Output growth quickened in 1997, spreading across sectors

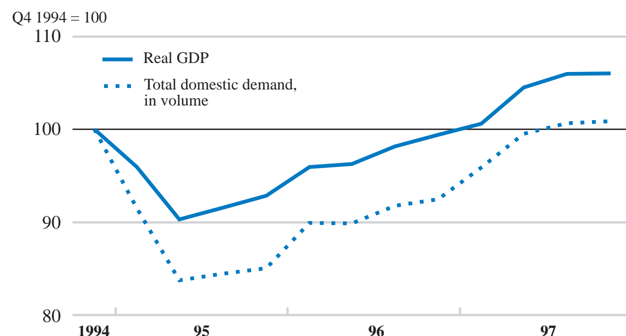
Real GDP grew by 7 per cent in 1997, driven by the recovery of household consumption and the continued strength of business investment and exports. Government spending, on the other hand, slowed down after mid-year. Trade moved into deficit during 1997 as imports picked up in line with the recovery of domestic demand, and the current account deficit widened US$7.4 billion (1.9 per cent of GDP) for the year. The unemployment rate has continued to decline, while the number of insured workers – an indicator of activity in the formal sector – has increased rapidly. Real monthly earnings in manufacturing, which fell sharply following the 1994/95 crisis, started to increase around the middle of 1997, though at a moderate pace. Consumer price index declined to 15.7 per cent in December 1997 (year-on-year), close to the 15 per cent target.

Monetary policy is aimed at further disinflation…

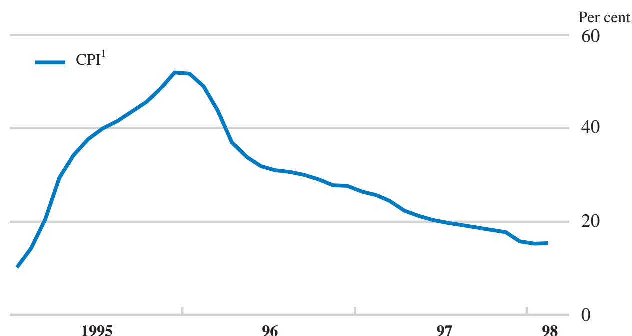
Nominal and real interest rates eased during most of 1997, in line with disinflation and a further reduction of the risk premium, while the exchange rate against the dollar remained roughly stable. Towards the end of the year, there was some turbulence in

Mexico

Output growth remains strong

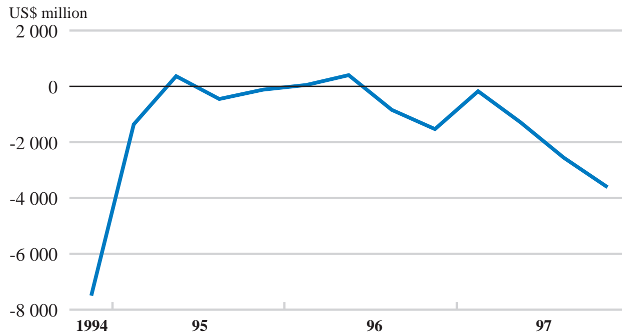


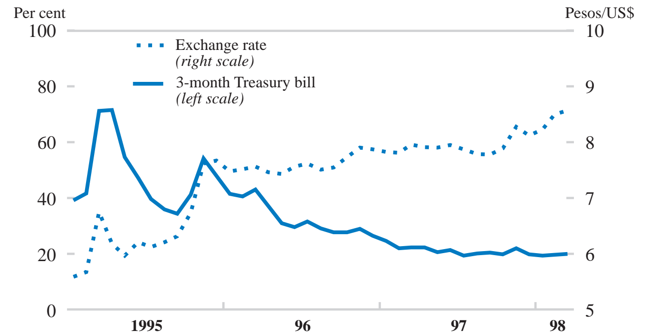
Inflation continues to decline



1. Year-on-year percentage change.

Mexico





financial markets linked to the Asia crisis, albeit less pronounced in Mexico than in some other Latin American economies. Following a bout of volatility, short-term interest rates stabilized in the first quarter of 1998 at around 20 per cent for the three-month Treasury bill (*Cetes*). After an initial depreciation at the end of 1997, the bilateral exchange rate of the peso slid further in 1998, to 8.6 pesos per dollar in mid-March, implying a 7 per cent depreciation relative to the 1997 average. In its monetary programme for 1998, the central bank set an inflation target of 12 per cent for December 1998 (year on year), which implies an annual average of about 13 per cent. Monetary policy is to remain flexible, with a view to responding to potential destabilizing influences from abroad.

… and a cautious fiscal policy stance is maintained

The public sector financial accounts recorded a small deficit in 1997 (0.8 per cent of GDP), close to budget projections. On average, oil prices were higher in 1997 than assumed when the budget was prepared, and GDP growth was much stronger (the budget assumption was only 4 per cent). The budget approved for 1998 foresees a small widening of the deficit, to 1.3 per cent of GDP. A fall in oil prices was assumed when the 1998 budget was prepared, but the drop in world oil prices around the turn of the year was larger than anticipated. As a consequence, in January and again in March 1998 the authorities announced public spending restraint relative to initial budget projections.[1]

Growth is expected to slow somewhat, with inflation falling and the current account deficit widening…

Real GDP growth is expected to slow to 5-5$^{1}/_{2}$ per cent over the projection period, as the catching up process from the 1995 recession comes to completion. The cuts in public spending programmes should contribute to the slowdown of domestic demand, thereby helping to limit the deterioration of the current account this year in a context of declining oil export revenues. The economic expansion will rely on private domestic demand, while the contribution to growth from the real foreign balance will continue to be negative. Under the OECD Secretariat's usual technical assumption in its projections of unchanged nominal exchange rates (at 8.6 pesos to a dollar), Mexico's price competitiveness would worsen gradually. The expected weakening of export growth and sustained import growth should translate into a widening of the current account deficit to close to US$20 billion in 1999 (about 3.9 per cent of GDP). Inflation is projected to continue to come down gradually to below 10 per cent on average

1. Receipts related to oil products account for 35 per cent of budget revenue. The cumulative fall of oil prices by $3 per barrel (from the initial budget assumption) represents a revenue loss of some 0.6 per cent of GDP, which is the approximate size of the total spending cuts announced by the government in January and March 1998.

Demand, output and prices

Percentage changes, volume (1993 prices)

	1994 current prices billion Pesos	1995	1996	1997	1998	1999
Private consumption	1 016.1	–9.5	2.2	6.3	4.5	4.2
Government consumption	164.2	–1.3	–0.7	1.8	1.2	2.5
Gross fixed capital formation	274.9	–29.0	16.4	20.9	15.7	14.1
Final domestic demand	1 455.2	–12.3	4.0	8.3	6.3	6.1
* stockbuilding	36.7[a]	–2.2	1.6	0.9	0.1	0.0
Total domestic demand	1 491.9	–14.0	5.6	9.0	6.2	5.9
Exports of goods and services	239.0	30.2	18.2	13.0	12.5	11.0
Imports of goods and services	307.5	–15.0	22.8	22.0	16.1	14.4
* net exports	–68.5[a]	8.5	–0.2	–1.7	–0.8	–0.9
GDP at market prices	1 423.4	–6.2	5.2	7.0	5.3	4.9
GDP deflator	–	38.0	29.4	18.8	12.0	9.8
Memorandum items						
Private consumption deflator	–	34.1	28.8	20.4	13.1	9.5
Unemployment rate[b]	–	6.3	5.5	3.7	3.4	3.4
Current account balance[c]	–	–0.5	–0.6	–1.9	–3.5	–3.9

* 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.

in 1999. These projections hinge on the assumption that the authorities maintain a tight policy stance over the projection period, thereby constraining domestic demand expansion to prevent the run up of an excessive current account deficit. Should the flexibility of the exchange rate be allowed to cushion the implied real appreciation, this would ease the external constraint on growth but it might slow the pace of disinflation somewhat.

… but the outlook hinges on developments abroad

The projections are also subject to uncertainties related to the external environment. First, the influence of the Asia crisis on capital flows is difficult to predict: on the one hand, confidence in Mexico's fundamentals might stimulate capital inflows, which would put upward pressure on the exchange rate; on the other hand, there could be a general withdrawal of funds by investors of the more industrialised economies away from emerging markets, including Mexico. Second, the Mexican economy remains vulnerable, although less so than in the past, to large changes in world oil prices. On the other hand, Mexico's growth prospects would improve if the expansion in other two North American countries, the United States in particular, turned out to be stronger than expected. Against this background, the authorities appear to be standing ready to adjust the policy stance in accordance with new developments abroad, so as to maintain the current account deficit within a sustainable range, the level of which is dependent on the size and composition of capital inflows.

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

The OECD Secretariat projections assume that the public sector financial deficit in 1998 will be close to the budgeted 1.25 per cent of GDP, with a primary surplus just below 2.5 per cent. The widening of the deficit by 0.5 per cent of GDP implied in this projection, relative to the 1997 outturn, is largely due to the additional fiscal cost (official estimate) of the social security reform introduced in mid-1997. The cuts in the public spending programmes announced in January and March this year, in response to the drop in budget revenue anticipated following the recent decline in world oil prices, were incorporated in this projection. For 1999, the OECD Secretariat assumes that a prudent policy setting will be maintained, with a public sector financial deficit just below 1 per cent of GDP, in conformity with the government's medium-term objectives stated in its National Development Programme, 1997-2000.

The Netherlands

Real GDP growth is projected to increase to 3¾ per cent in 1998 but to abate somewhat in 1999, with net exports taking over from domestic demand as the driving force. The rise in inflation in 1997 was mainly due to the strong dollar, but with the unemployment rate having fallen back to the levels of the early 1980s and projected to decline further, some upward pressure of domestic origin on wages and prices is expected. The budget deficit, which fell to less than 1½ per cent of GDP in 1997, is projected to rise slightly.

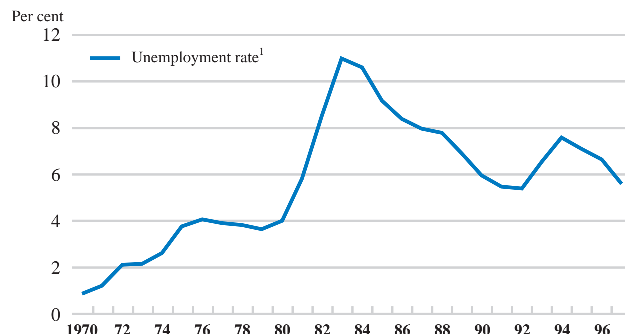
With output close to estimated potential, monetary conditions remaining easy, and fiscal policy somewhat expansionary, there is some risk of inflation. If this risk were to materialise, the built-in fiscal stabilizers should be allowed to work fully. The still low labour participation as well as population ageing – among other things – call for structural reform to be continued on a broad front. The pace of regulatory reform should be stepped up, and special attention should be given to measures enhancing the return of older unemployed and persons of working age, currently in the disability and social assistance schemes, to the active labour market.

Economic performance has been quite good

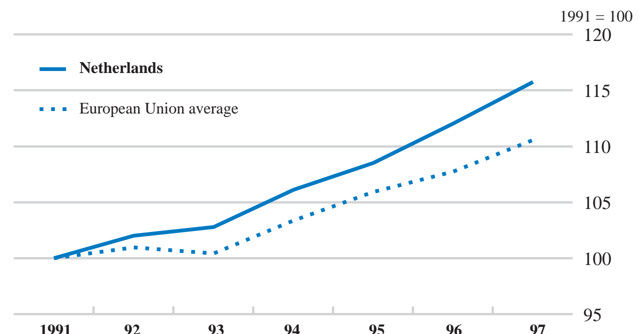
Real GDP growth, which is estimated to have been 3.3 per cent in 1997, is continuing at a rapid pace, and the economy seems to be close to full capacity. Unlike in most other European Union (EU) countries, private consumption has been an engine of growth, and the saving ratio has fallen to an unusually low level: strong job creation has bolstered consumer confidence, and rising house prices combined with historically low interest rates have encouraged mortgage borrowing, often used to finance consumption. Business fixed investment has also been strong, buoyed by a high rate of capacity utilisation, good profitability and special projects, mainly in the energy sector. Conditions in the labour market have tightened, with vacancies increasing and the unemployment rate (national definition) falling to around 5 per cent in early 1998 – close to the trough of 1992 and back to the levels prevailing in the early 1980s. However, inflation has generally remained subdued. Compensation per employee and contractual wages have accelerated only modestly; and consumer price inflation, after

Netherlands

Unemployment is falling



Output growth exceeds the European Union average



1. National definition (registered unemployment as a percentage of the labour force).

Demand, output and prices

Percentage changes, volume (1990 prices)

	1994 current prices billion Gld	1995	1996	1997	1998	1999
Private consumption	369.4	1.8	3.0	3.2	3.1	2.7
Government consumption	88.0	0.6	1.2	2.9	2.8	1.5
Gross fixed capital formation	115.2	5.0	6.1	6.1	3.5	4.1
Final domestic demand	572.7	2.3	3.4	3.8	3.1	2.8
* stockbuilding	2.3[a]	–0.2	0.2	–0.1	0.1	0.0
Total domestic demand	575.0	2.0	3.6	3.6	3.3	2.9
Exports of goods and services	314.4	7.1	4.6	5.9	6.6	6.0
Imports of goods and services	275.2	7.2	5.3	6.8	6.4	5.9
* net exports	39.3[a]	0.5	0.0	–0.1	0.6	0.5
GDP at market prices	614.3	2.3	3.3	3.3	3.7	3.2
GDPdeflator	–	1.6	1.3	2.2	2.1	2.0
Memorandum items						
Private consumption deflator	–	1.5	1.3	2.1	1.9	2.1
Industrial production	–	2.3	3.2	4.2	3.3	3.0
Unemployment rate	–	7.1	6.7	5.6	5.1	4.8
Household saving ratio[b]	–	0.8	1.2	0.6	0.7	0.6
General government financial balance[c]	–	–3.7	–2.3	–1.4	–1.7	–1.6
Current account balance[c]	–	6.2	6.2	6.5	6.9	7.0

* 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, excluding net contributions (actual and imputed) to life insurance and pension schemes.
c) As a percentage of GDP.

a spike in mid-1997 largely due to the strength of the dollar and the consequent depreciation of the guilder in effective terms, has abated to less than 2 per cent.

The economy seems close to full capacity but progress in structural reform makes this difficult to assess

The Dutch economy is benefiting from several years of wage moderation, structural reform – in the labour market, the social security system, and product markets – and capacity-boosting investment which have allowed its growth performance to exceed the EU average without major inflationary pressures. But these factors have also made it difficult to assess the exact degree of tightness in the labour market and the risk of overheating. Economic activity may increasingly be underpinned by foreign trade, which will benefit from the depreciation of the guilder in effective terms recorded in 1996-97 and the projected continuation of the upturn in continental Europe. The Asia crisis – even if the Netherlands does not seem to be particularly exposed to it, either in terms of trade flows, bank lending or inward direct investment – is nonetheless expected to curb somewhat the contribution of the foreign balance to growth and, more generally, reduce the risk of overheating. Interest rates are projected to increase, but only moderately, as a result of robust economic growth in EU countries generally: long-term rates may thus remain historically low. The 1998 budget, combined with more recent tax cuts and expected expenditure overruns, entails a somewhat expansionary stance of fiscal policy. The general government deficit is expected to rise to around $1^3/_4$ per cent of GDP in 1998-99. The debt-to-GDP ratio is projected to fall to 69 per cent of GDP in 1999.

The outlook is favourable but there is some risk of inflation

Largely reflecting the disappearance of last year's negative impact of swine fever on exports and stockbuilding, real GDP growth is projected to increase to $3^3/_4$ per

cent in 1998, before slowing to around 3¼ per cent in 1999. Stronger exports and a positive contribution of the foreign balance to growth should progressively be outweighed by a deceleration of domestic demand. As house prices are unlikely to keep rising as fast as in the last few years, wealth effects may wane, restraining the rise of private consumption; and, due to the completion of a few major projects, business fixed investment should also be somewhat less dynamic. With job creation remaining robust, the unemployment rate is projected to fall below 5 per cent – the lowest level since the early 1980s – despite a labour force growing at some 1½ per cent per year. Compensation per employee may accelerate to around 3½ per cent in 1999, and despite a marked slowdown in the increase of import prices – largely as a result of the Asia crisis and lower low prices – consumer price inflation is expected to remain around 2 per cent, as in 1997. The current-account surplus is projected to widen moderately – from around 6½ per cent of GDP in 1997 to 7 per cent in 1999. The major risks and uncertainties concern, on the domestic side, the reaction of wages and prices to this situation of tight labour market conditions and, on the external side, the impact of the Asia crisis and its global repercussions.

FISCAL POLICY ASSUMPTIONS
UNDERLYING THE PROJECTIONS

Projections for 1998 are based on the 1998 budget released in September 1997 which includes a Gld 4 billion (or ½ per cent of GDP) tax reduction package. A shift in the financing of the social security sector towards greater reliance on government transfers results in higher direct taxes and lower social security contributions. Premium differentiation and a limited opting-out possibility are introduced in the employees' disability scheme and contributions for this scheme are no longer levied on employees but instead on employers. Energy taxes are further increased, compensated by a lowering of direct taxes. Social security benefits are fully linked to the rise in the contractual wage index. Measures to promote employment for low-skilled workers include higher wage subsidies and the creation of 10 000 subsidised jobs in the public sector, bringing their total to 40 000. An additional tax reduction package (Gld 0.8 billion) was introduced at the beginning of 1998. For 1999, the projections include a continuation of the government's restrained expenditure policy, full linkage of social security benefits to contractual wages, and constant rates for taxes and social security contributions.

New Zealand

For the second year in a row, the New Zealand economy expanded at slightly below the OECD Secretariat's estimated rate of potential output growth of around 3 per cent per annum. Although the financial crisis in Asia may adversely impact on business confidence and export performance in the near term, macroeconomic policies are positioned to overcome this negative influence. A substantial depreciation of the exchange rate since last June has resulted in a marked easing of monetary conditions and this, combined with significant fiscal stimulus, makes a moderate pick-up in activity over the next two years a likely prospect.

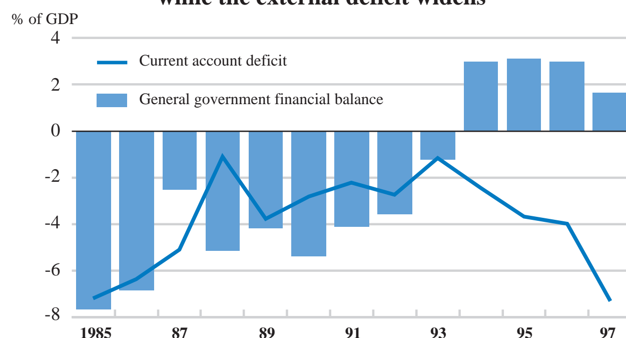
The marked widening of the current account deficit, combined with the uncertainties generated by events in Asia, leaves New Zealand vulnerable to shifts in financial market sentiment. In these circumstances, it is important over the short term to at least achieve existing budget surplus projections, as a signal of fiscal prudence. The government's commitment to reduce all tariffs unilaterally should be acted upon quickly, since foreign competition is an important driver of structural change. Growth prospects would also be enhanced over time by continuing microeconomic reforms, progressing measures to improve the quality and responsiveness of the education and training system to raise the skill level of New Zealand's labour force, and examining disincentives for private saving to help alleviate the pressure on the current account deficit.

The recovery has continued at a moderate pace

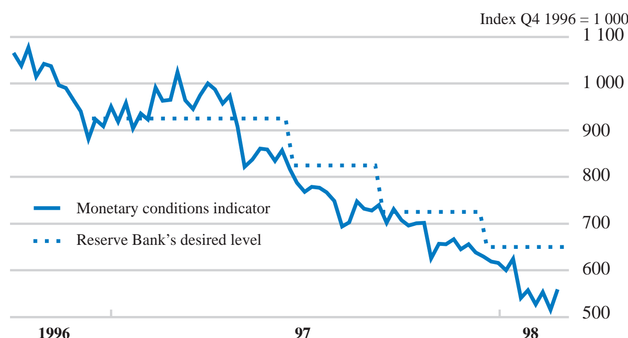
The New Zealand economy probably grew by around 2 3/4 per cent in 1997 (the same rate as the previous year), marking the seventh year of an expansion which began in 1991. The strength of domestic demand over the past year was largely driven by housing investment and public spending on goods and services, with private consumption probably registering its lowest rate of growth in four years while business investment declined. Moderate economic growth has not been sufficient to sustain the high rates of job creation of the past several years, so that unemployment has edged up from just under 6 to 6 3/4 per cent. The emergence of some spare capacity and the impact of the high exchange rate until the middle of last year has led to a decline in underlying inflation to just above the mid-point of the Reserve Bank's 0 to 3 per cent target range. A sharp rise in the invisibles deficit provoked a significant widening of the current account deficit to around 7 per cent of GDP in 1997, the worst outcome since 1985.

New Zealand

Fiscal surplus shrinks while the external deficit widens



Monetary conditions continue to ease



Demand, output and prices

Percentage changes, volume (1991/92 prices)

	1994 current prices million NZ$	1995	1996	1997	1998	1999
Private consumption	51 872	4.9	4.4	2.4	2.9	3.3
Government consumption	12 522	2.5	2.1	6.0	3.5	–2.0
Gross fixed capital formation	16 878	12.0	6.3	4.3	4.3	6.2
Final domestic demand	81 272	6.0	4.4	3.4	3.3	3.1
* stockbuilding[a]	1 733[b]	–0.7	–0.5	–0.3	0.0	0.0
Total domestic demand	83 005	5.2	3.9	3.0	3.3	3.1
Exports of goods and services	26 649	2.8	4.4	2.5	3.8	6.6
Imports of goods and services	24 353	8.9	8.2	3.3	4.4	5.5
* net exports	2 296[b]	–1.8	–1.2	–0.3	–0.3	0.2
GDP (expenditure) at market prices	85 301	3.3	2.7	2.8	3.1	3.4
GDP deflator	–	2.6	1.9	1.3	1.9	1.9
Memorandum items						
GDP (production)	–	3.6	2.8	2.4	3.1	3.4
Private consumption deflator	–	2.4	2.0	1.5	1.9	1.7
Unemployment rate	–	6.3	6.1	6.7	6.7	6.4
Current account balance[c]	–	–3.7	–4.0	–7.3	–6.9	–6.6

* 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.

With macropolicy providing most of the impetus…

In the macroeconomic policy area, three main factors have shaped recent developments. First, receding inflation pressures and the effects of the Asia crisis have allowed overall monetary conditions to ease substantially, although the effect of a lower exchange rate has been partly offset by higher short-term interest rates. Second, the depreciation of the effective exchange rate by more than 10 per cent since June 1997 has alleviated the burden on the tradable sector of nearly four years of continuous appreciation. Third, although the budget has remained in surplus, fiscal policy has eased substantially, with expenditure increases and tax cuts providing economic stimulus of more than 2 per cent of GDP in the current year (see box on fiscal assumptions). With respect to structural policy, the Coalition government has placed renewed emphasis on furthering reform, after a period when efforts had largely been aimed at implementing and consolidating past measures. Important steps will be taken to eliminate tariffs on automobiles in a short time frame, which will be extended to include all imported goods. To improve New Zealand's productivity performance, the authorities are moving to address the challenges created by its relatively low-skilled labour force, through, for example, making the education system more responsive to demand and raising immigration levels.

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

The fiscal projections are made on a national accounts basis for general government which differs from the accrual-basis of official New Zealand government accounts. The fiscal assumptions, based on the *December Economic and Fiscal Update*, include: *i)* additional spending increases of NZ$ 4 billion over the next two years; *ii)* the abolition of the superannuation surcharge in April and a personal income tax cut in July 1998; and *iii)* firm control over expenses to generate a steady decline in the ratio of expenditure to GDP and continuing fiscal surpluses. In 1998, government consumption is "artificially" boosted by the equivalent of nearly 1/2 per cent of GDP due to the purchase of a frigate, which by convention is recorded under public consumption.

... activity should strengthen, although events in Asia pose a major downside risk

Although recent indicators have been mixed, the macroeconomic factors described above have set the stage for a strengthening of activity. Given the boost to both domestic demand and to exports coming from these broad influences, real GDP is projected to expand at rates slightly above the growth of potential, estimated by the OECD Secretariat at around 3 per cent, over the next two years. As an output gap persists over the projection period, inflation pressures will probably be well contained despite the substantial exchange rate depreciation. The main risk to the outlook concerns the prospects for exports in light of the evolving situation in Asia and New Zealand's trade linkages in the region. (In 1996, the share of New Zealand's exports to Dynamic Asian economies amounted to 21 per cent, those to Japan were 15 per cent, while those to Australia were 20 per cent.) A further worsening of the current account could lead to downward pressure on the exchange rate and a compensating increase in interest rates which could dampen domestic demand.

Norway

In its fifth year of robust expansion, the Norwegian economy is on the brink of overheating. Indeed, the scope for further non-inflationary employment growth may be about to be exhausted, with labour force participation rates at a record high and the unemployment rate near its structural level. Wage inflation, although remaining moderate to date, may prove difficult to contain in the years ahead, the more so since macroeconomic policies have, on balance, been eased.

Although the monetary authorities have been able to exploit the limited room for manoeuvre available to them, the task of preventing overheating falls predominantly on budgetary and income policies. Indeed, the government should, in addition to the downscaling of investment in oil extraction facilities, ensure an appropriately tight stance of fiscal policy. It should, moreover, encourage the social partners to moderate wages, while at this critical time avoiding further concessions – such as paid education leave – which reduce labour supply.

A booming economy

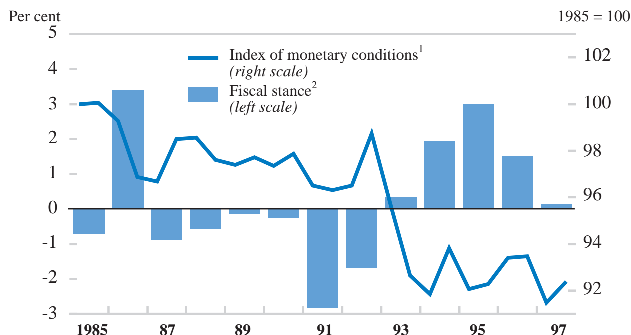
The economic expansion underway since 1993 continued to gain momentum in 1997, even though a pause in petroleum exports served to limit overall GDP growth to $3^1/_2$ per cent. Indeed, mainland GDP (excluding petroleum production) accelerated to almost 4 per cent – spurred by vigorous business capital formation, sharp increases in housing investment and an expansion in public infrastructure and petroleum extraction facilities. While employment surged for the fourth consecutive year, the unemployment rate fell only slightly to around 4 per cent, as labour force participation continued to increase markedly. However, rising numbers of unfilled vacancies and reported labour shortages indicate a rapid tightening in the labour market. Wage inflation has accordingly accelerated in several industries – most prominently in construction – although it remained on aggregate moderate at around $4^1/_2$. Consumer price inflation, after picking up to over $2^1/_2$ per cent in 1997, has edged down in recent months.

Macroeconomic policies have been successful to date…

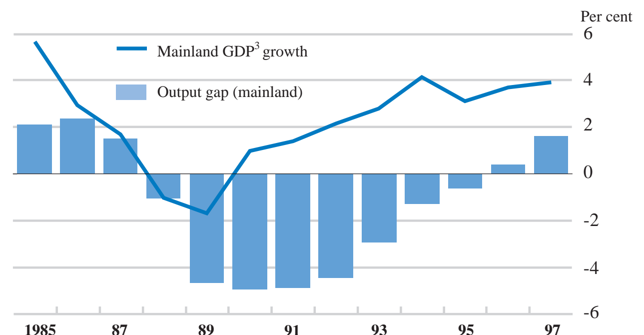
Norway's success to date in achieving a strong economic upswing while keeping inflation in check has been facilitated by a three-pronged policy framework adopted

Norway

Macro-policies have eased



The economy risks overheating



1. The weights used are 75 per cent for the short-term interest rate (divided by the deflator for consumer prices) and 25 per cent for the real effective exchange rate (constant trade weights).
2. Change in the cyclically adjusted net primary non-oil balance as a percentage of potential mainland GDP.
3. Mainland GDP excludes exports and imports of petroleum, oil rigs and ships.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1994 current prices billion NKr	1995	1996	1997	1998	1999
Private consumption	433.1	2.7	4.7	3.0	3.8	3.3
Government consumption	186.6	1.0	3.3	2.5	2.0	1.6
Gross fixed capital formation	179.4	3.7	4.8	15.1	6.7	–5.0
Final domestic demand	799.0	2.5	4.4	5.7	4.1	0.8
* stockbuilding	14.5[a]	1.6	–0.5	0.6	0.0	0.0
Total domestic demand	813.5	4.3	3.6	6.2	3.9	0.8
Exports of goods and services	333.2	3.6	10.0	4.1	5.7	5.4
Imports of goods and services	279.2	5.5	6.5	11.9	5.8	0.7
* net exports	54.0[a]	–0.2	2.2	–2.1	0.5	2.3
GDP at market prices	867.6	3.6	5.3	3.5	4.1	3.0
GDPdeflator	–	3.4	4.1	3.1	–0.4	3.2
Memorandum items						
Mainland GDP at market prices[b]	–	3.1	3.7	3.9	3.4	2.0
Mainland GDP deflator[b]	–	4.5	1.5	1.8	2.7	3.2
Exports of non-manufactures (incl. energy)	–	7.3	14.0	2.4	8.3	5.0
Private consumption deflator	–	2.8	1.1	2.8	2.5	2.9
Unemployment rate	–	4.9	4.9	4.1	3.3	3.0
Household saving ratio[c]	–	5.6	5.2	5.9	5.8	6.3
General government financial balance[d]	–	3.3	5.8	7.3	6.2	7.4
Current account balance[d]	–	3.3	7.1	5.5	3.1	5.2

* 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.

in the early 1990s. It, firstly, commits the monetary authorities to keep the exchange rate stable *vis-à-vis* a basket of European currencies, while, secondly, the social partners delivered wage restraint in order to preserve the international cost competitiveness of mainland industries. The role of fiscal policy, thirdly, has been to keep demand in line with the output potential of the economy, by keeping the lid on government expenditure. The mounting budget surpluses, exceeding 7 per cent of GDP in 1997, in part due to soaring petroleum revenues, have been invested in financial assets abroad on behalf of the government Petroleum Fund – *inter alia* in order to reduce upward pressure on the exchange rate emanating from buoyant current account surpluses.

… but now face major challenges as the economy is on the verge of overheating

In 1997 this policy framework came under increasing strain, however, as bouts of upward pressure on the exchange rate forced the monetary authorities to lower interest rates to slightly above German levels. Notwithstanding a recent increase in official interest rates, following some weakening of the exchange rate as oil prices plummeted, monetary conditions have remained relatively easy. Moreover, as the new government, in office since October 1997, adopted new social welfare programmes (notably child care cash benefits) and extended several others, the stance of fiscal policy has become less restrictive. Such an overall easing of macroeconomic policies is contributing to boost economic activity, which, despite the government's agreement with operators on the continental shelf to restrain investment activity, may prove unsustainable. Yet the authorities see little room for a further

tightening of monetary conditions as a departure from exchange rate stability is perceived to jeopardise the incomes-policy co-operation with the social partners. As growth in petroleum production is expected to pick up soon, overall GDP is projected to expand by over 4 per cent in 1998, before tapering off to 3 per cent in 1999. Meanwhile, domestic demand should remain buoyant, sustaining mainland economic growth at well above 3 per cent in 1998. In 1999, however, the residential investment cycle is likely to mature and capital formation on the Norwegian continental shelf to be cut back, slowing down the expansion of mainland GDP to 2 per cent. Consequently, employment growth would taper off, with the unemployment rate stabilizing at 3 per cent by the end of the projection period. Under such tight labour market conditions, wage and price inflation might reach 6 and 3 per cent, respectively, with the balance of risk clearly on the upside. If the inflation risk materialises, the economy may be set for a "hard landing" towards the end of the projection period.

FISCAL POLICY ASSUMPTIONS
UNDERLYING THE PROJECTIONS

Projections for 1998 are based on the Budget released by the new Centre Coalition Government in November 1997, which was approved in December. Central government real "underlying" expenditure (excluding unemployment benefits and the impact of changes in accounting methods) is projected to expand by 2¼ per cent, with the bulk of the increase in public pensions, family allowances, and health care. This is more than offset by increases in social security contributions and excise duties, so that the budget's net impact on domestic demand is projected to be somewhat negative (¼ per cent of GDP). For 1999 constant tax and social security contributions are assumed, but a carry-over effect of earlier measures to raise social expenditure will fully materialise in that year. The recent drop in oil prices and the associated decline in petroleum proceeds is absorbed by reduced foreign financial investment by the government Petroleum Fund and, hence, should not affect the fiscal stance.

Poland

Notwithstanding the floods in July, economic activity remained buoyant in 1997 for the fourth consecutive year, and its momentum appears to have carried over into 1998. Growth accelerated to almost 7 per cent in 1997, unemployment declined markedly, approaching the single-digit range, consumer prices continued to slow down, and the current account deficit widened. With a tightening of financial policies, these trends are projected to become less marked in 1998-99.

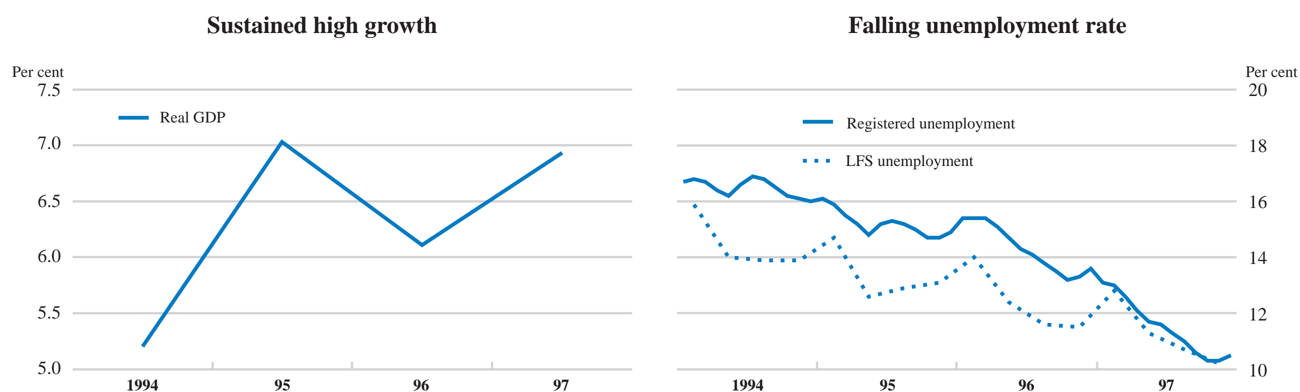
The stance of monetary policy has been tightened considerably but fiscal policy has remained rather loose. In order to bring the expansion of domestic demand more closely in line with that of output, the budget deficit needs to shrink by at least 1 per cent of GDP per annum over the next few years. Quickening the pace of structural reforms, notably privatisation, would help. In the longer run, those reforms are also key if the momentum of growth is to be preserved.

Investment-led growth accelerated, with inflation and unemployment declining and the current account deficit widening

Even though disinflation continued in 1997, acceleration of growth from already high rates and a sharp rise in the current account deficit are symptomatic of an overheating economy. For the first time in years, the inflation target was not significantly exceeded, with the 12-month rate for the consumer price index falling to 13.2 per cent in December. Producer price inflation, however, picked up somewhat in the course of 1997. Employment increased only modestly, but the rate of registered unemployment dropped faster than commonly foreseen (to 10.5 per cent in December), partly reflecting more restrictive eligibility and benefit rules. Domestic demand continued to soar, fuelled by the investment boom that started around 1994, with capital formation expanding three times as fast as GDP for the third year in a row. As well, consumption rose by 6 per cent, pulled by rapid wage increases and fast developing consumer credit. Real GDP grew by almost 7 per cent in 1997, with net exports contributing negatively. The current account deficit widened from 2.5 per cent of GDP in 1996 to an estimated 4.4 per cent in 1997.[1] The pace of the deterioration, however, started to slow down in the second half of the year, with export growth picking up and import growth continuing to gradually decline.

Monetary policy was tightened considerably in 1997

Faced with overly rapid domestic demand growth, monetary policy was increasingly tightened during 1997, with two increases in required reserve ratios and one

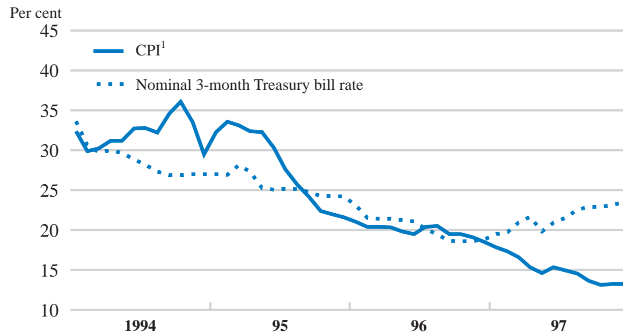


Source: Central Statistical Office.

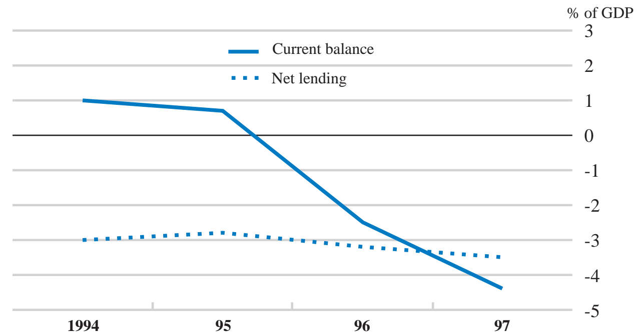
1. On an accruals basis, and taking into account unrecorded net exports.

Poland

Rising real interest rates



Widening fiscal and external gaps



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

in the central bank's benchmark rates. The central bank also collected term deposits from households at attractive rates in an effort to boost saving. Nominal market interest rates were on a rising trend throughout the year despite the deceleration of inflation, driving real interest rates towards the double digit range. Concomitantly, credit decelerated somewhat, although it continued to grow swiftly. Corporate borrowing was up by 30 per cent in 1997 and personal loans by 56 per cent, contributing to broad money overshooting its target by a substantial margin. The monthly rate of crawl of the central parity of the ±7 per cent exchange rate band remained unchanged at 1.0 per cent between January 1996 and February 1998, partly reflecting a concern to protect price competitiveness in the face of a widening trade deficit. Official foreign exchange reserves rose in dollar terms but remained equivalent to about half a year of imports.

The pace of exchange rate depreciation has been slowed down in early 1998

The central bank aims at reducing the rate of money expansion in 1998 to around 20 per cent, implying a further decline in velocity. At the end of February 1998, the rate of exchange rate crawl was cut to 0.8 per cent per month, and the width of the band enlarged to ±10 per cent, with a view to containing short-term portfolio inflows, which have picked up of late.

Fiscal policy was loose in 1997, but has become slightly restrictive in 1998

Fiscal policy was not intended to be tightened in 1997, though the state cash deficit – 1.4 per cent of GDP (counting privatisation receipts as revenue) – turned out to be less than half of the objective enshrined in the budget, largely reflecting stronger activity. One-third of the difference between the target and the outcome stems from the expenditure side, and two-thirds from the revenue side. Privatisation receipts ended up well above target, reaching 1.7 per cent of GDP. However, excluding those receipts, the overall general government deficit was on the order of 3.5 per cent of GDP in 1997, up from 3.2 per cent in 1996. The draft 1998 budget prepared before the parliamentary elections last fall was amended by the new government that took office in October. It sets a deficit target for the general government of 3.2 per cent of GDP, with privatisation receipts for the state budget projected at 1.3 per cent of GDP. Tax revenue will suffer from the cuts in corporate and personal income tax rates but benefit from increases in indirect taxes. Expenditure restraint is to be achieved *inter alia* through subsidy cuts.

FISCAL POLICY ASSUMPTIONS
UNDERLYING THE PROJECTIONS

The projections for 1998-99 are based on the enacted 1998 budget and on the broad medium-term fiscal strategy of the authorities as reflected in some tax laws (notably the pluriannual schedule of cuts in the corporate income tax rate) and in the budget law. However, the impact on the deficit of the shift to a multi-pillar pension system, currently foreseen as starting in 1999, is not factored in. Headline budget data in Poland are confined to the State budget and until 1997 treated privatisation receipts as a revenue item. The fiscal balance shown here includes the other components of general government as well, and treats privatisation proceeds as a source of deficit finance.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1994 current prices billion Zl	1995	1996	1997	1998	1999
Private consumption	135.4	3.6	8.7	7.0	4.6	3.7
Government consumption	39.5	2.9	3.4	3.6	1.8	1.5
Gross fixed capital formation	34.1	16.9	20.6	21.9	15.1	12.5
Final domestic demand	208.9	6.3	10.4	10.2	7.1	6.0
* stockbuilding[a]	–0.7[b]	0.8	1.9	0.9	0.1	0.0
Total domestic demand	208.2	7.2	12.3	10.9	7.1	5.9
Exports of goods and services	50.6	23.6	12.5	9.9	11.8	11.6
Imports of goods and services	48.4	24.3	28.0	18.3	13.4	11.0
* net exports	2.2[b]	–0.1	–6.1	–4.5	–1.9	–0.9
GDP at market prices	210.4	7.0	6.1	6.9	5.8	5.6
GDP deflator	–	27.1	19.4	14.6	12.0	9.8
Memorandum items						
Private consumption deflator	–	28.8	19.9	14.9	12.1	9.6
Industrial production	–	9.7	8.7	10.8	8.9	7.5
Unemployment rate	–	13.3	12.3	11.2	10.1	9.3
General government financial balance[c]	–	–3.0	–3.2	–3.5	–3.0	–2.0
Current account balance[c]	–	0.7	–2.5	–4.4	–6.0	–6.1

* 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.

The outlook remains bright provided financial and structural policies are ambitious enough

The current stance of financial policies may allow real GDP to decelerate while remaining on a growth path of over 5.5 per cent per annum, as well as further disinflation. The significant tax and price hikes early this year will contribute to pushing average annual inflation slightly above the targeted 11 per cent, even if the end-year 9.5 per cent objective were to be met. The current account deficit seems bound to rise but less than in 1996-97, as import growth drops further and export growth picks up a little.[2] The main risk surrounding this generally favourable outlook continues to be that the ongoing efforts to reduce the fiscal deficit and to accelerate structural reforms might not be sufficient to bring Poland back on a balanced, high-growth path.

2. The underlying exchange rate assumption is that the zloty depreciates by 0.8 per cent per month from March 1998, and by 0.7 from the start of 1999.

Portugal

The economy has entered its fifth consecutive year of expansion, with lower interest rates and continuing disinflation stimulating domestic demand. Reflecting an acceleration of employment growth, the unemployment rate has fallen further and is now only about 0.7 percentage points above its estimated structural level. While the construction boom is projected to taper off with the conclusion of large infrastructure projects, domestic demand should remain buoyant, as both consumer spending and private investment are stimulated by the further reductions in interest rates likely to materialise in the transition to the European Economic and Monetary Union (EMU). Exchange rate stability and nominal wage moderation should ensure that inflation remains at around 2 per cent, while increased revenues from tourism, associated with the Expo 98 in Lisbon, should help narrow the current account deficit despite strong import growth.

The strong growth outlook and the imminence of EMU make it opportune to press ahead with both fiscal consolidation and structural reforms. As in previous years, lower public debt servicing costs and strong revenue growth will help reduce the budget deficit in 1998; as the output gap closes and interest rate convergence is completed, however, further fiscal consolidation will require better control of primary spending. Furthermore, structural reforms in the spheres of education, health and social security will need to be stepped up in order to improve the conditions for non-inflationary growth and to reduce unemployment.

Output growth has accelerated…

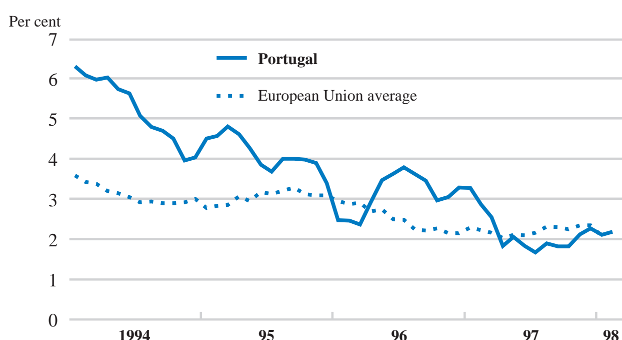
The economic expansion, which began in 1994, has continued to gather strength, with GDP growth reaching an estimated 3.5 per cent in 1997 as private domestic demand responded to falling interest rates, disinflation and related confidence gains. Public infrastructure investment has been particularly buoyant, comprising several large projects: preparations for the Expo 98 in Lisbon, a new bridge over the Tagus river and the expansion of the Lisbon Metro.

… while unemployment is falling and disinflation continues

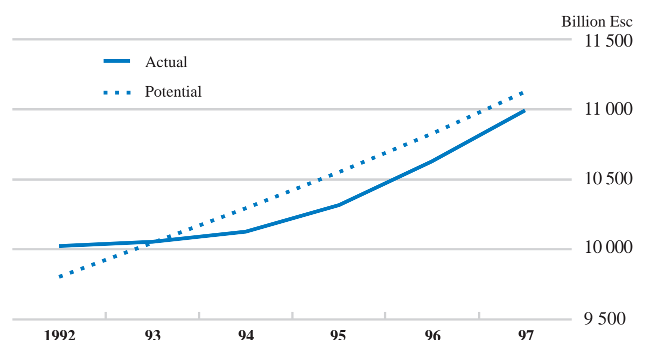
Thanks to rising employment in the construction and agricultural sectors, the unemployment rate has continued to decline in spite of an increase in labour force participation rates, reaching 6.5 per cent at the end of last year. Youth unemployment has fallen particularly rapidly – by more than 2 percentage points during 1997 – but still remains twice as high as the overall unemployment rate. Helped by exchange-rate stability and continued moderate growth of unit labour costs, consumer price inflation has remained on a downward trend, largely completing the process of convergence

Portugal

Inflation convergence is complete



The output gap is closing



Demand, output and prices

Percentage changes, volume (1990 prices)

	1994 current prices billion Esc	1995	1996	1997	1998	1999
Private consumption	9 370.8	1.0	2.2	2.6	2.8	2.8
Government consumption	2 537.8	2.4	1.8	1.9	1.8	1.5
Gross fixed capital formation	3 293.7	3.6	5.2	13.5	8.0	6.8
Final domestic demand	15 202.3	1.9	2.9	5.3	4.1	3.7
* stockbuilding	–13.6[a]	–0.4	–0.8	0.0	0.0	0.0
Total domestic demand	15 188.7	1.5	2.2	5.3	4.1	3.8
Exports of goods and services	4 323.8	12.1	10.9	8.3	10.4	8.0
Imports of goods and services	5 429.9	8.8	7.4	11.0	9.5	8.0
* net exports	–1 106.1[a]	0.2	0.6	–2.4	–0.8	–1.0
GDP at market prices	14 082.6	1.9	3.0	3.5	3.8	3.2
GDP deflator	–	5.1	2.2	2.6	2.7	2.4
Memorandum items						
Private consumption deflator	–	4.2	3.1	2.2	2.1	2.0
Industrial production[b]	–	4.7	1.4	4.1	5.1	4.8
Unemployment rate	–	7.2	7.3	6.7	6.3	6.0
Household saving ratio[c]	–	12.2	10.4	10.3	10.3	10.2
Current account balance[d]	–	–0.7	–1.5	–2.2	–1.7	–1.9

* 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.

towards the European Union average. The current account deficit has reached 2¹/₄ per cent of GDP, as a widening trade deficit resulting from strong import growth more than offset rising official and private transfer receipts.

Monetary conditions are set to ease with the transition to EMU helping the government meet its fiscal targets

The strong likelihood of Portugal participating in EMU from the start implies a further convergence of interest rates towards German levels during 1998. Although the long-term spread *vis-à-vis* Germany had fallen to about 20 basis points in March 1998, short-term rates still exceeded their German equivalent by about 100 basis points. Given increasingly tight labour markets in some sectors, especially construction, the Banco de Portugal remains cautious and is likely to proceed slowly with further cuts in policy-controlled rates. As in previous years, current primary spending is not expected to decrease significantly as a percentage of GDP. However, lower public debt servicing costs and strong revenue growth associated with buoyant activity should help ensure a further reduction in the budget deficit towards the government's target of 2.0 per cent of GDP in 1999 from an estimated 2.5 per cent in 1997. As the output gap closes and interest rate convergence is completed, consolidating progress over the medium run is likely to require better control of public spending, including through further progress on structural reforms.

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

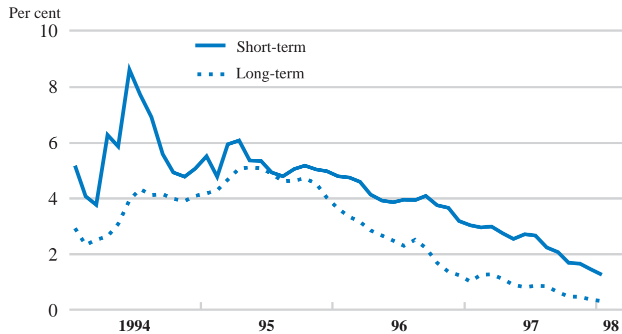
The projections for the general government budget in 1998 assume transfer payments to the health system to be slightly larger than scheduled, but this is more than offset by lower than budgeted public debt-servicing costs. Current primary expenditures are projected to grow slightly less than nominal GDP, reflecting a decline in both transfers to the European Union and defence spending. For 1999, the assumption of unchanged policies implies largely unchanged current receipts in terms of GDP. Current expenditure is projected to fall relative to GDP, as a result of lower interest payments.

Economic activity should remain buoyant…

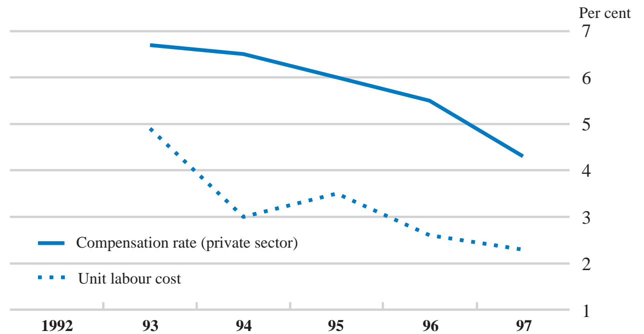
Output growth is expected to continue to strengthen during 1998, as a further decline in interest rates boosts domestic demand, and tourism receipts increase with the Expo 98 in Lisbon. A rising surplus in the invisibles account should more than

Portugal

Interest rate differentials[1] continue to narrow



Wage growth remains moderate



1. Portuguese rates less equivalent German rates.

offset the widening of the trade deficit, as import growth remains strong, in line with domestic demand. Some deceleration of output growth is expected in 1999, as the construction boom cools down with the conclusion of large infrastructure projects. As a result, skill shortages in the construction sector are expected to ease. Unemployment should continue to move down, approaching the level corresponding to full employment by the end of the projection period. Exchange rate stability and nominal wage moderation should keep consumer price inflation at around 2 per cent.

… although uncertainties attach to the effects of the Asia crisis

The main risk to the projections concerns the outlook for wages. Skill shortages could lead to some wage drift towards the end of the projection period. A further uncertainty attaches to the effects of the Asia crisis: Portugal's export markets as well as its competitiveness in labour intensive sectors might be more seriously affected by the economic turmoil in that region than allowed for.

Spain

The strong recovery has created many permanent jobs, and has neither impeded inflation from stabilizing near 2 per cent nor prevented the current account from remaining in surplus. Conditions are in place for a continuation of good economic performance, which should bring unemployment down relatively swiftly from the current very high level. The feed-through of the economic developments in Asia may provide a slight brake to demand, and combined with plunging world commodity prices, should support the continued lowering of inflation expectations.

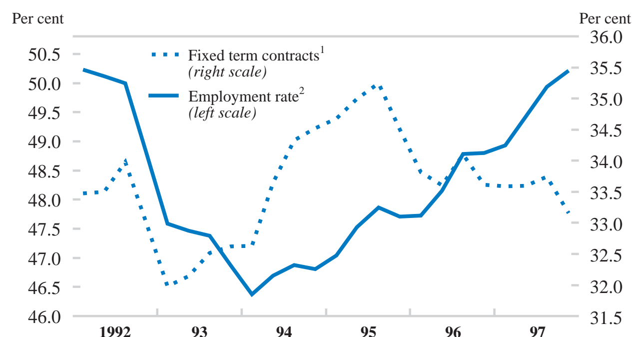
There has been a substantial improvement in macroeconomic policy settings, and recent product and labour market reforms represent important first steps to alleviate supply side constraints to non-inflationary growth; the successful implementation of the 1998-2000 convergence programme would reinforce this process. However, the window of opportunity provided by current economic circumstances should be used to make bolder reforms to address several long-standing structural problems, especially in labour markets but also concerning the structural component of the budget deficit. These reforms would improve the chances for the Spanish economy to perform successfully within the European Economic and Monetary Union (EMU).

The strong economy has created jobs while inflation has fallen to a 30 year low

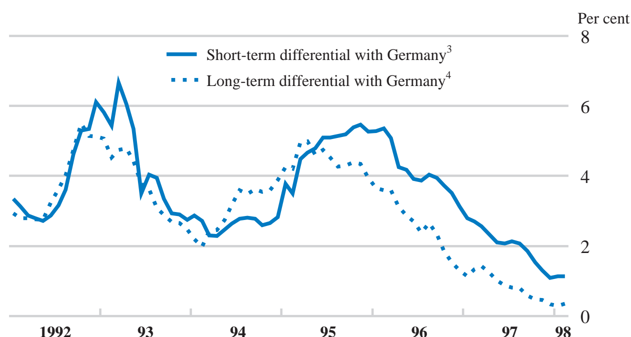
Economic activity has accelerated and GDP growth was 3.4 per cent in 1997 compared with 2.3 per cent in 1996. Domestic demand strengthened, to become the principal source of output growth. Private consumption and investment were spurred by declining interest rates, rising disposable income and improving confidence. Output growth was reinforced by the continued strength of external demand, as the competitiveness of Spanish exports was broadly maintained and the buoyancy of Spain's main trading partners strengthened. Strong private sector activity has more than offset the demand effects of a significant fiscal consolidation, as the credible reduction in the deficit towards the Maastricht limit prompted a large reduction in interest rates. The strong economy has created many jobs, mostly under permanent contracts, and pushed the unemployment rate down to near 20 per cent at end-1997. Despite the high level of structural unemployment, there was sufficient labour market slack for

Spain

The labour market improves



Interest rate spreads have fallen substantially



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

wage settlements to moderate in the latter part of 1997 – a sign that economic agents are adapting to the low inflation environment. Nevertheless, real wages rose more than productivity in 1997. With declining financial costs offsetting rising unit labour costs, underlying inflation stabilized near 2 per cent in late 1997 and early 1998.

The rising prospects of achieving the Maastricht criteria…

A major impetus to Spain's fine economic performance has come from the visible progress in implementing sound policies, especially fiscal consolidation. The 1997 State Budget overperformed and as a result the general government deficit fell to 2.6 per cent in 1997. This outturn is partly due to lower interest payments and higher corporate income tax revenue, with the latter reflecting healthy firm profiles and several one-off measures. Fiscal policy has moved to a more accommodating stance in 1998 following the pronounced tightening in 1996 and 1997. The 1998 Budget takes advantage of the cyclical increase in revenues and the continued decrease in interest rates to raise public investment and spending on social programmes (see box). Nevertheless, the Budget aims to come in below the target for the general government deficit of 2.5 per cent of GDP contained in the 1998-2000 convergence programme.

… facilitated the task of monetary policy

The sharp fall in inflation during 1997 has permitted the Bank of Spain to gradually relax a relatively tight monetary policy. The 1997 inflation target of 2.6 per cent at year-end, based on the consumer price index, was met by a large margin, allowing the Bank of Spain to cut short-term interest rates to within 100 basis points of German rates in early 1998. Looking forward, a further easing of monetary policy will probably take place: long-term interest rates have nearly converged with those in Germany, and short-term rates should follow in the prelude to monetary union. Moreover, concerns regarding inflation being above the Bank of Spain's target of near 2 per cent in

Demand, output and prices

Percentage changes, volume (1986 prices)

	1994 current prices billion Ptas	1995	1996	1997	1998	1999
Private consumption	40 723.7	1.6	1.9	3.1	3.2	3.5
Government consumption	10 963.2	1.8	0.1	0.7	2.0	2.0
Gross fixed capital formation	12 843.0	7.8	0.9	4.7	6.2	6.4
Final domestic demand	64 529.9	3.0	1.4	3.0	3.7	3.9
* stockbuilding	150.1[a]	0.2	–0.1	–0.4	0.0	0.0
Total domestic demand	64 680.0	3.2	1.4	2.7	3.7	4.0
Exports of goods and services	14 440.6	10.0	9.9	12.9	11.2	9.2
Imports of goods and services	14 331.4	11.0	6.2	10.1	11.3	10.7
* net exports	109.2[a]	–0.6	0.9	0.7	–0.2	–0.7
GDP at market prices	64 789.2	2.7	2.3	3.4	3.5	3.3
GDP deflator	–	4.8	3.1	2.2	2.5	2.7
Memorandum items						
Private consumption deflator	–	4.7	3.4	2.5	2.2	2.5
Industrial production	–	6.0	0.6	6.9	6.5	7.0
Unemployment rate	–	22.7	22.2	20.8	19.6	18.4
Household saving ratio[b]	–	12.8	12.2	12.1	11.9	11.4
General government financial balance[c]	–	–6.5	–4.7	–2.6	–2.2	–1.8
Current account balance[c]	–	0.2	0.3	0.5	0.5	0.3

* 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.

1998 have been assuaged by moderate wage demands, the recent decline in international commodity prices, and the anticipated slight dampening of output growth due to the economic crises in Asia.

Progress in implementing structural reform…

Progress has also been achieved in implementing structural policies and this has reinforced business sentiment and households' confidence. An ambitious privatisation programme has been implemented on schedule and ailing public industries are being restructured. Some important steps to promote competition in the sectors previously dominated by public enterprises have also been undertaken or are underway (notably in the energy and telecommunication sectors). Meanwhile, the 1997 labour market and pension system reforms were first steps to address critical problems in these areas.

… would facilitate employment creation and give the Spanish economy the best chance to perform successfully within EMU

With policies moving to a more accommodating stance and economic growth in Spain's main trading partners gathering steam (despite the aftershock from Asia), growth is projected to strengthen further to $3^1/_2$ per cent in 1998 but slow slightly in 1999 as the external sector acts as a large drag on output. Private consumption should continue to accelerate as wage gains in real terms and employment creation will sustain increases in disposable income. Moreover, the prospects for Spain's entry in the EMU with the first group of countries and the rapid increase in stable employment should improve consumer confidence and lead to a decline in the household saving ratio. Forward looking indicators for business investment are all pointing to its further acceleration (order books are booming, capacity utilisation is at its highest level for the past 8 years, and inventories in the manufacturing sector are falling rapidly). Such buoyant demand is expected to lead to a further decline in the unemployment rate, to below 19 per cent by 1999. The negotiating positions of social partners suggest a small deceleration in real wage gains in 1998. Along with lower international commodity prices, especially for oil, inflation in 1998 should remain near 2 per cent. However, in a labour market where much of the high level of unemployment is structural, wage-cost pressures are expected to provide a small upward push to inflation in 1999. The crises in Asia should provide a moderate and perhaps well-timed brake to economic activity. There is the risk, of course, that the effect on the demand of Spain's main trading partners will be larger than expected. Export demand could also be dampened by the consolidation processes being introduced in several Latin American countries, which have recently been very dynamic markets for Spanish goods. Such a course of events would serve to lower inflation relative to the basic projections. On the other hand, if these effects are small and domestic demand is stronger than expected (boosted either by gains in purchasing power of incomes or reduced savings), the rebound in inflation could be higher than projected.

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

For 1998, expenditure developments will reflect wage increases for employees of the general government of 2.1 per cent (the official consumer price inflation target) combined with restrained employment growth reflecting the policy of replacing only one of four retirees (excluding employees in education and the armed forces). The main factors affecting 1998 revenues are: *i)* a rise in the elasticity of indirect taxes reflecting the recent increase in the price of tobacco and the transformation of the carbon levy on electricity prices into a tax; *ii)* unchanged tax elasticities for both the personal and business income tax (though for the latter a correction is included for once-off 1997 measures); and *iii)* a slight decrease in property and entrepreneurial income as a share of GDP, reflecting the privatisation of profitable public enterprises. For 1999, the projections assume that: *i)* tax elasticities remain broadly constant; *ii)* wages in the general government increase in line with those in the private sector; *iii)* employment policy continues to be restrictive; *iv)* public investment retains its share in GDP; and *v)* transfers to public enterprises are constant in nominal terms.

Sweden

Economic growth has been moderate over the past two years, with exports having supplied the main impulse to activity. Accelerating domestic demand should now ensure more rapid output growth: private consumption and business fixed investment growth are picking up as the completion of the 1995-98 fiscal consolidation is felt in growing confidence, lower interest rates and recovering real disposable incomes. The improved credibility of monetary policy has fed into lower inflation expectations. However, wage growth remains rather high from an international perspective, and continues to restrict employment growth. Unemployment is expected to continue to fall over the projection period, chiefly because the strong expansion of education programmes is reducing labour supply.

The fiscal consolidation process has been highly successful and the long-term goal of maintaining the budget surplus at an average of 2 per cent of GDP over the economic cycle is within reach provided cyclical improvements in the budget balance are not used to raise government expenditure. Long-term growth prospects would improve if public spending – especially on transfers – were reduced and tax rates lowered, as part of a broadening of the current employment strategy from its main reliance on educating those at risk from unemployment to a more incentive-based approach, which would allow relative wages to adapt in the short run.

GDP growth strengthened in 1997…

The present economic expansion got under way in 1994, with exports and the resulting rebound in business fixed investment as the main expansionary forces. These factors diminished in strength in 1996 so that, despite a gradual pick-up in private consumption, economic growth slowed. Against the background of a more favourable international climate, economic activity expanded more strongly in the course of 1997. Notwithstanding a continued contraction in public demand and a collapse of housing investment, GDP increased by 1.8 per cent in 1997. Other demand components have been moving up, with private consumption increasing by 2 per cent over the last four quarters despite declining real disposable incomes.

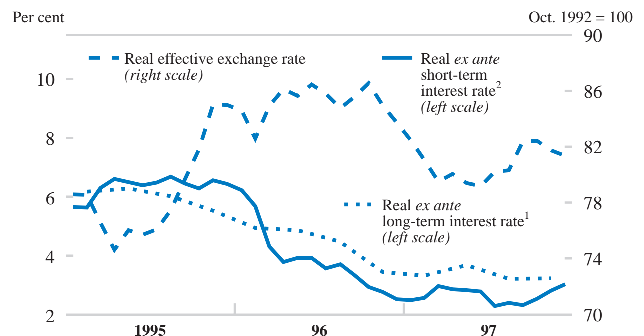
… but labour demand remained weak

Labour demand remained subdued throughout 1997 and did not respond to stronger output growth, leaving average employment for the year 1 per cent below 1996; indeed, after four years of growth it is still no higher than at the start of the expansion.

Sweden

House prices are recovering

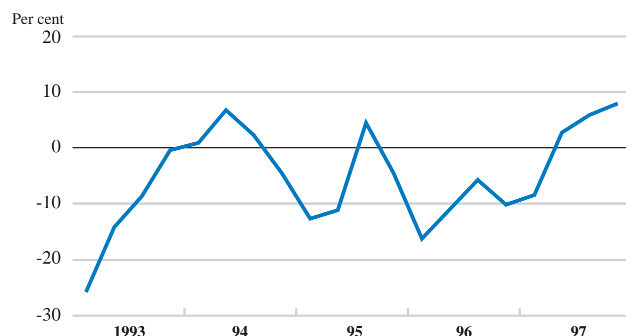
Monetary conditions are supportive



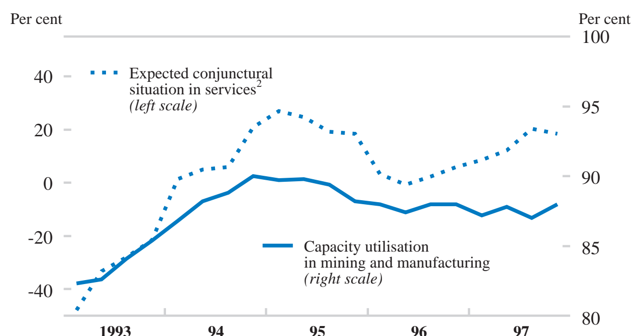
1. Rate of 5-year government bonds adjusted for bond investors' CPI expectations over the next 5 years.
2. Rate of 3-month Treasury bills adjusted for the CPI change expected by households in the coming year.
Sources: SCB; Sveriges Riksbank; OECD.

Sweden

Consumer confidence[1] strengthening



Domestic demand growth benefits services



1. Balance between households' optimistic and pessimistic answers regarding the development of the Swedish and their own economic situation over the past and future 12 months and their assessment of purchasing consumer durables.
2. Balance between firms' optimistic and pessimistic answers regarding the conjunctural situation in the forthcoming semester.
Sources: SCB; Sveriges Riksbank.

Reflecting a strong increase in tertiary and adult education, the labour force has been contracting strongly since mid-1997, with a concomitant reduction in open unemployment, which currently amounts to 6.7 per cent. Wage growth fell in 1997, but is still running at a twelve-month rate of 4.0 per cent for blue-collar and 3.5 per cent for white-collar workers. The headline inflation rate picked up as the effect on housing costs of falling short-term rates during 1996 disappeared but with long-term rates continuing to fall, it is still no higher than 1.2 per cent.

Budget balance is being restored, while monetary conditions continue to be supportive

Fiscal consolidation has been rapid over the past few years, and the general government balance is scheduled to move into surplus in 1998. With municipalities legally obliged to balance their books by 2000, and central government expenditures controlled by a set of expenditure ceilings covering the years up to 2000, the aim of achieving a surplus of 2 per cent of GDP by 2001 should be within reach. Achieving the longer-run goal of maintaining an average surplus of similar magnitude over the cycle will require even larger surpluses at the peak of the cycle, depending on the evolution of the output gap, since Sweden's budget balance is very cyclically sensitive. The decision not to participate in the European Economic and Monetary Union from its inception leaves inflation targeting as the framework of monetary policy. To ensure a configuration of interest rates consistent with its inflation objective of 2 ±1 per cent annual growth in the consumer price index, the central bank increased its key rate, the repo rate, from 4.10 to 4.35 per cent in mid-December, a move which followed twelve months of unchanged rates. Monetary conditions are nevertheless highly supportive, and long-term interest rates have fallen by almost 1½ percentage points since mid-1997, reflecting (in about equal measure) the international trend and a fall in the differential against Germany, to currently below ½ percentage point. In view of the projected strengthening of economic activity short-term rates may be expected to move upwards, although more slowly than elsewhere in Europe, while the potential for a further reduction of the long-term differential seems rather limited.

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

The 1998 and 1999 fiscal projections are based on *i)* the revenue and expenditure measures incorporated in the 1995-1998 fiscal consolidation programme of the Swedish government, evenly balanced between expenditure cuts and tax increases and amounting to an improvement of the structural balance of the central government by 8 per cent of GDP by 1998 but also having effects beyond that year; and *ii)* an underlying improvement of the fiscal balance of local authorities, set in train by the legal obligation for them to achieve budget balance by 2000. Compared with official projections, the present projection embodies *i)* somewhat lower tax revenues and higher social security transfers stemming from assumptions of weaker activity growth; *ii)* a slower pick-up in public demand; and *iii)* lower wage increases for public sector employees than for the private sector.

Demand, output and prices

Percentage changes, volume (1991 prices)

	1994 current prices billion SKr	1995	1996	1997	1998	1999
Private consumption	834.5	0.8	1.3	2.0	2.5	2.1
Government consumption	416.2	–0.9	–0.2	–2.1	0.5	0.5
Gross fixed capital formation	209.2	12.4	3.7	–4.8	5.9	6.8
Final domestic demand	1 459.9	2.1	1.3	–0.3	2.5	2.5
* stockbuilding	7.2[a]	0.5	–1.1	0.7	0.0	0.0
Total domestic demand	1 467.1	2.6	0.1	0.4	2.5	2.5
Exports of goods and services	557.8	12.9	6.1	12.8	6.0	5.5
Imports of goods and services	493.7	10.2	3.7	11.7	6.7	6.5
* net exports	64.0[a]	1.5	1.2	1.4	0.3	0.1
GDP at market prices	1 531.1	3.9	1.3	1.8	2.6	2.4
GDP deflator	–	3.7	1.0	1.2	1.7	1.9
Memorandum items						
Private consumption deflator	–	2.7	1.2	2.2	1.5	1.7
Industrial production	–	11.7	2.3	7.0	5.0	4.0
Unemployment rate[b]	–	7.7	8.1	8.0	6.7	6.2
Household saving ratio [c]	–	6.3	4.4	0.8	0.9	1.7
General government financial balance[d, e]	–	–7.0	–3.5	-0.8	0.8	0.5
Current account balance[d]	–	2.1	2.3	2.7	2.9	3.2

* 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.

Domestic demand will drive the expansion…

The growth of domestic demand is becoming more rapid as private consumption benefits from stronger employment growth, the completion of the fiscal consolidation and wealth effects induced by higher house prices and stock market gains. Lower interest rates should also stimulate residential investment, albeit slowly. Business investment intentions are again strengthening, with capacity utilisation still high in export industries and domestically-oriented sectors continuing to pick up. Economic growth should continue to benefit from expanding foreign demand, although the effect of the Southeast Asian crisis reinforces the decline in the contribution to growth from net exports. In aggregate, output growth is projected to strengthen to 2 $^{1}/_{2}$ per cent in 1998-99.

… but strong wage growth poses a risk to sustained growth

On the output side, the risks seem to be evenly balanced. However, risks still attach to the evolution of inflation. The first wage agreements to be concluded in the 1998 wage round, covering manufacturing industries, signalled outcomes around 3-3 $^{1}/_{2}$ per cent. These agreements are based on an estimated contribution from wage drift of $^{1}/_{2}$-1 per cent, lower than anything seen during the past two decades. If the sheltered sectors, which traditionally do not have a significant wage drift and which are dominated by low-wage workers, were to incorporate a more historically-based wage-drift allowance in order to preserve wage relativities, together with a component reflecting higher increments to low-wage workers, the resulting aggregate wage growth would continue to be on the high side with respect to the inflation objective of the central bank. This could trigger a monetary policy response which would reinforce the labour shedding still taking place.

Switzerland

The Swiss economy continued to recover during the second half of 1997, led by strongly rising exports; but due to a negative carry-over, real GDP is estimated to have grown by only 0.7 per cent for the year. With the business climate and consumer confidence expected to improve further, and helped by easy monetary conditions, an economic upswing, supported by accelerating domestic demand, is projected for this year and next. Employment growth is likely to resume as from 1998, while the large output gap will keep price and wage inflation low.

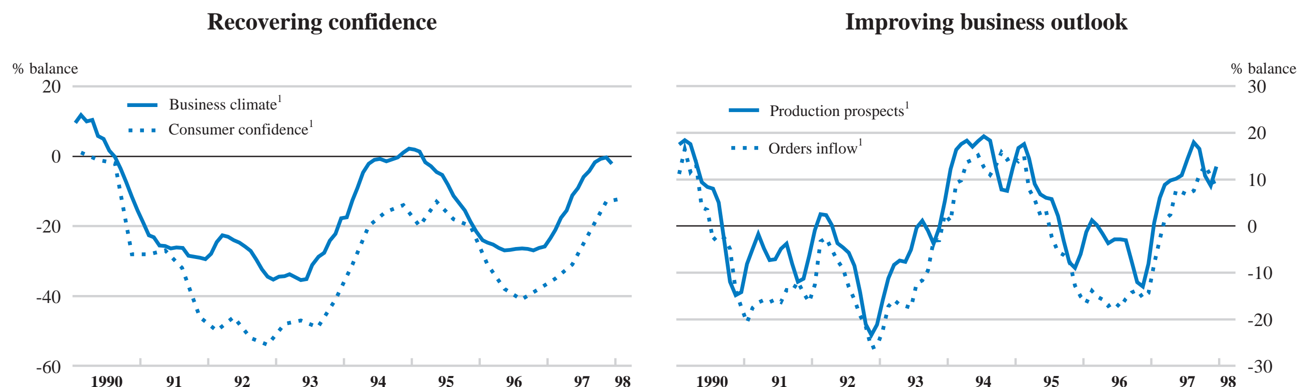
With the economic recovery still in its infancy, a premature firming of monetary conditions should be avoided. Federal budgetary policy should let the automatic stabilizers work in the short run while maintaining its objectives of reducing the deficit to under SF 1 billion by 2001 and maintaining a balanced budget over the business cycle thereafter. Sound macroeconomic policies should be complemented by further structural reforms such as opening infrastructure services up to competition and a comprehensive overhaul of the entire tax system.

The recovery from protracted stagnation is export-led

The pick-up of real GDP growth in the course of 1997 confirms that the economy is on the road to recovery from a seven-year period of broad stagnation. The upswing has been led by buoyant exports in response to strong growth of export markets and improved competitiveness, reflecting a reversal of earlier exchange rate appreciation. Private consumption held up surprisingly well, in line with improving consumer confidence throughout 1997, and in spite of rather flat real disposable household income. But total domestic demand remained subdued due to falling construction investment, reflecting excess supply of structures. And with a negative carry-over from 1996, real GDP grew by only 0.7 per cent for 1997 as a whole, further increasing an already large output gap. Starting from a depressed level, indicators of business climate and business expectations steadily improved throughout 1997, so far showing little impact of the Asia crisis and the renewed firming of the effective Swiss franc exchange rate since early 1997.

Employment has fallen further while prices have remained stable

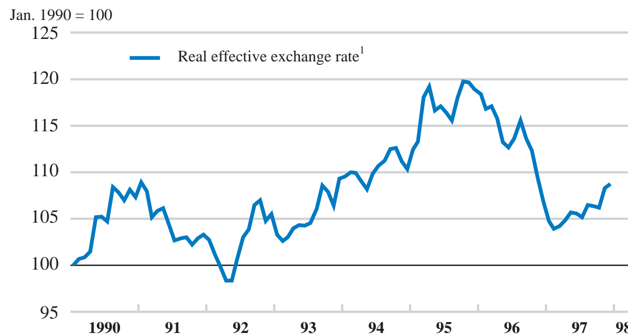
Employment – the number of full-time jobs in particular – continued to fall in 1997, although recently the decline seems to have come to a halt. Nevertheless, the rate of registered unemployment dropped from a peak of 5.7 per cent in early 1997



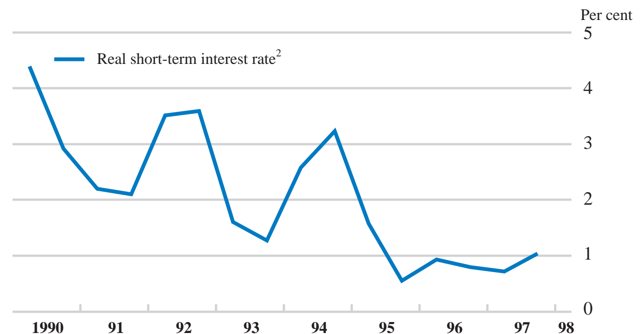
1. Balance of positive and negative responses.
Source: KOF/ETH, *Konjunktur.*

Switzerland

Restored competitiveness



Easier monetary conditions



1. CPI based.
2. 90-days Euro-Swiss franc rate deflated by the private consumption deflator.
Source: Banque Nationale Suisse, *Bulletin mensuel*.

to below 5 per cent in early 1998, as jobseekers progressively participated in newly introduced active labour market programmes, while many others ceased to be eligible for unemployment benefits. Accordingly, broader measures of job seekers do not reveal any reduction in labour market slack. In spite of a substantial pick-up in import prices in 1997 due to the decline of the effective exchange rate during 1996, consumer price inflation fell to an average rate of 0.5 per cent in 1997 and remained very low in early 1998.

Easy monetary conditions…

The decline in the real effective Swiss franc exchange rate from its peak in late 1995 remains a major factor underlying the projected cyclical upswing. It was helped by the shift of policy focus away from control of the narrow monetary base towards a more eclectic approach. But, in view of strong money supply growth and in line with developments in other European countries, the Swiss National Bank allowed the three-month euro-Swiss franc interest rate to edge up to just under 2 per cent in November, before it eased again. This seems to have accentuated the observed strengthening of the effective exchange rate during 1997, which is largely a reflection of the franc's appreciation *vis-à-vis* European currencies: against the Deutschemark the Swiss franc rose by some 7 per cent in the course of 1997 and remained strong in early 1998, which diminished the easiness of overall monetary conditions. However, the long-term bond rate remained stable at around 3$^1/_3$ per cent, before dropping to below 3 per cent in early 1998. In its latest year-end statement the Swiss National Bank announced that it does not envisage any tightening of monetary policy in 1998, given the favourable inflation outlook. Accordingly, the projection is based on interest rates remaining broadly at recent levels throughout 1998 and on stable short- and long-term Swiss franc-Deutschemark interest rate differentials thereafter, which implies some edging up of interest rates in 1999.

… and supportive fiscal policy…

The financial deficit of the Confederation is budgeted to rise by one-third to SF 7.6 billion (2 per cent of GDP) between 1997 and 1998. However, if adjusted for a one-off payment of the federal government to the national railways for financial restructuring, the projected deficit would remain roughly unchanged. With the finances of the social security system and the cantons deteriorating further, the general government deficit may attain some 3$^1/_2$ per cent of GDP in 1998 after 2$^1/_2$ per cent in 1997. Given the objective of bringing the Confederation's budget deficit down to SF 1 billion in the year 2001, a federal

Demand, output and prices

Percentage changes, volume (1990 prices)

	1994 current prices billion SF	1995	1996	1997	1998	1999
Private consumption	211.0	0.9	0.7	0.9	1.2	1.5
Government consumption	54.8	–0.8	0.7	–0.3	0.0	0.5
Gross fixed capital formation	78.7	1.9	–2.7	–1.5	1.9	5.0
Final domestic demand	344.4	0.9	–0.2	0.1	1.2	2.2
* stockbuilding	–3.6[a]	1.3	–0.1	–0.1	0.2	0.2
Total domestic demand	340.8	2.3	–0.2	0.1	1.4	2.5
Exports of goods and services	127.4	1.3	2.5	8.2	6.2	5.8
Imports of goods and services	111.0	5.4	2.4	6.7	6.3	7.4
* net exports	16.4[a]	–1.5	0.0	0.6	0.0	–0.7
GDP at market prices	357.2	0.8	–0.2	0.7	1.5	1.8
GDP deflator	–	1.3	0.0	0.1	0.5	1.2
Memorandum items						
Private consumption deflator	–	1.9	1.1	0.7	0.5	1.3
Industrial production	–	2.0	–0.1	3.5	4.0	4.5
Unemployment rate	–	4.2	4.7	5.2	4.5	4.1
Current account balance[b]	–	6.9	7.3	8.3	8.4	8.2

* 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.

savings package is scheduled to be implemented by mid-1999, targeted at expenditure cuts primarily in the areas of social welfare, transport and defence. The package is foreseen to bring the federal deficit down to about 1 per cent of GDP in 1999.

… are likely to promote a recovery of domestic demand…

While exports are projected to remain a major engine of the upswing, they are expected to decelerate somewhat this year and next as a result of some slowing of export market growth caused by the Asia crisis, and the firming of the Swiss franc exchange rate during 1997. Domestic demand is set to strengthen, with both business investment and private consumption gathering pace. Recovering employment should support household incomes and stimulate consumer confidence further. A weak spot in the picture remains the continuing contraction of construction investment this year, in spite of the Confederation's fiscal stimulation programme aimed at advancing infrastructure maintenance in 1998 and 1999; construction investment may turn around in 1999. With both the output gap and cyclical unemployment large, price and wage inflation should not be a problem. About $^1/_2$ percentage point of the expected increase in consumer price inflation in 1999 is attributable to the rise in the value-added tax (VAT) rate from 6.5 to 7.5 per cent at the beginning of the year. The projected employment gains will help to bring the headline unemployment rate down further.

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

The projections incorporate the federal government's objective to support economic activity in the short run but to return to balanced budgets in the medium term. This is assumed to result in an increase in general government expenditures by 3$^1/_2$ per cent in 1998 – 2$^1/_4$ per cent if adjusted for a one-off payment to the national railways – and lower growth thereafter. Government revenues are expected to rise by $^1/_2$ per cent in 1998 and to accelerate in 1999, when the VAT rate will be raised from 6.5 to 7.5 per cent.

… but exchange-rate related uncertainty persists

Changing sentiment in foreign exchange markets about the value of the Swiss franc and the consequent implications for the Swiss economy's international competitiveness remain a major uncertainty in the projections, together with the effects of the Asian crisis on the global economy. Another substantial uncertainty concerns the projection of construction investment and when it will bottom out.

Turkey

The Turkish economy recorded strong growth in 1997 for a third consecutive year, amidst a chronically high budget deficit and extreme inflation. The current account deficit may have been limited to 1 per cent of GDP; and foreign exchange reserves in early 1998 were a record $20 billion (around five months of imports). A gradual reduction is projected for economic growth and inflation, while the current account deficit may rise to 2 per cent of GDP in 1998.

The Government aims to reduce the budget deficit by 1 per cent of GDP in 1998 and to cut inflation to 65 per cent through tight monetary policy and a 6-month freeze on some public sector charges. With uncertainty about government borrowing reduced, a monetary programme was set for the first three months of 1998, and results have so far been encouraging. However, sustained inroads into deficits and inflation require vigorous reform of the deficit-ridden state pension system, continuing improvements in the taxation system, rapid privatisation, and restructuring of state economic enterprises.

The economic expansion continued in 1997 for the third consecutive year, while inflation accelerated into 3-digit levels

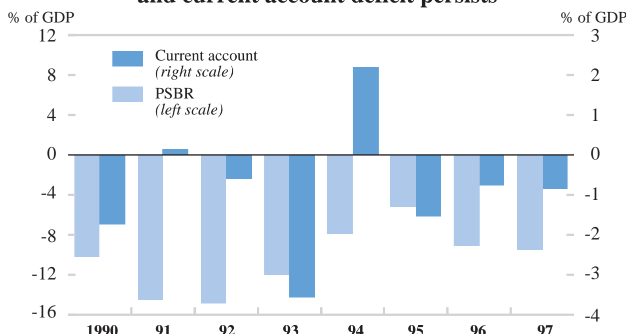
Since the financial crisis in 1994, economic activity has continued to expand at a brisk pace, though output growth began to moderate a little in the second half of 1997. Industrial output rose 10.8 per cent in 1997, and with a small drop in agricultural output, GDP growth was 6.3 per cent. Inflation, which had remained steady at around 75 per cent in the first half of 1997, accelerated to more than 100 per cent by the beginning of 1998. Aggregate expenditure remains buoyant and, to date, little affected by financial market turmoil in Asia. The stock market rose by 115 per cent in US dollar terms in 1997, despite a change in government and intense political uncertainty, and advanced erratically in early 1998.

External financing remains unconstrained

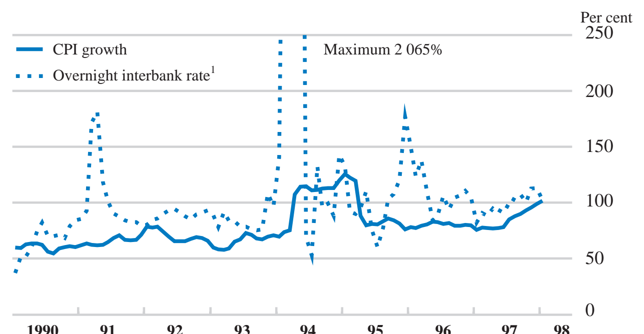
External developments remain benign. The current account deficit (including unrecorded trade) was surprisingly modest in 1997, reflecting strong tourism and steady export growth, as the Turkish lira was allowed to depreciate broadly in line with inflation differentials. External financing, though expensive, has posed no problems. Official off-shore borrowing totalled $2.6 billion in 1997, and a 5-year euro-Deutschemark bond was sold in January at 284 basis points over German Treuhand bonds. Short-term

Turkey

Public sector borrowing remains high and current account deficit persists



Inflation remains extremely high



1. At annual rates.
Source: State Planning Organisation.

Demand, output and prices

Percentage changes, volume (1987 prices)

	1994 current prices trillion TL	1995	1996	1997	1998	1999
Private consumption	2 706	5.8	9.1	6.0	6.0	5.5
Government consumption	451	6.8	7.7	4.5	4.5	4.0
Gross fixed capital formation	932	9.1	18.2	6.4	7.2	7.7
Final domestic demand	4 089	6.7	11.4	6.0	6.2	6.0
* stockbuilding	–121[a]	4.7	0.1	0.0	0.1	-0.1
Total domestic demand	3 968	11.7	11.4	6.0	6.3	5.9
Exports of goods and services	826	8.0	15.0	17.5	11.0	10.0
Imports of goods and services	789	29.6	29.6	13.4	12.0	11.3
* net exports	38[a]	–4.7	–4.5	–0.1	–1.2	–1.4
* Statistical discrepancy	–137[a]	0.3	–0.1	0.0	0.0	–0.1
GDP at market prices	3 868	7.2	7.2	6.3	5.5	5.0
GDP deflator	–	86.9	78.6	83.0	75.0	65.0
Memorandum items						
Private consumption deflator	–	91.0	74.1	80.5	75.0	65.0
Manufacturing production	–	8.7	6.8	9.5	7.5	6.5
Unemployment rate	–	6.9	6.0	5.7	5.6	5.6
Current account balance[b]	–	–1.5	–0.8	–0.9	–1.7	–2.2

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

foreign debt at end-1997 was $20 billion (around 10 per cent of GDP), of which about a half is related to trade financing.

The government targets slower growth and inflation in 1998 and a smaller budget deficit

The Government's 1998 budget assumes that GDP growth will slow to 3 per cent in 1998, and inflation will average 65 per cent (50 per cent by end-1998). The consolidated budget deficit is officially projected to fall by 1 per cent of GDP to 6.5 per cent, despite a 6-month freeze on public sector prices (which necessitates increased subsidies) and a tight monetary policy (which boosts interest costs). However, initiatives to reform the social security system and the tax system, which would generate additional revenues of more than 1 per cent of GDP, are pending parliamentary approval. Privatisation receipts are targeted at $10 billion (5 per cent of GDP).[1] Given uncertainty over the fiscal outlook, the Bank of Turkey's monetary programme for 1998, which targets the growth of reserve money, covered only the first three months of the year. Two-year bonds, indexed on the consumer price index, with real interest rates of 20 per cent are yielding 125 per cent at going rates of inflation, with overnight interbank rates close to 120 per cent.

Although increased privatisation receipts may reduce public borrowing, the budget deficit is likely to remain very high

There are signs that the Government's long-delayed privatisation programme may be gaining speed. Even though the official target will be difficult to achieve, the OECD Secretariat assumes that cumulatively some $4 to $5 billion in privatisation receipts may be achieved in 1998 and 1999. Assuming that a small primary budget surplus is realised, the budget deficit might rise in 1998 to 9.5 per cent of GDP (owing to a bulge in interest payments) and then drop back to 7 per cent of GDP in 1999. By

1. This includes the sale of 49 per cent of Telekom, $1 billion in GSM licences (both items were included in the previous year's budget) and $1.6 billion through the sale of seven regional electricity distribution networks.

contrast, the public sector borrowing requirement (including privatisation receipts) could drop to 7½ and 5½ per cent of GDP in 1998 and 1999 respectively.

Economic growth and inflation may exceed the Government's targets, and financial crisis remains a constant threat

On current policies, the Government's 1998 macroeconomic targets will be difficult to achieve, given the entrenched nature of inflation expectations. Private-sector expectations for output growth and inflation are substantially higher than official targets. The OECD Secretariat's projections are that economic growth will slow gradually towards its potential of 5 per cent in 1999, reflecting a small rise in the real exchange rate. The temporary freeze on public charges is expected to have little effect on underlying inflation. Inflation is projected to slow only modestly in the coming two years, dropping to around 65 per cent by 1999, while the current account deficit widens to around 2 per cent of GDP. The risks of another financial crisis and runaway inflation are ever present. The risks attached to these projections are thus large, as the economy's triple-digit inflation inspires scant investor confidence. Moreover, there is a risk that new elections could lead to a surge in government expenditures that would increase inflationary pressures. To date, Turkey has been little affected by Asian financial market turmoil, perhaps because short-term foreign debt is small and banks play such a minor role in financial intermediation (preferring to hold government bonds instead). Indeed, the economy may well continue to achieve high output growth, despite extreme inflation and high real interest rates. But financial market sentiment is notoriously fickle, and long delays in implementing key structural reforms are indeed a major reason why Turkish real interest rates are among the highest in the world, and capital flight a constant threat to financial stability.

FISCAL POLICY ASSUMPTIONS UNDERLYING THE PROJECTIONS

The OECD Secretariat's fiscal projections are based on the following technical assumptions: *i)* consolidated budget revenue excluding privatisation is assumed to rise to 20½ per cent of GDP in 1998-99; *ii)* consolidated primary spending is assumed to stabilize at around 19 per cent of GDP; *iii)* off-budget transfers (including transfers to social security funds and subsidies to other state-owned entities) are assumed to be 0.5 per cent of GDP in 1998 and 1999, assuming slow progress on tax and social security reform; *iv)* a primary budget surplus of 1 and 1½ per cent of GDP is assumed for 1998 and 1999; *v)* interest on the public debt is assumed to rise to 10.8 per cent in 1998, falling to 8.7 per cent of GDP in the following year. Partial privatisation of Telekom is assumed in the second half of 1998; privatisation receipts are assumed to rise from 0.6 per cent of GDP in 1997 to 2 and 1.5 per cent of GDP in 1998 and 1999, respectively.

III. DEVELOPMENTS IN SELECTED NON-MEMBER COUNTRIES*

Non-member countries have been affected in different ways by the financial turbulence spreading from Thailand to other emerging markets since mid-1997. In the Asian countries directly hit by the financial crisis, the combination of massive currency depreciations, balance sheet problems of the banking sector and restrictive credit conditions is exerting severe contractionary pressures on the real economy. Economic activity is also slowing down in other Asian countries, reflecting their trade linkages with the economies most severely affected by the crisis and the overall worsening of investor sentiment. In most of these countries, recovery may not begin before next year, and it could take longer in the most severe cases.

In Central and Eastern Europe, real activity has not been strongly affected by the developments in Asia. However, there has been increased financial market turbulence; in Russia, this has led to much higher interest rates and aggravated an already problematic fiscal situation. As for South America, following the region's best growth performance since the early 1970s, its vulnerability to external shocks has again been demonstrated in the wake of the instability in world financial markets. Macroeconomic policy is being tightened, particularly in Brazil, and economic growth is projected to slow in most countries in the region in 1998.

East Asia and China

Although the crisis has abated for now, overall prospects have worsened since the latter months of 1997

The severe pressures in foreign exchange markets that re-emerged in late 1997 have accentuated internal financial strains and the contractionary forces pressing on economic activity. The crisis has since been stabilized and contained, at least for now, and currencies regained in March some of the ground lost over the prior three months. Nevertheless, short-term interest rates remain high compared with a year ago and most equity markets are still depressed. Adverse terms of trade shifts, declines in private sector net worth, increases in the cost of capital, and, in the worst cases, a major credit crunch are exerting powerful downward pressures on domestic demand. Property prices have already fallen by nearly 30 per cent in Hong Kong, China and have also weakened in Malaysia, Thailand, and Singapore. Partly as a result, banks are experiencing financial strains that are likely to worsen as the economic downturns proceed.

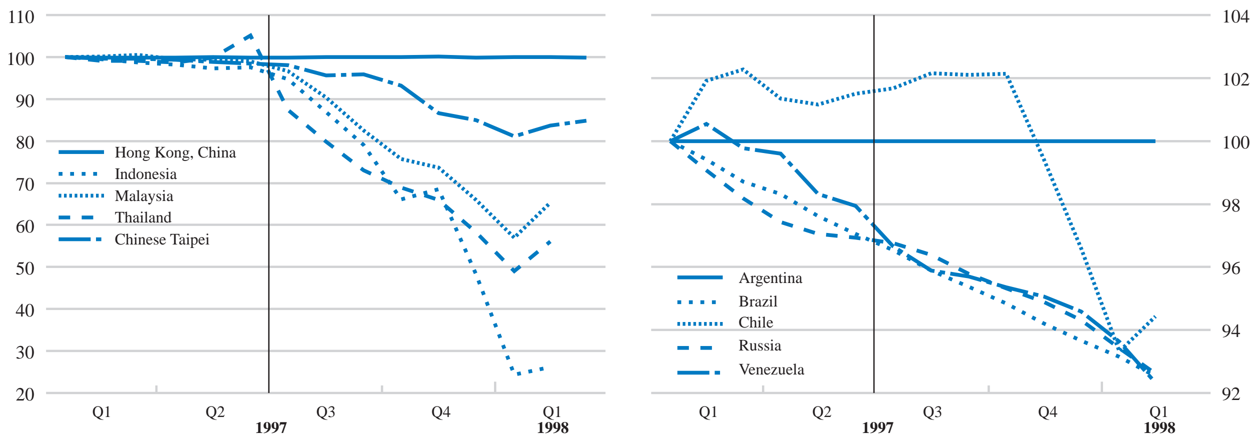
A marked slowdown in economic activity is under way…

A marked slowdown in economic activity is increasingly evident. In Thailand, industrial production fell sharply in the latter months of 1997, and by December was nearly 11 per cent below the level of a year earlier. Activity has also fallen precipitously in Indonesia, where corporations have been forced into a *de facto* moratorium on servicing of their external debt. Milder growth slowdowns are under way in Malaysia, the Philippines and Singapore (also members of the Association of South-East Asia Nations, or ASEAN) and in Hong Kong, China. The slowdown in domestic demand growth in China that began in the second half of last year is continuing while its exports,

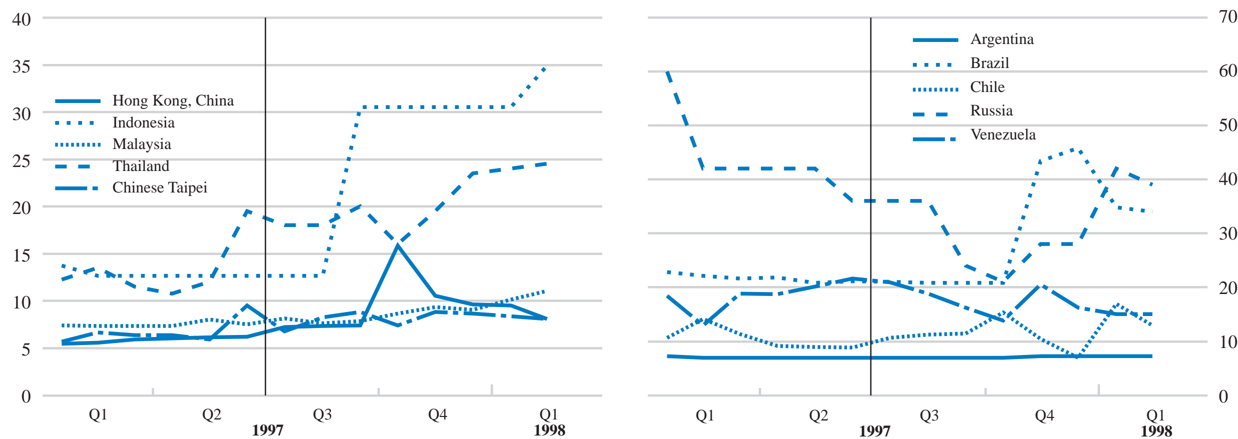
* This note focuses on developments in non-member economies in East Asia, Central and Eastern Europe, and Central and South America. The specific countries covered are listed in the tables in this section. The economies of Africa, the Middle East and India are not covered.

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

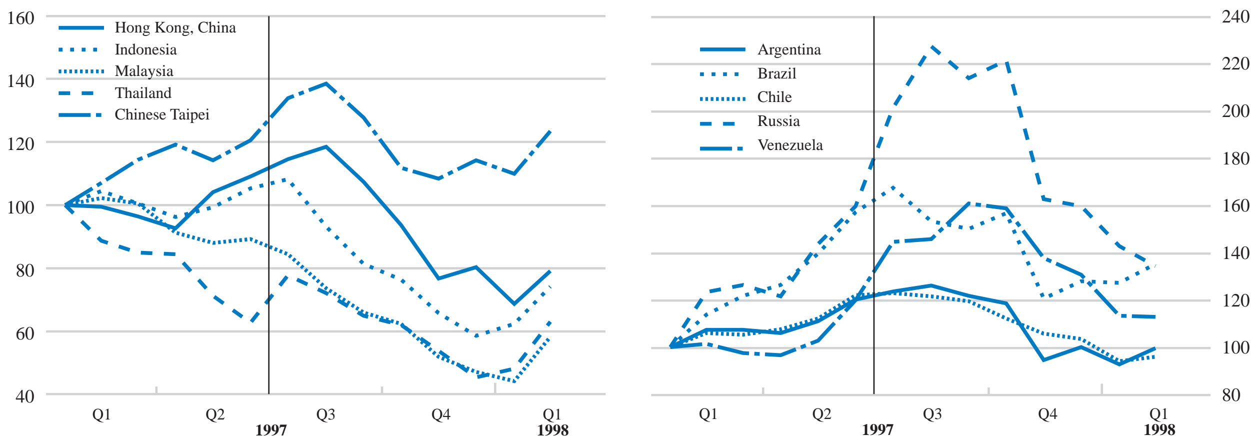
Most Asian currencies have weakened sharply, leading to pressures on other emerging markets



Authorities have raised short-term interest rates to counter currency pressures



Equity markets have been depressed by the crisis



Notes: Exchange rates are indexes of the dollar value of the foreign currency, with January 1997 = 100; short-term interest rates are representative 3-month money market rates; equity prices are standardly quoted indexes from the country stock exchange. The vertical line corresponds to the date of the devaluation of the Thai baht. Data are monthly.
Sources: The Economist and Bloomberg.

which were a major support to GDP growth last year, are being adversely affected by the downturns elsewhere in Asia. The inflationary pressures from the currency depreciations are also becoming manifest in many of the countries, especially in the most affected ones such as Indonesia and Thailand where consumer prices were up nearly 32 per cent and 9 per cent, respectively, in February compared with a year earlier. In particular, spiralling food prices are affecting the poorer segments of the population, which has sparked civil unrest in Indonesia.

… leading to falling imports, while exports have yet to be appreciably affected by the changes in competitiveness

The currency depreciations and their repercussions on domestic demand have already had a marked effect on trade accounts. A severe contraction of trade credit, along with a marked drop in business investment and spending on household durables, have led to a precipitous fall in imports in Thailand and Indonesia. Thus far, exports have been mainly affected by the slowdowns in regional activity and, in Indonesia and Thailand, by limits on financing. The effects of the improvement in competitiveness on the exports of the depreciating countries are not yet evident.

Extensive economic adjustments are necessary…

The repercussions of the financial turmoil on the economies of the region will continue for some time further. The economic downturns are likely to be severest in those countries where the depreciations have been greatest and where their effects have been reinforced by pre-existing weaknesses in the financial sector. Extensive adjustments will be required in the near term to stabilize the situation, restore confidence and so lay the basis for recovery to begin sometime in 1999. Monetary policy will have to be restrained for some time to prevent the inflationary pressures from the currency depreciations from becoming embedded. In the most seriously affected economies, the financial position of the banking system will have to be bolstered so that it can provide the financing needed to sustain a healthy recovery. All the countries of the region need to undertake extensive structural reforms to improve the functioning of the financial system and reduce distortions in the real economy; and in most such reform efforts are getting under way. The reforms are needed both to improve confidence in the near term and to prevent future crises. Fiscal authorities face an especially difficult challenge in this context: providing adequate social support during the downturn to sustain the consensus for reforms while maintaining sound public finances over the longer term.

… and will result in large swings in current account positions

Overall, the adjustments will produce a sizeable increase in the region's current account balance during 1998 and 1999, despite a substantial fall in the surplus of China. The surpluses of the ASEAN four (Indonesia, Malaysia, the Philippines and Thailand) are expected to rise markedly, reflecting a drop in investment relative to national saving that is likely to be at least partly reversed over the longer term. These countries will experience a sharp increase in export growth and gains in market share which, judging from past experience, could increase trade tensions and pressures for protectionist measures.

Indonesia faces a long adjustment before genuine recovery

The crisis in *Indonesia* originated in serious but not unique external imbalances and banking sector problems that were aggravated by its large short-term external debt. However the crisis has turned into a major depression as a result of the nearly 80 per cent depreciation of the currency *vis-à-vis* the dollar that took place between early November, 1997 and early January of this year. Doubts about the authorities' commitment to measures to address the crisis precipitated the currency collapse; and downward pressures re-emerged in mid-February following reports that the authorities were considering the adoption of a currency board. The precipitous rise in the burden of the external corporate debt resulting from currency depreciation has led to a virtual financial paralysis in the private sector comparable to that following banking

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

	1997	1998	1999
China			
Output	8.8	7.2	7.5
Domestic demand	6.7	7.2	7.7
Inflation	0.8	1.2	2.0
Current account balance ($ billion)	22.8	11.9	6.0
Current account balance (% of GDP)	2.5	1.2	0.6
Indonesia			
Output	4.7	–8.5	2.0
Domestic demand	6.0	–19.3	–1.0
Inflation	11.1	35.0	10.0
Current account balance ($ billion)	–5.8	5.0	8.7
Current account balance (% of GDP)	–2.8	6.5	9.9
Thailand			
Output	–0.4	–1.5	4.5
Domestic demand	–2.5	–11.5	2.5
Inflation	6.0	12.0	6.0
Current account balance ($ billion)	–3.6	7.0	8.5
Current account balance (% of GDP)	–2.2	5.2	5.7
Malaysia			
Output	7.8	1.4	3.5
Domestic demand	6.4	–6.0	–2.5
Inflation	2.7	7.5	3.8
Current account balance ($ billion)	–4.8	–0.4	4.5
Current account balance (% of GDP)	–5.1	–0.5	4.9
Philippines			
Output	5.1	1.8	4.0
Domestic demand	4.4	–2.0	2.5
Inflation	5.0	10.2	6.0
Current account balance ($ billion)	–4.2	–0.4	1.1
Current account balance (% of GDP)	–5.0	–0.7	1.4
Chinese Taipei			
Output	6.0	5.9	6.2
Domestic demand	6.8	5.0	5.8
Inflation	0.9	2.0	2.5
Current account balance ($ billion)	7.4	9.2	9.7
Current account balance (% of GDP)	2.6	3.5	3.5
Singapore			
Output	7.5	3.2	5.2
Domestic demand	8.0	3.5	4.2
Inflation	2.2	2.5	2.5
Current account balance ($ billion)	14.6	14.1	16.1
Current account balance (% of GDP)	14.9	15.4	16.6
Hong Kong, China			
Output	5.2	0.9	3.8
Domestic demand	7.7	1.5	3.5
Inflation	5.9	4.3	3.5
Current account balance ($ billion)	5.1	3.7	4.7
Current account balance (% of GDP)	3.0	2.1	2.5
***Memo.*: DAE**[b]			
Output	4.9	0.1	4.2
Domestic demand	5.1	–4.7	3.1
Current account balance ($ billion)	8.7	38.2	53.3

a) The figures for real output (GNP for China, GDP for the other countries) and real domestic demand growth are percentage changes from the previous period. Inflation is measured by the annual change in consumer prices, except for China where it is measured by the change in retail prices. 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: Indonesia; Hong Kong, China; Malaysia; the Philippines; Singapore; Chinese Taipei; and Thailand.

panics in the past. Restructuring of the external debt is highly complicated, and likely to take considerable time, given the diverse nature of the creditors. Defaults on loans to businesses are likely to more than wipe out the capital of the banking sector, which was already in a financially weakened position as a result of the crisis of the early 1990s. Experiences with past banking crises suggest that total public outlays to restore the financial system could reach 10 per cent or more of GDP. Given these circumstances, there is a need to restore confidence and stabilize the currency through the implementation of credible measures to re-establish financial viability and to correct long-standing structural problems that contributed to the crisis. Some steps have been taken to help restructure and recapitalise the banking system and to improve financial stability over the long term (see box). In early February, the authorities announced a draft bankruptcy law in an effort to improve the environment for foreign investment as well as deal with the immediate problems of the corporate sector. Under its stabilisation programme with the International Monetary Fund, the government has also agreed to reduce tariffs on raw materials and intermediate goods and to relax regulations in order to boost the efficiency of the real economy. Rigorous implementation of the financial and structural reforms is essential, both to prevent the crisis from re-emerging and to allow an eventual return to sustainable growth. However, given the depth of the financial and economic problems that now exist, the downturn is likely to be especially severe and prolonged without timely actions being taken by the authorities.

Prospects in Thailand for a recovery next year are somewhat better

Thailand's problems prior to the crisis were comparable to those of Indonesia; yet, thanks in part to prompt and vigorous policy actions, it has suffered less currency depreciation and its downturn should be less severe. Much adjustment in the external accounts has already occurred, mainly in imports. Domestic demand is likely to be further depressed by declining property prices as the previous speculative boom in real estate gives way to contraction. The banking system, with a large exposure to real estate, comparatively low capital ratios, and an already elevated level of non-performing loans, faces considerable losses. The prospects for a sustained recovery depend upon the authorities' ability to maintain the viability of the banking sector and to restrain growth in public spending. The authorities have moved fairly quickly to lay the basis for financial system restructuring and to allow greater participation of foreign institutions in domestic financial activities. The progress in these and other measures mandated under Thailand's stabilisation programme with the International Monetary Fund has already helped to bolster confidence. A return to sustained healthy growth will also require structural reforms to allow the real economy to benefit fully from its enhanced international competitiveness. The extensive privatisation programme recently announced should assist in this regard, and should help to finance outlays for the financial sector. Measures are also planned to boost productivity in the private sector by encouraging greater foreign participation and technology transfer and, to a lesser extent, to alleviate serious skill shortages in industry.

Deflationary pressures are likely to accumulate in Malaysia

Malaysia also faces serious risks. It has had a large current account deficit in relation to GDP; a property sector vulnerable to a serious contraction as a result of the speculative boom over the past several years; and financially exposed banks with capitalisation and problem-loan levels only moderately more favourable than those of Thailand. Partly because it is not as dependent on short-term external debt, Malaysia has not undergone a liquidity crisis of the sort experienced by Indonesia and Thailand. However, the fall in external demand from other Asian countries along with accumulating financial strains are likely to result in a significant slowdown in activity extending into next year. The extent to which the authorities are successful in taking advance measures to deal with the coming problems is likely to have an important bearing on the depth and duration of the contraction. The authorities have begun to cut

Box III.1. **Recent financial reforms in non-member Asian countries**

Thailand

- The newly-created Financial Sector Restructuring Agency (FRA) closed 56 of the 58 suspended finance companies; their assets are now in the process of being liquidated by auction.
- Bank supervisory authorities have announced a financial restructuring package which sets a target to raise prudential banking standards to international norms by the year 2000. Subsequently, criteria for further liquidity support by the Financial Institutions Development Fund (FIDF) has been strengthened, loan classification and provisioning rules have been tightened, and stricter banking licence requirements have been issued. The authorities have also announced plans to amend the bankruptcy law and to enact foreclosure laws this year.

Indonesia

- The Bank of Indonesia has undertaken to develop a comprehensive set of improved prudential requirements, with all locally incorporated banks to be subject to enhanced oversight.
- The authorities have announced a series of reforms to rehabilitate the banking sector, including the new policy that the government would guarantee all deposits and credit issued by domestic banks. Following the closure of 16 banks last November, the government announced plans to reduce the number of banks by drastically increasing paid-up capital requirements, which were expected to be met by accelerated mergers, the injection of additional capital by shareholders, or acquisitions by foreign and domestic investors. An Indonesian Bank Restructuring Agency (IBRA) has been established to consolidate and restructure all financially weak banks.

Malaysia

- The authorities have ordered banks to tighten standards for reporting bad loans, bolster provisions, and cease lending to non-performing borrowers – in addition to imposing a ceiling on overall credit expansion. The government has also set up a fund to support finance companies in difficulty, while the central bank is seeking to encourage mergers of weaker finance companies and banks with stronger partners.

Philippines

- The central bank required banks to set aside a general loan loss provision of 1 per cent by October this year, rising to 1.5 per cent next year, and 2 per cent by 2000.

China

- The government has allowed banks to determine interest rates on loans based on borrowers' ability to repay. It has also approved a US$32.5 billion special bond issue to recapitalise state banks.

Hong Kong, China

- The Hong Kong Monetary Authority has launched its first major review of its banking sector since the mid-1980s.

Singapore

- The authorities have accepted wide-ranging reform proposals in a bid to boost the competitiveness of its banking and financial sectors in the face of increasing competition. The reform package includes raising the amount of public funds placed with private asset managers, permitting public funds to invest in approved trusts, lifting controls on brokerage rates, encouraging bank mergers, and increasing bank disclosure towards the US level.

Chinese Taipei

- The government plans to sell off several major enterprises, including a few state-owned banks.

back on public spending and to limit aggregate credit growth, although they have allowed little increase in domestic interest rates. Measures are also being taken to address the problems of finance companies over the near term, and, for the longer term, to strengthen the financial system. In addition, the corporate tax rate has been reduced in order to improve the environment for foreign investment. Credible implementation of these measures should help to bolster confidence in the currency, which had been unsettled earlier by the authorities' threats to limit foreign currency transactions and the imposition, and removal shortly thereafter, of restrictions on stock market trading.

Growth will also slow in the Philippines despite somewhat better fundamentals

Due in part to measures taken in the wake of its debt problems during the 1980s, the *Philippines* is not suffering from the internal financial imbalances of some of the other ASEAN countries. In particular, the banking sector is relatively well capitalised, problem loans are comparatively low and the property sector has been fairly subdued. However, as with a number of Latin American countries, the Philippines' relatively high external debt ratio and large current account deficits – along with its record of past debt-financing problems – have made it vulnerable to the regional turmoil. The rise in interest rates to counter currency pressures along with the uncertainties engendered by the turmoil elsewhere in the region are likely to hit investment and slow overall real growth. Maintaining the confidence of domestic and foreign investors will be essential to contain the downturn. In this respect, continued progress on structural reforms, notably the tax reforms stipulated by the country's programme with the International Monetary Fund, and on the privatisation programme are quite important. The revenues from privatisation are also needed to offset the prospective drop in tax receipts, and so avoid a reversal of the progress made over the last several years in limiting public debt growth.

Singapore faces a growth recession from the downturns in its neighbours

Growth in *Singapore* is likely to be slowed by the effects of the higher interest rates it has had to maintain to contain pressures on its currency, as well as by several external shocks. These include: declining exports of construction services to Thailand and Malaysia; falling prices of computer disk drives (which make up nearly one-quarter of total exports); and the drop in activity in its financial services sector stemming from the regional crisis. Although banks' current financial positions are relatively strong, they are heavily exposed to the property sector and have outstanding loans to other troubled Asian countries amounting to about 18 per cent of their total assets. To maintain confidence and bolster the financial system as well as to sustain Singapore's competitiveness as a regional financial centre, the authorities have announced an extensive programme to improve prudential standards while increasing competition in financial markets.

China faces a difficult task in sustaining real growth this year…

The main near-term challenge for the authorities in *China* is to maintain growth in real GDP at a level sufficient to at least prevent unemployment from worsening much further. To offset the drag from the external sector, a significant boost will need to be given to consumer spending and capital investment, which have been depressed under the austerity drive that began in 1994. This task has become more difficult due to the marked decline in foreign direct inflows, much of which come from other Asian countries. With inflation contained, there is some room to ease monetary policy – although interest rates are already fairly low. In part to stimulate demand, the government plans to increase housing loans substantially and to embark on an ambitious three-year programme of infrastructure investment amounting to roughly $750 billion. However, the scope for net fiscal stimulus is limited by the overall budget deficit. Accordingly, it will be difficult to attain the authorities' official target of 8 per cent real GDP growth in 1998.

… and the difficulties are likely to increase without substantial progress in implementing structural reforms

Beyond this year, prospects for growth depend critically and increasingly on the government's success in reforming the state-owned enterprise (SOE) sector and repairing the badly weakened financial position of banks. Many of the highly-indebted SOEs are effectively bankrupt and overburdened with redundant workers. Although the SOE sector accounts for less than 20 per cent of GDP, it employs two-thirds of the urban labour force and provides essential social welfare functions for its work force. The planned downsizings, mergers and bankruptcies will involve massive layoffs and end cradle-to-grave welfare for tens of millions of workers. State banks have been channelling funds to the loss-making SOEs and are now burdened with mountains of non-performing debts. Restoration of bank financial positions along with extensive financial liberalisation are essential to keep up with the increasing dominance of market forces in the real economy. These problems pose a delicate balancing task for the authorities. The drag on demand from the structural problems is likely to gather momentum if reforms to address them are delayed or falter. However, unless growth is high enough to absorb the workers displaced, it will be difficult to sustain the social and political consensus necessary to carry the reforms through.

Hong Kong, China will be hit by the repercussions on its banks of falling property prices and the crises elsewhere in the region…

Although precipitated by currency pressures and aggravated by the regional downturn as well as declining activity in the financial sector, the downturn in *Hong Kong, China* largely stems from the contraction in real estate prices and its adverse effects on the banking sector. Banks, whose overall exposure to equity and real estate markets is on the order of one-third to one-half of their total lending, face a substantial increase in problem loans. However, the banks, with relatively high capital ratios for the region and low starting levels of non-performing loans, are in a relatively strong position to withstand the losses – thanks in no small part to earlier efforts by supervisory authorities to ensure that prudential standards were maintained. The authorities' most immediate challenge is to sustain and bolster the financial sector. Assuming they succeed, the economy should be in a position to stage a moderate recovery in 1999. However, there are serious downside risks, particularly if China were to devalue its currency or if bad loans to the property sector or to other Asian crisis countries turned out to be greater than now expected. Over the longer term, measures to alleviate the pressure on housing and land are important to prevent a recurrence of the boom-bust cycle in real estate.

… but Chinese Taipei has been virtually untouched

The apparent ability of *Chinese Taipei* to weather the regional crisis with little ill effect is traceable to its generally favourable internal and external fundamentals along with its past record of good economic performance. Internally, the banking sector is healthy and inflation subdued; externally, the current account has remained in surplus and the external debt ratio is quite low. These factors also make Chinese Taipei less vulnerable than its neighbours to a renewal of currency pressures. Its vulnerability to the likely growth slowdown in China, which takes about 12 per cent of exports, is also limited. However there are longer-term issues, notably fiscal consolidation and privatisation of the still substantial public enterprise sector. The government is committed to eliminate the public sector budget deficit, which was about 7 per cent of GDP in 1997, by the fiscal year 2000/01, while consolidating regional budgets with the national budget. The government also has accelerated plans to sell off several major enterprises, including Chinese Petroleum and several banks.

Russia and Central and Eastern Europe

Economic and social conditions are gradually improving in many parts of Russia…

In 1997, for the first time since the beginning of economic transition, the *Russian Federation* did not register a yearly decline in output. GDP growth in Russia was virtually flat for the year, estimated by preliminary figures at 0.4 per cent, while industrial production increased by 1.9 per cent. A number of branches of industry showed renewed signs of life in 1997, most notably machine-building and metals. Oil production did not decline, for the first time in many years. The long free fall in Russian light industry and food production may also be over, as outputs in those industries in 1997 remained close to 1996 levels. The turnaround in output has occurred in the context of continuing disinflation, with 12-month consumer price inflation declining to 11 per cent in December 1997. Several social indicators have also shown signs of improvement. Real disposable income increased by an estimated 3.5 per cent and the percentage of the population with (official) incomes below the poverty line declined slightly to 20 per cent. Although unemployment was increasing in early 1997, official statistics show a subsequent decline in the second half of the year, leaving the December figure essentially unchanged from the end of 1996. Fixed capital investment continues to decline, however. Russia's current account balance remains positive, but is projected to have weakened relative to 1996 on the basis of strong import growth in the second half of the year and a fall in the dollar value of exports. Lower oil prices should have an additional dampening impact on the current account in 1998.

… but difficulties remain with tax collection and wage arrears

Despite these encouraging developments, Russia made little progress in tackling its chronic fiscal problems in 1997. The general government deficit for 1997 is estimated to be close to 7 per cent of GDP. A further deterioration in tax collection in the autumn of 1997 induced the Ministry of Finance to resort again to the collection of taxes partly in the form of debt offsets, a practice that it had pledged to abandon in the early part of the year. This apparently contributed to an acceleration in tax collection in the fourth quarter of 1997. Cash receipts apparently improved further in the first quarter, but these gains may be jeopardised by falling oil prices and mounting pressures from the oil sector for tax exemptions. A major fiscal reform initiative of 1997, involving the drafting of a new comprehensive Tax Code, fell victim to political conflicts. As in the past, shortfalls in tax revenue were paralleled by a significant sequestration of federal budgeted expenditures. The accumulation of wage arrears, particularly in the state budgetary sector, continued to fuel social discontent during the year.

Russian financial markets have recently been turbulent…

The recent stabilization in output and inflation in Russia stands in sharp contrast to the volatility that has recently plagued Russian financial markets. A new reform mandate from the 1996 presidential elections, and the subsequent liberalisation of financial markets for foreign participation, helped to attract roughly US$18 billion in portfolio investment between 1 July 1996 and 1 July 1997, in contrast to about US$4 billion in foreign direct investment during the same period. Interest rates on state bonds fell dramatically to under 20 per cent (average annualised) from their extremely high mid-1996 levels, and average Russian stock prices almost tripled during the first half of 1997. But this euphoria proved short-lived. In the context of the mounting economic crisis in Asia, the deterioration of the fiscal situation, and heightened political conflicts in the government, Russian financial markets began to experience turbulence in late 1997 and early 1998, with stock prices plummeting, interest rates soaring, and capital flowing out of the country. A temporary lull between mid-December and mid-January, following announcements by the central bank of increases in basic interest rates and a more flexible exchange rate policy for 1998,

gave way to renewed instability in late January. The central bank was compelled to raise the refinance rate to 42 per cent at the end of the month. By this time, gross gold and foreign currency reserves had been depleted to less than US$16 billion, down from 24.5 billion in mid-1997. Renewed calm in the second half of February and March allowed authorities to reduce central interest rates back to 30 per cent.

... with higher interest rates adding to fiscal pressures and possibly slowing the development of the financial sector

The implications for the Russian economy of the current negative trends on financial markets are still unclear. Indeed, given chronic fiscal imbalances, the implied higher cost of government debt could be very problematic. Despite lower interest rates for most of 1997, interest payments on domestic debt still reached close to 5 per cent of GDP for the year. At higher interest rates, government debt could potentially spiral out of control, particularly if growth in the economy does not pick up and fiscal imbalances are not corrected in the near future. While the crisis also implies more limited access to external finance for a number of Russian firms, the already very low level of financial intermediation in Russia means that the immediate consequences for the real sector of the economy should be much less significant than, for example, in East Asia. At the same time, very high interest rates on state securities, which increase the attractiveness of government paper relative to corporate debt or equity, may have the effect

Table III.2. **Projections for European economies in transition and the Russian Federation**[a]

	1997	1998	1999
Bulgaria			
Output	– 7.5	3.0	6.0
Inflation	579.0	20.0	10.0
Unemployment	13.7	14.0	12.0
Budget balance (% of GDP)	– 2.8	– 3.0	– 3.0
Current account balance ($ billion)	0.5	0.4	0.3
Romania			
Output	-6.5	0.0	3.0
Inflation	151.0	40.0	25.0
Unemployment	9.0	10.0	10.0
Budget balance[b] (% of GDP)	– 3.5	– 3.5	– 3.0
Current account balance ($ billion)	– 2.0	– 2.0	– 2.0
Russia			
Output	0.4	2.0	4.0
Inflation	11.0	10.0	10.0
Unemployment	9.0	9.5	10.0
Budget balance (% of GDP)	– 6.9	– 5.0	– 5.0
Current account balance ($ billion)	4.0	1.0	0.0
Slovak Republic			
Output	6.5	4.0	4.0
Inflation	6.4	6.0	6.0
Unemployment	11.5	11.0	11.0
Budget balance (% of GDP)	– 3.3	– 2.5	– 2.0
Current account balance ($ billion)	– 1.4	– 1.3	– 1.3
Slovenia			
Output	3.2	3.5	3.5
Inflation	9.4	8.0	7.0
Unemployment	7.1	7.0	7.0
Budget balance (% of GDP)	– 1.5	– 1.0	– 1.0
Current account balance ($ billion)	– 0.1	– 0.2	– 0.2

a) Output data are average annual percentage changes of real GDP. Inflation data refer to end-year per cent changes in consumer prices. Unemployment definitions may differ significantly across countries; where available, survey-based estimates (by ILO definition) are used.
b) On an accrual basis and including refinancing from the Central Bank.

of delaying the development of institutions for effective financial intermediation in the future. For Russia, the most critical policy imperatives remain in the sphere of structural reform. These include comprehensive tax reform, essential for the improvement of tax collection, the rationalisation of state expenditures, the introduction of effective procedures for insolvency and bankruptcy, the development of fiscal federalism, and continued progress in large-scale privatisation. The future health of the Russian economy, and a revival of fixed capital investment, will depend greatly on progress in reform in these areas.

If structural reforms in Romania are firmly pursued, stabilization should continue and the output contraction should bottom out

Economic activity in *Romania* contracted sharply in 1997 under the impact of the stabilization and restructuring programme adopted at the end of 1996. Effective implementation of this programme is essential for the medium-term growth of the economy although, in the short-term, it inevitably generates social and political tensions. There is a range of potential positive and negative influences on the outlook for 1998 and 1999. The 1997 budget targets were reached, and a slightly lower deficit is projected for 1998. Inflation, however, remains high and volatile on a monthly basis, although recent developments reflect in part changes in indirect taxes. The supply side of the economy, including the large agricultural sector, should benefit from price liberalisation and other microeconomic reforms. The legislative and economic climate for foreign investment has improved, and exports should pick up as market growth improves. However, there are important downside risks. The restructuring programme, including privatisation or liquidation of large state-owned enterprises, has been moving ahead more slowly than originally intended. As a result, the fall in employment and output in sectors undergoing restructuring is far from over. Arrears and bad debts are still at high levels, adding to the fragility of the banking sector. The GDP projections are that positive and negative influences on the economy broadly balance out in 1998, leading to a moderate rebound in 1999.

On-going progress with stabilization and restructuring in Bulgaria should allow moderate growth to resume

Although output, investment, and trade volumes continued to decline in 1997, the *Bulgarian* economy has improved even beyond most expectations. Since mid-1997, a currency board has pegged the Bulgarian lev to the DM. The restoration of confidence in the government and the currency has been reflected in a much higher domestic and international demand for lev-denominated assets. In this context, between 1 July 1997 and 1 February 1998, the foreign exchange assets of the currency board more than doubled to over DM4 billion and interest rates on government paper have actually fallen to levels close to those on German treasury bonds. At the same time, average monthly inflation remained above 2 per cent. Lower-than-expected interest rates and improved tax collection helped to reduce the consolidated budget deficit to an estimated 2.8 per cent of GDP, less than half of its planned size. In the context of rapid progress in stabilization, the Bulgarian government has also been attempting to press the pace of structural reforms to ensure the robustness of the future economic recovery. The pace of privatisation and the volume of foreign direct investment have increased notably. Bulgaria should experience moderate economic growth in 1998, while the sustainability of the recovery will depend on further success in structural reform.

Strong growth continues in Slovakia, although concerns remain about the current account deficit and the banking sector

GDP in *Slovakia* grew by 6.5 per cent in 1997, supported by increasing household consumption and public fixed investment. Consumer inflation has been running at 6 to 7 per cent, and unemployment has been stable at just over 11 per cent. The current account deficit declined from 10 per cent of GDP in 1996 to around 7 per cent in 1997, driven by increased exports and a sharp slowdown in imports, although this deficit is still the main source of concern in the macroeconomic outlook. The firm monetary stance of the central bank has been the key element supporting the Slovak

Table III.3. **Ukraine and the Baltic states: key economic indicators**[a]

	1995	1996	1997
Ukraine			
Output	–12.0	–10.0	–3.2
Inflation	181.0	40.0	10.0
Unemployment	1.0	2.0	2.5
Budget balance (% of GDP)	–5.0	–4.0	–6.0
Current account balance ($ billion)	–1.3	–1.0	–1.4
Estonia			
Output	4.3	4.0	9.0
Inflation	28.9	14.8	12.5
Unemployment	5.0	5.5	4.6
Budget balance (% of GDP)	–0.9	–1.5	–0.2
Current account balance ($ billion)	–0.2	–0.4	–0.4
Latvia			
Output	–0.8	2.8	6.0
Inflation	23.1	13.1	7.0
Unemployment	6.6	7.2	6.7
Budget balance (% of GDP)	–2.9	–1.2	0.0
Current account balance ($ billion)	–0.2	–0.4	–0.4
Lithuania			
Output	3.0	4.2	6.0
Inflation	35.7	13.1	8.4
Unemployment	7.3	6.2	6.3
Budget balance (% of GDP)	–1.8	–2.5	–1.2
Current account balance ($ billion)	–0.6	–0.7	–0.8

a) Output data are average annual percentage changes of real GDP. Inflation data refer to end-year per cent changes in consumer prices. Unemployment rates refer to official registration data.

crown against regional and international financial turbulence. Fiscal restraint and further improvements in the current account during 1998 should contribute to some easing in domestic interest rates. Real interest rates are currently very high, increasing the costs of much needed restructuring. One of the major banks was placed under direct central bank supervision at end-1997, raising concerns about the financial health of the banking sector as a whole. The prospects of substantial reforms of this sector and other parts of the economy may be even more uncertain in the context of the 1998 election period.

Macroeconomic conditions have been stable in Slovenia, but there is need for further structural reforms

Economic activity has been stable in *Slovenia*, with the 1997 levels of GDP growth, inflation, unemployment and the current account little changed from 1996. The public deficit widened to over 1 per cent of GDP from a previously balanced position, under pressures of public sector wages and social expenditures. Exports grew in real terms by almost 8 per cent in 1997 but imports also picked up, so that the current account was slightly in deficit. Inflows of foreign direct investment increased significantly last year and this trend is expected to continue in the perspective of the EU accession process. The outlook for 1998-99 is for a generally steady macroeconomic picture. However, further restructuring of banks and large enterprises, especially those under state ownership, is needed to ensure that the microeconomic conditions supporting growth remain favourable.

While the output contraction in Ukraine is slowing, financial market uncertainty and delays in restructuring may impair recovery

Output in *Ukraine* continued to contract in 1997 by a currently estimated 3.2 per cent. But signs of life in certain branches of industry, such as ferrous metals and fuels, as well as a vibrant informal sector, indicate that output may be close to turning around. Consumer price inflation continued to fall, reaching a record low of 10.1 per cent in December 1997 in the context of restrictive monetary policy. A widening budget

deficit and delays in structural reforms have plagued the economy, however, and prompted the International Monetary Fund and World Bank to withhold disbursement of several loan facilities. As in Russia, beginning in the second half of 1997, Ukrainian financial markets have been experiencing some turbulence, although the estimated US$700 million in short-term capital inflows in the first half of 1997 do not compare with the magnitudes received by Russia. Nevertheless, the combination of poorly-developed financial markets, fiscal imbalances, and uncertainty over the future course of reform has made Ukraine potentially vulnerable to financial volatility. As in Russia, authorities have been raising interest rates and drawing down reserves in the process of defending the currency in recent months.

Growth has strengthened and inflation declined in the Baltic countries, but current account deficits remain high

The growth of the *Baltic* economies accelerated markedly in 1997, to 9 per cent in Estonia and around 6 per cent in Latvia and Lithuania. Stringent monetary and fiscal policies contributed to a further slow-down of annual inflation, which in December registered 7.0 per cent in Latvia, 8.4 per cent in Lithuania, and 12.5 per cent in Estonia. However, despite relatively strong export performance, these countries incurred current account deficits on the order of 8 to 10 per cent of GDP in 1997. Even though these deficits were partly compensated by a pickup in foreign direct investment, the economies of the Baltics remain potentially vulnerable to volatile short-term capital flows. In fact, Estonia, Latvia, and Lithuania have felt some effects of the turbulence on international financial markets since the third quarter of 1997, but have so far managed to weather the storm quite well.

South America

1997 was a record year for growth…

In 1997, GDP growth in South America averaged 5 per cent, approaching the rates recorded before the first oil crisis. While the current account deficit of the region has widened considerably, unprecedented capital inflows have easily covered this gap. Real GDP growth was especially strong in Argentina, Peru and, as in all years since the mid-1980s, Chile. In all these countries, prudent fiscal policies and declining inflation have assisted the take-off of investment, although the related rise in imports of capital goods has aggravated trade imbalances. Venezuela has started recovering from the 1996 recession, as high inflationary pressures are slowly receding, banks' balance sheets are improving, and the privatisation programme is finally gaining momentum. The Colombian economy, on the other hand, rebounded from the mild slump of the first quarter, with growth accelerating well beyond 5 per cent at year-end, partly on account of the reversal of the appreciation of the peso.

… but Brazil is now experiencing a marked slowdown

Problems in finding the right balance between fiscal and monetary policies, on the other hand, have impaired higher growth in *Brazil*, which accounts for two-thirds of the region's GDP. During the first half of last year, the Brazilian economy benefited from renewed confidence on the part of domestic consumers and foreign investors, as further progress on the inflation side was matched by a more resolute tackling of structural reforms, most notably the acceleration of privatisation and concession awarding. Despite higher tax receipts and larger contributions from state-owned enterprises, however, the fiscal situation was not showing signs of improvement at mid-year, when international investment sentiment about emerging markets started deteriorating. In the fall, with the current account deficit continuing to deteriorate and markets conveying

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

	1997	1998	1999
Argentina			
Output	8.4	4.0	4.0
Inflation	0.5	0.5	0.5
Budget balance (% GDP)	–1.2	–1.0	–1.0
Current account balance (% GDP)	–3.5	–4.0	–4.0
Current account balance ($ billion)	–9.5	–14.0	–14.5
Brazil			
Output	3.0	1.0	3.0
Inflation	6.1	3.2	3.0
Budget balance (% GDP)	–5.9	–4.0	–3.0
Current account balance (% GDP)	–4.2	–3.0	–3.5
Current account balance ($ billion)	–33.8	–25.0	–27.0
Chile			
Output	7.1	5.0	4.0
Inflation	6.2	5.1	4.0
Budget balance[b] (% GDP)	1.0	1.0	1.0
Current account balance (% GDP)	–5.5	–6.0	–4.0
Current account balance ($ billion)	–4.0	–5.3	–4.0
Colombia			
Output	3.2	4.0	4.0
Inflation	18.5	16.0	15.0
Budget balance (% GDP)	–4.5	–4.5	–4.0
Current account balance (% GDP)	–6.5	–6.3	–5.8
Current account balance ($ billion)	–6.2	–6.0	–5.4
Peru			
Output	7.4	4.0	5.0
Inflation	8.5	6.0	5.0
Budget balance (% GDP)	–1.2	–2.2	–2.2
Current account balance (% GDP)	–5.2	–6.0	–6.0
Current account balance ($ billion)	–3.4	–3.9	–4.0
Venezuela			
Output	5.1	3.5	4.5
Inflation	53.6	31.0	22.0
Budget balance[c] (% GDP)	0.3	–3.5	–2.0
Current account balance (% GDP)	6.0	–0.5	2.0
Current account balance ($ billion)	5.4	–0.4	1.8

a) The figures for output (GDP) and inflation (based on consumer prices) are percentage changes from previous year.
b) Overall balance adjusted for the operation of the Copper Stabilization Fund.
c) Overall balance includes assistance to banks and transfers to central government from the oil sector.
Sources: United Nations Economic Commission for Latin American and the Caribbean, *Preliminary Overview of the Economy of Latin America and the Caribbean 1997*; national sources, and OECD.

clear signals that the currency was vulnerable, Brazilian authorities reacted decisively, first by raising policy-controlled interest rates to very high levels, then by announcing a vast array of restrictive fiscal measures, to the tune of 2 per cent of GDP.

Following a tightening late in the year, the Brazilian economy is adjusting…

In Brazil, the adjustment to these measures is already visible, especially in credit-sensitive sectors, such as cars and other consumer durables, where domestic production shrank in the last quarter of 1997. It is still difficult to read too much from trade data, although the growth rate of imports seems to have stabilized below that of exports and the strong 1997/98 harvest is going to shore up export earnings in the coming quarters. The Brazilian parliament has also approved, at least in a first reading, important structural reforms. The new labour law introduces temporary contracts; the social security reform raises the minimum retirement age and years of contribution and tightens eligibility conditions for a number of special regimes; and the administrative

reform introduces a salary cap for all civil servants and makes it possible to fire unperforming and redundant civil servants. Pressures on Brazil have correspondingly abated. Since the beginning of the year, cuts in the key policy rate have gone beyond market expectations, as the central bank signalled its reasonable comfort with the international environment and domestic developments. Fiscal results at decentralised levels of government, however, are still far from balance, and improvements are unlikely before the October elections.

… cooling off the Argentine economy

Given the large increase in the country's current account deficit, *Argentina* also suffered in late 1997, as investors' concerns with the fate of the monetary regime of Hong Kong, China, put into question the sustainability of the currency board system. In Argentina, the increasing cost of consumer credit and the contraction of Brazilian demand has brought about some slowdown in economic activity. Nonetheless, with domestic demand remaining brisk, the agreement reached with the International Monetary Fund in early 1998 includes a trigger clause requiring prompt policy action if external imbalances exceed certain thresholds. Unemployment data may deteriorate again after the slight improvement recorded in 1997, making it all the more necessary to implement the labour reforms currently under consideration. The government is also taking action to fight tax evasion.

In the rest of South America the effects of the Asian turbulence are milder…

For other countries the prospects for 1998 are moderately good, though not without risk since their financial markets have also felt the negative consequences of the turbulence in Asia. In *Chile*, the currency slide has been significant, prompting the central bank to raise interest rates twice in the first two months of the year. The peso's depreciation, however, is unlikely to feed strongly into prices, given the authorities' strong commitment to the inflation target and a slowdown of growth caused by falling export prices and volumes. Substantial long-term overseas financing, including sizeable unrecorded capital transactions, and a high level of international reserves should reduce *Colombia*'s vulnerability to a currency crisis, despite a big current account shortfall. There, as in *Peru*, negative consequences of *El Niño* and lower commodity prices will not offset the positive growth contribution of the weaker currency on non-traditional exports, and last year's good performance is unlikely to lose momentum. Faced with the possible derailment from the goal of reducing inflation, *Venezuelan* authorities have also raised interest rates to defend the bolivar. Policy management, however, is made difficult by declining oil prices, which are reducing export earnings as well as fiscal revenues.

… though projections are contingent on a stabilization of investor sentiment towards emerging markets

Given available information on economic activity since the financial turmoil of late 1997 and plausible hypotheses on the international economic situation, South America is poised for a marked deceleration of growth in 1998, possibly with a mild recession in Brazil in the first half of the year. In this context, the current account deficit will decrease, although still hovering around $50 billion. Financing is expected to be largely met by long-term foreign investment, lured by privatisation, mainly in Brazil, Colombia, and Venezuela, and by the continuing decline of inflation. At this stage, the major downside risk relates to a worsening of the Asian financial crisis. In that case, the determination of Brazilian authorities to defend their currency would be tested again. Abandoning the Real plan could shatter confidence in the whole region, bringing about a steep rise of risk premia, while, in an economy still relatively closed like Brazil's, the possible increase of price competitiveness would be unlikely to compensate for the plunge in domestic demand. On the other hand, a further tightening of Brazil's monetary and fiscal policies and the inevitably much steeper recession could cause rising urban unemployment, especially in the São Paulo area, leading to social and political unrest. In such a scenario, growth prospects could become uncomfortably gloomy in Argentina, given increased interdependence between the two countries.

IV. FORCES SHAPING TAX POLICY

Taxation, public spending, budget deficits and debt all rose faster than GDP in virtually all OECD countries over the past 30 years. On the other hand, the fiscal outlook has improved in several countries with significant tax reforms in the past 15 or 20 years and reductions in deficits (at least in relation to GDP) in the past 10 years. Nevertheless, challenges remain and this chapter focuses on four forces that are likely to shape taxation policy in the years ahead: pressures on expenditures that, if undertaken, would have to be financed either through increased taxes or redeployment of existing revenues; the need to limit and reduce further the adverse economic effects of the distortions caused by historically high tax burdens; erosion of tax bases which has intensified as tax rates have increased; and, as an important special case of tax-base erosion, the threat posed by the increasing geographical mobility of tax bases. Of course, all of these factors have already had significant effects.

Most of the growth in public outlays over the past 30 years has been social spending – both transfers to households and social programmes. There will be pressure in coming years to raise social spending further. Technology and, perhaps, globalisation are tending to increase income inequalities, increasing demands for more extensive income redistribution. In addition, population ageing will, in the absence of reforms, raise public spending on pensions and health care. Thus, other ways will have to be found to contain social spending, or further increases in tax revenues will be needed.

But taxation appears to be increasingly constrained. Past increases in taxes have raised distortionary costs, despite the tax reforms that have been put in place. These reforms have tended to shift marginal taxation from capital and high incomes toward labour and low incomes. Although overall incentives have probably improved as a result, high labour-tax wedges and implicit marginal tax rates at the low end have been blamed for high levels of structural unemployment and low labour-force participation in many countries. Reforms in these areas would be welcome, but could be costly in terms of lost revenue. It is unclear how much more other taxes can be raised without imposing unacceptable economic costs.

There is also increasing concern that high tax rates are undermining tax bases, thereby restricting revenues. To some extent, legal tax avoidance can be reduced by closing loopholes and illegal tax evasion can be contained by better enforcement of tax codes. But the root of the problem appears in many cases to be high tax rates.

Institutional and economic developments have interacted with high tax rates to create a worrying tendency for some tax bases to migrate to low-tax jurisdictions. Such developments include reduced transportation, communication and transaction costs and the consequent increase in the globalisation of markets. Although globalisation has raised overall economic prosperity, it has also made the taxation of certain types of income increasingly difficult. Although there is no evidence that major tax bases – personal and corporate income taxes, and consumption taxes – have begun to collapse, it is almost certain that past trends in this area will continue and the effects on tax bases may therefore intensify.

Pressures on public expenditures

Public expenditures have risen faster than output

Since 1960, general government expenditures in the OECD area as a whole have risen from 30 to nearly 50 per cent of GDP. A little more than half of this in crease of some 20 percentage points was accounted for by transfers, with the rest being divided between government consumption – purchases of goods and services and, in particular, public employment – and interest payments on the national debt, which accumulated in many countries as a result of chronic budget deficits. By 1995, overall social spending (transfers plus other social programmes) was equivalent to one-quarter of average OECD GDP and explained virtually all of the variation in overall public spending across OECD countries.

Social expenditures have accounted for most of this

For the OECD as a whole, about two-thirds of social spending is accounted for by health and pension programmes. In terms of changes over the past 15 years, country experiences differ significantly. Pension outlays have increased in most countries due to the maturing of pension plans; in some countries increases in health-care costs pushed up outlays for this item; and in several, mainly European countries, unemployment insurance and assistance benefits have increased substantially, largely reflecting increased structural unemployment.

These large social-spending programmes have to be judged successful in important respects. For example, at least in the limited group of OECD countries for which data are available, transfers and taxes have clearly reduced income inequality and poverty rates, in that both are substantially lower in terms of income after taxes have been paid and transfers received than before (Burniaux *et al.,* 1998). Public pension plans have been particularly successful in increasing the incomes and reducing poverty of the old. And the expansion of public responsibility for health-care financing has improved access to health care, and thus well-being, for many.

At the same time, however, inequalities of disposable income have not generally narrowed since the 1980s. One interpretation of this is that the expansion of taxes and transfers offset increasing inequalities in terms of market income (that is, before transfers are received and taxes are paid). But it is also possible that the expansion of taxes and transfers itself contributed to increasing inequalities of market incomes. Taxes at the low end of the distribution (which, as will be shown below, have tended to increase) have been shifted back to wages, and rising tax and transfer wedges have discouraged firms from offering employment and individuals from taking it, reduced employment and increased inequality.

Pressures to raise social spending will increase in the future

All these factors are likely to persist and even intensify in the future. Lower birth rates, increased longevity and a marked tendency towards earlier retirement will result in sharply rising ratios of retired people to working people in the next century. This development will have many economic and social effects, among which will be upward pressure on public expenditures on old-age pensions and health care. Indeed, in the absence of profound reforms to pension systems, the result is likely to be unsustainable fiscal positions in many OECD countries (OECD, forthcoming).

This pressure on outlays will occur when the labour-tax base will be growing only slowly or, in some countries, shrinking. Increasing tax rates on labour to compensate would only aggravate labour-market distortions, resulting in lower take-home wages or higher unemployment. If higher tax wedges were to increase unemployment, the tax

base would be further eroded and outlays on unemployment compensation and other social programmes could rise. The adverse effect of rising unemployment on public finances is illustrated by simulations of the OECD's INTERLINK model of the fiscal deterioration resulting from the historical increase of structural unemployment in several OECD countries (from an arbitrary 6 per cent) to the levels that prevailed in 1996 (Table IV.1). Indeed, recognition of the high economic and social costs of labour-market distortions has led to increasing emphasis on employment creation, which, as the *OECD Jobs Study* (1997) emphasised, includes the reform of transfer programmes to improve incentives, as well as other important measures.

Table IV.1. **The budgetary impact of a rise in the structural unemployment rate from 6 per cent**

	General government financial balances[1] (per cent of GDP)		Memorandum item:
	Balance if unemployment were 6 per cent	Actual balance in 1996	Structural unemployment in 1996 (per cent of labour force)
Germany	–0.9	–3.4	9.6
France	–1.5	–4.0	10.2
Italy	–2.6	–6.7	10.6
Belgium	1.4	–3.2	11.7
Denmark	1.6	–0.9	9.1
Finland	3.6	–3.4	14.7
Ireland	3.1	–0.9	11.7
Spain	8.2	–4.7	20.3
Sweden	–2.6	–3.5	7.0

1. Assuming real interest rates and labour efficiency are not affected by a fall in structural unemployment.
Source: Derived from INTERLINK model simulations.

High taxes and economic distortions

High taxes to pay for rising expenditures distort economic activity

Taxes rose along with expenditures over the past 30 years, although not quite as much in most countries because of a tendency to resort to debt financing. It is difficult to reliably estimate the net economic costs of these higher taxes. The dead-weight cost of taxation has been analytically and empirically explored, but there tends to be little cross-country comparability in studies. Even in the same country, estimates can vary by large margins. To take one example, recent estimates of the net cost of raising an extra kroner of income tax in Norway varies between 10 (Holmoy, 1997) and 50 (Vennemo, 1993) per cent. In addition to their sensitivity to modelling methods, such estimates depend critically on demand and supply elasticities, in particular on the supply elasticity of labour. Unfortunately, there is lack of consensus on the empirical value of these crucial parameters.

In the aggregate, to the extent that high levels of government taxing and spending are an economic burden, they should be negatively related to economic performance. For the OECD area, the evidence, though somewhat mixed, suggests a connection between a large government sector – as measured, for example, by expenditures or taxes as a per cent of GDP – and lower economic growth (Leibfritz, *et al.*, 1997). But in general, the effect of the public sector on economic performance is difficult to assess. On the one

hand, the government can adversely affect the allocation of resources and economic performance in ways other than taxing and spending. For example, regulation can also impose dead-weight costs. On the other hand, some government spending would be expected to enhance growth. In particular, infrastructure investment can provide externalities which increase private-sector productivity, and in all OECD countries public education systems are instrumental in building human capital. Thus, aggregate comparisons across countries must be interpreted with considerable caution.

Important reforms have improved the efficiency of tax systems...

Since about 1980, important tax reforms have been implemented in most OECD countries.[1] Personal income-tax schedules of central governments generally became flatter (Table IV.2, first column). Reductions in top marginal rates were often accompanied by base broadening, including limiting exemptions and taxing fringe benefits. This flattening tended to result in convergence of statutory tax rates across countries: between 1986 and 1997 the range (maximum rate minus minimum rate) fell by about 2 percentage points.

Table IV.2. **Trends in central-government statutory tax rates**

Change in percentage points: 1986 to 1997

	Top marginal rate of personal income tax	Basic rate of corporate income tax
United States	–10.4	–11.0
Japan	–20.0	–5.5
Germany	. .	–11.0
France	–11.0	–11.7
Italy	–11.0	0.0
United Kingdom	–20.0	–2.0
Canada	–2.7	–7.0
Australia	–10.0	–13.0
Austria	–12.0	–16.0
Belgium	–15.3	–6.0
Denmark	–14.0	–16.0
Finland	–13.0	–5.0
Greece	–23.0	–9.0
Iceland	–3.1	–18.0
Ireland	–10.0	–12.0
Luxembourg	–7.0	–7.0
Mexico	–15.0	–5.2
Netherlands	–12.0	–7.0
New Zealand	–24.0	–12.0
Norway	–16.5	–7.3
Portugal	. .	–6.0
Spain	–10.0	0.0
Sweden	–25.0	–24.0
Switzerland	–1.5	. .
Turkey	5.0	–21.0
Average[1]	–12.4	–10.3
Range	–1.5	–9.8
Standard deviation	0.0	–2.8

1. Unweighted average. Excludes Germany, Portugal and Switzerland.
Source: Owens and Whitehouse (1996) *Emerging Issues in Taxing Business in a Global Economy; The OECD Tax Data Base (1997);* 1986 data for Mexico and 1997 data for Denmark are from national sources.

Basic statutory corporate income-tax rates also fell in nearly all countries (Table IV.2, second column). Base broadening was extensive as incentives, which had often favoured investment in plant and equipment, were limited in many countries. As

1. This historical discussion draws heavily on Owens and Whitehouse (1996).

a result, there was a significant reduction in variations in the taxation of different types of physical capital (Chennells and Griffith, 1997). There was also significant convergence of central-government corporate tax rates across OECD countries. Despite this convergence of statutory rates, however, corporate tax systems still vary markedly in terms of the average, or *ex post*, tax rates they impose and the revenues they generate.[2] *Ex post* corporate tax rates (total corporate taxes paid divided by pre-tax corporate profits) vary from nearly 50 per cent in Japan, Italy and Australia to around 10 per cent in the United States, Germany, the United Kingdom and Canada. By contrast with statutory rates, there has been no obvious convergence in *ex post* rates.

... but have also reduced tax progressivity and shifted tax burdens to labour and consumption

There has also been increased reliance on social charges, which now raise as much revenue as the personal income tax for the OECD as a whole and in 16 countries account for more revenue than the personal income tax. Since these charges are generally levied at a fixed rate and often have an income cap, they tend to be either proportional or regressive. As a result of higher social charges and flatter personal income-tax schedules, effective tax rates have risen at the low end of the earnings scale (Table IV.3). For the OECD as a whole, tax rates for families with labour income equal to two-thirds of the average production worker's (APW) income rose by more than 7 percentage points, between 1978 and 1995. The pattern for high-income families varied greatly across countries, but tax rates typically increased only modestly or fell.

Table IV.3. **Marginal tax rates by income level**[1]

Change in percentage points: 1978 to 1995

	66 per cent of APW	100 per cent of APW	200 per cent of APW
United States	21.7	18.5	–4.6
Japan	9.0	18.7	7.7
Germany	–18.6	4.2	–5.4
France	10.9	1.1	3.0
Italy	14.5	9.0	8.4
United Kingdom	–4.5	–4.5	7.0
Canada	3.0	20.7	0.6
Australia	. .	2.0	1.0
Belgium	36.3	5.3	12.3
Denmark	5.5	–8.9	–0.4
Finland	14.5	3.8	0.8
Netherlands	8.9	–5.8	10.0
Norway	4.2	–6.8	–20.1
Spain	3.4	2.4	4.9
Sweden	–4.5	–22.5	–25.2
Average[2]	7.5	2.5	–0.1
Standard deviation[2]	–0.7	–4.8	–4.7

1. One-earner couple with two children. Includes personal income taxes, social security contributions by employees and "universal" (not means-tested) cash benefits.
2. Unweighted average. Excludes Australia.

Source: 1995: OECD tax equations. 1978: *The OECD Jobs Study: Taxation, Employment and Unemployment* (1995).

2. Average (or *ex post*) and statutory rates differ due to tax credits, allowances and exemptions, and because leakages can occur as corporations manage their tax liabilities (*e.g.* by moving costs into high tax environments and profits into low tax ones). Unfortunately, it is not possible to distinguish these factors.

Another important development in tax policy has been the increasing importance of consumption taxes, particularly the value-added tax (VAT). Since 1980, eight countries have implemented VAT and now nearly all OECD Member countries have one (Table IV.4). Once countries put this tax in place, they subsequently tended to raise rates and to broaden bases. Broad consumption taxes are proportional if they are viewed as being levied on lifetime (or "dynastic") consumption, which would equal income. They are regressive in terms of annual tax burdens because the poor have a higher average propensity to consume than the rich.[3] Thus, the shift from income to consumption taxation also tended to reduce the progressivity of the overall tax system.

Taken as a whole, these changes to tax systems probably reduced distortions and thereby helped to improve economic performance. In addition to more general effects on incentives, flatter tax schedules sharpened incentives to invest in human capital. Entrepreneurial incentives were also probably enhanced, as the tax rate on returns to successful business ventures fell and, for lower-paid workers, taxes on the alternative of dependent employment rose.[4] Reductions in statutory rates on corporate income and narrowing of differences in the tax treatment of various types of physical capital improved the environment for investment decisions.

Table IV.4. **Trends in value-added taxation**

	Year VAT introduced	Initial standard rate	1996 standard rate
Austria	1973	16	20
Belgium	1971	18	21
Canada	1991	7	7
Denmark	1967	10	25
Finland	1969	11.1	22
France	1964	20	20.6
Germany	1968	10	15
Greece	1987	16	18
Iceland	1989	22	24.5
Ireland	1972	16.4	21
Italy	1973	12	19
Japan	1989	3	5
Luxembourg	1970	8	15
Mexico	1980	10	15
Netherlands	1969	12	17.5
New Zealand	1986	10	12.5
Norway	1970	20	23
Portugal	1986	16	17
Spain	1986	12	16
Sweden	1969	11.1	25
Switzerland	1995	6.5	6.5
Turkey	1985	10	15
United Kingdom	1973	10	17.5

Source: Owens and Whitehouse (1996).

There are gains to further tax reforms...

These improvements worked to mitigate the adverse economic effects of the substantial increases in overall tax burdens in the past three decades. Nevertheless, tax burdens remain very high in some countries, and the pressures on expenditures suggest that there will be significant potential gain from pursuing further tax reform.

3. Consumption taxes often have some progressive elements, for example lower rates on necessities and higher ones on luxuries.
4. The effects of the changes on incentives to entrepreneurship are complex, however, and depend on the interaction between personal taxes and corporate tax reforms, on the current and prospective tax bracket of the potential entrepreneur and on corporate tax rates and on loss provisions.

Past reforms effectively resulted in heavier taxation of labour income which, as noted above, may have contributed to higher unemployment. Recently, some countries, including France, Belgium and the Netherlands, have reduced payroll taxes or social-security contributions for low-paid workers. Other countries have altered tax schedules at the low end to encourage labour-market participation, the US earned income-tax credit being an example. Nevertheless, in the absence of changes in government expenditures, such possibilities are limited because they would tend to be expensive in terms of lost revenue, which would have to be replaced by increased taxation elsewhere.

Both expenditures and tax burdens could be reduced by restructuring programmes to lower the degree of "churning": the extent to which the same households both receive government payments and pay taxes. In principle, some churning could be reduced without affecting the net financial position of the households that both receive transfers and pay taxes. But there are also limits to such possibilities. Some programmes involve substantial transfers within income groups as well as across them. An example is publicly funded medical care, access to which depends principally on health status, rather than income. Clearly, reducing such programmes and the taxes needed to pay for them would reduce apparent churning, but would not generally leave households unaffected.

Table IV.5. **Churning of taxes and transfers**

Per cent

	Churning as a per cent of income before taxes and transfers	**Government expenditures as a per cent of GDP**
United States, level in 1995	9.0	32.9
Japan, level in 1994	11.6	34.4
Germany, level in 1994	15.7	48.9
Italy, level in 1993	22.7	57.4
Canada, level in 1994	11.7	47.5
Australia, level in 1993/94	6.5	36.8
Belgium, level in 1995	23.7	53.8
Denmark, level in 1994	28.0	59.3
Finland, level in 1995	15.5	57.9
Netherlands, level in 1994	21.1	52.8
Sweden, level in 1994	34.2	68.3
Average	18.2	50.0

Source: OECD. See text for a definition of "churning".

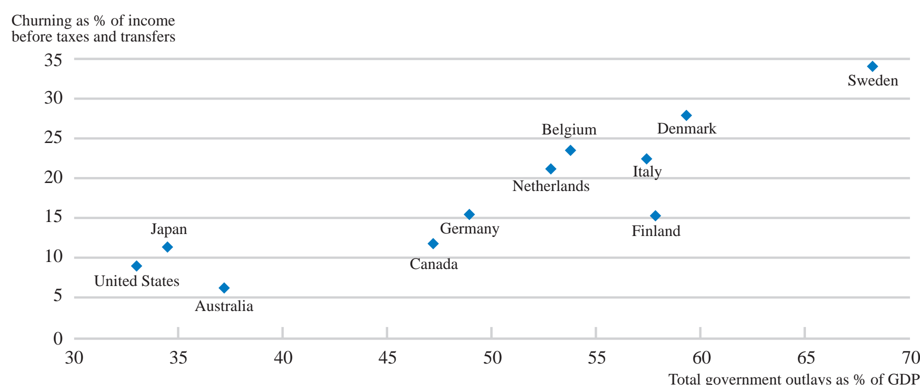
One measure of churning is the amount by which taxes or transfers could be reduced for the average person in each income decile by netting out taxes (where they are smaller than transfers) or transfers (where they are smaller than taxes).[5] Churning, so measured, varies considerably across countries for which the requisite data are available (Table IV.5). The net gains from reducing churning depend the effects on household incentives, which is difficult to assess in the absence of detailed information on the payment and tax scheduled households face.

5. For example, if the tax paid in the bottom decile were $100 and transfers received $200, taxes and transfers could both be reduced by $100, leaving net transfers unchanged. Adema (1998) adopts the narrower measure of transfers net of direct and indirect taxes paid on them (rather than all taxes paid).

... although the trade-offs are complex

The trade-offs that may be involved in such policy reform, however, are likely to be complex. On the one hand, because of churning households may face both a reduction in transfers and an increase in taxes as their incomes rise. That is, they face a double disincentive. However, churning is closely related to the overall scale of government taxes and expenditures (Figure IV.1), which is in turn related to the degree to which social programmes are universal, rather than more narrowly targeted. Moving from a universal to a more narrowly targeted system would reduce churning but, for a given generosity of transfers at the low end, targeted systems need to claw back benefits more rapidly as income rises. Thus, there is a trade-off between high implicit marginal tax rates due to the tapering off of targeted benefits and high explicit tax rates due to the extra budgetary cost of maintaining universal programmes.

Figure IV.1. **Churning rises with the size of government**



The tax treatment of different sources of financing and types of investment remains uneven, despite the progress made during the past 15 years. In most countries, corporate taxation still favours debt finance over retained earnings and machinery investment over inventories, although to a lesser degree than 15 or 20 years ago. Likewise, differences in the tax treatment of pensions, housing, equities investments and bank deposits have been narrowed in some countries, but they generally remain large. For seven OECD countries, marginal tax rates between the most and least favoured of these saving instruments differed by at least 30 percentage points, and frequently by more, based on 1994 tax parameters (Owens and Whitehouse, 1996).

Tax-base erosion

High tax rates have eroded tax bases through avoidance and evasion

The tax reforms implemented over the past several years were, at least in part, a response to the need to enhance economic performance. But they can also be understood as a response to the perception that tax bases were being eroded due to high tax rates, increased avoidance and evasion, and the migration of taxable income to low-tax jurisdictions. Thus, reform tended to reduce tax rates on elastic tax bases, and raise them on inelastic ones. Wealthy households and corporations, taxes on which have generally fallen, were (and are) well placed to benefit from opportunities to lower tax liabilities, either by receiving income in forms that bear relatively low tax

rates (capital gains or fringe benefits, for example), or by arranging to receive taxable income in relatively low-tax jurisdictions. In general, such opportunities are more limited for low and medium-income labour compensation, and for consumption.

Tax-base erosion can take the form of legal avoidance or illegal evasion. Examples of avoidance are numerous: individuals receive income in forms that are excluded from taxable personal income (*e.g.* fringe benefits, office amenities, first-class travel, corporate health facilities, slower pace of work, etc.); capital gains are realised in the current fiscal year in anticipation of an increase in the capital gains tax in the following year; or activities are incorporated in order to benefit from corporate tax rates that are below individual rates. Taxes can be illegally avoided, in which case it is referred to as evasion. For example, income may be under-reported, business expenses may be misclassified or consumption taxes may go unpaid. In addition, taxes can be avoided or evaded by shifting the taxable location of the activity to other jurisdictions; the issues regarding the geographical mobility of tax bases are discussed in the next section of the paper.

Tax avoidance and evasion are economically costly...

Tax avoidance and evasion are economically costly. Legal avoidance may entail costs in terms of discovering the best (*i.e.* least taxable) way to organise activity and because it may lead to an inefficient choice of organisation. To the extent that avoidance is easier in some economic activities than others, economic activity is further distorted by (unintended) *de facto* differences in tax rates. Evasion also gives rise to these real costs. In addition, resources must expended to camouflage income or activities and there are costs related to private contract enforcement, rather than legal enforcement mechanisms. These latter costs are closely associated with the creation of an underground, or black, economy that accompanies illegal tax evasion.

Avoidance and evasion tend to be mitigated by reductions in tax rates. Evasion depends, in addition, on the probability of being caught and the size of the penalty, as well as on the value of public services foregone if economic activity is undeclared (*e.g.* in-work benefits or accumulated rights to unemployment insurance, injury compensation or pensions). Of course, some public services – such as excessive or poorly structured regulation – have negative value and thus increase the incentive to evade. Finally, of course, erosion of a given tax base implies that either taxes must be raised on other bases or government expenditure must be foregone, both of which may have costs.

... but little is known about the scale of these costs

Not a great deal is known about the costs of avoidance. Feldstein's (1995) estimates, which attempt to account for both dead-weight costs and avoidance, suggest that under the 1994 US tax system the net cost of raising an extra dollar of tax revenue was 300 per cent (*i.e.* one dollar of tax revenue and two dollars of net cost). Taken at face value and by comparison with standard estimates of the dead-weight cost – generally, the extra cost of raising one dollar is estimated to be well under a dollar – this figure would suggest a very high cost of avoidance.

For obvious reasons, still less is known about the costs of illegal tax evasion. However, studies of the scale of underground activity suggest that it significantly reduces tax revenues, is increasing over time, and part of this increase can be attributed to higher tax burdens. From the point of view of containing underground activity, however, the effect of high tax burdens can be at least partly offset by effective tax enforcement and by linking the receipt of social benefits to above-ground employment or the payment of taxes. Reservations regarding estimates in this area are worth emphasising: underground activity is intrinsically difficult to measure; only part of it is related to tax evasion; and the scale of underground activity is much larger than its net economic cost.

Geographical mobility of tax bases

Technology and globalisation have increased the mobility of some tax bases

One type of tax-base erosion that has attracted considerable attention and concern is the geographical mobility of tax bases. Changes in technology – notably information, communication and transportation technology – as well as liberalisation of commercial and financial transactions have increased the scope for tax avoidance and evasion through the choice of location of economic activity. Business functions can be moved to low-tax jurisdictions and bank accounts and other financial assets can be held offshore. There are numerous examples of avoidance reducing tax revenues and, in some cases, tax rates have had to be reduced in order to stem the revenue losses. Empirical research also supports the view that taxation influences international investment flows, although some studies find little effect (Leibfritz *et al.*, 1997). And, as noted above, the pattern of convergence in OECD tax systems is broadly consistent with pressures stemming from mobility of capital and highly paid labour.

This could lead to difficulties in raising revenues

The effect of geographical mobility on tax bases raises a number of concerns. The first is the extent to which the overall revenue-raising power of governments has been constrained. Theory offers a wide range of possibilities, with the most pessimistic being that tax rates and tax revenues will be forced progressively downwards, even to the point where it becomes impossible to collect any revenues at all. There appears to be little evidence, however, that major tax bases – household income taxes, corporation income taxes and consumption taxes – have collapsed in this way. Overall, taxes have risen, not fallen, over the past several years, and although tax rates have tended to converge over time there remains substantial variation across countries. And within countries, where there are few formal barriers to geographical mobility, differentials of major taxes also seem to be significant and stable over time (Box IV.1).

Or to greater distortions in tax systems

A second issue is the extent to which the response to the threat of geographical tax-base erosion has resulted in poorly functioning public finances. Again, theory offers a range of possibilities. Severe compression of taxes would clearly make meeting important social needs impossible. An alternative view is that the ability to choose the location of economic activity offsets shortcomings in government budgeting processes, limiting a tendency to spend and tax excessively. Of course, to some extent these two views need not be in conflict. If tax burdens were initially "too high", pressure to reduce them could increase economic efficiency. But such pressures could go too far, reducing tax bases (or certain tax bases) below the point needed to fund desirable public expenditures.

A variation on this issue is the extent to which the threat to tax bases has resulted in a distorted tax system and therefore in undesirable inefficiencies. Not all tax bases are equally mobile, and so the geographical mobility of tax bases will change the structure of taxation, as well as its overall level. The shift of taxes away from capital and onto low-paid labour has already been described, as have the possible adverse consequences on labour markets. Reducing the tax burden at the low end may be impossible if it would require attempting to raise tax rates on highly mobile tax bases. An important case is taxation of financial instruments. Taxes on transactions of financial instruments have virtually disappeared and the ability to tax income from financial instruments has been weakened by the existence of tax havens. The globalisation of financial markets, the reduction in the costs of financial transactions and the difficulties in tracing such transactions have all played a role in the erosion of these tax bases.

Box IV.1. **Sub-national tax differentials in Switzerland and Canada**

Both Switzerland and Canada are federations in which the sub-national government levels – cantons and provinces, respectively – have wide autonomy in taxation. In neither country are there formal restrictions on the geographical mobility of either households or firms; certainly, barriers to mobility are far lower than they are between most countries. Thus, the threat to tax bases from geographical mobility within these countries ought to be greater than the threat from mobility across countries. The pressures to harmonise or even reduce sub-national tax rates in response to such a threat ought to be correspondingly greater as well.

The Swiss Statistical Office calculates indexes of tax burden on individuals *(personnes physiques)* and companies *(personnes morales)* for each canton as a per cent of the national average. In both 1985 and 1996, there were significant differences in individual and company tax burdens across cantons. The 1996 index of company tax burden varied from a low of 57.8 per cent of the average in the canton of Zug, to a high of 148.5 per cent in Glarus; for individuals it varied from 55.5 in Zug to 136.6 in Fribourg. These cantons are obviously extreme cases, but even if they are removed the differential is 58 percentage points for corporate taxes and 59 percentage points for personal taxes. The dispersion across cantons of both types of tax burden has been broadly stable over time; the standard deviations of both indexes increased very slightly between 1985 and 1996. The range of (average) tax rates for individuals – that is the difference between the top cantonal rate (including all types of cantonal tax) and the lowest rate – was about 11 percentage points in 1996, which is a bit under half of the range of average personal income-tax rates for the OECD as a whole.

Kirchgässner and Pommerehne (1996) conclude that the most important factors explaining concentrations of high-income tax payers are large stocks of infrastructure and a strong service orientation in the local economy; taxes play a “small but statistically significant” role. Geneva, a relatively high-tax canton, had a much higher concentration of extremely affluent taxpayers than can be explained by any of the factors used in their study, including relative tax burdens. Thus, tax differentials appear to affect the geographical location of tax base to some extent, but other factors – political, geographic and economic – also permit significant diversity in tax policies among cantons.

Canada’s experience has been broadly similar, although the available data are not as good for this purpose as the Swiss data. Differences in tax rates, as measured by their range and coefficient of variation, rose between 1987 and 1997 for the personal income tax, the capital tax, and excise taxes on fuel, gasoline and tobacco. The dispersion of corporate tax rates fell, with large-firm corporate tax rates converging towards a higher average rate and the small-firm rate to a lower average rate.

And such pressures will probably increase in the future

As with the other forces acting on tax policy that have been discussed in this paper, there is reason to believe that the pressures stemming from geographical mobility of tax bases will increase in the years ahead. To take one example, improvements in electronic commerce are likely to make the base for consumption taxes, such as the VAT or sales taxes, more geographically mobile and harder to trace. In general, the location of economic activity depends on many factors, of which taxation is one. An equilibrium taking account of these factors is established that, to date, has both constrained tax rates in many case while still allowing substantial variability of tax rates across jurisdictions. But this equilibrium is likely to shift as, *inter alia*, institutions and technologies develop. The challenge for tax policy will be to respond to these developments in order to fund needed government expenditures with a tax system that has minimal economic distortions.

Box IV.2. **Harmful tax competition**

In May 1996 Ministers requested the OECD to "develop measures to counter the distorting effect of harmful tax competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998", a request which was subsequently endorsed by the G7 heads of state in Lyon. The OECD's Committee on Fiscal Affairs launched a project on harmful tax competition, which has resulted in a report and recommendations for containing and reducing it.

This report addresses practices in the form of tax havens and harmful preferential tax regimes in OECD and non-member countries, focusing on geographically mobile activities, such as financial and other service activities. It defines the factors to be used in identifying harmful practices, makes 19 recommendations to counteract such practices and provides guidelines for implementing the recommendations. Taken together, these elements represent a comprehensive approach by Member countries for dealing with the problems of harmful tax competition.

Some of the recommendations encourage countries to eliminate, or to refrain from adopting, measures constituting harmful tax competition. Others are aimed at offsetting the benefits for taxpayers of certain forms of harmful tax practices. Still others address the issue indirectly by focusing on tax evasion and avoidance.

The effectiveness of many of the recommendations depends in part on their implementation in a co-ordinated way. Thus, a key recommendation is to establish a forum to monitor the application of the recommendations and guidelines. As part of this activity, the forum would undertake an ongoing evaluation of existing and proposed preferential tax regimes and assess the effectiveness of counter-measures. In addition to its recommendations, the report identifies areas where further study that could result in new initiatives, which the forum would examine. The forum would also engage in a dialogue with non-member countries.

International co-operation will be a key to dealing with these pressures

The challenge for policy makers will be to respond to these developments to ensure that needed government expenditures can be funded and that tax distortions are minimised. In view of trend toward globalisation and the threat posed by the geographical mobility of tax bases, a significant part of the response will necessarily involve greater international co-operation. It is increasingly difficult for individual countries to manage their tax bases in the face of these forces and, in particular, some tax practices have led to harmful and distortive cross-border "tax competition". The OECD has recently undertaken a study of this emerging issue, which has resulted in a set of recommendations and guidelines (Box IV.2).

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V. IMPLEMENTING THE OECD JOBS STRATEGY: PROGRESS REPORT*

Introduction

The policy recommendations of the OECD Jobs Strategy…

The *OECD Jobs Study* was published in 1994 and contained a comprehensive analysis of the problem of high and persistent unemployment in many OECD countries and widening income differentials in some. The Jobs Study also developed more than 60 concrete, but not country-specific, policy recommendations for dealing with those issues. Building on these recommendations, the *OECD Jobs Strategy* has been articulated around ten broad orientations for macroeconomic and structural policy which together form a comprehensive blueprint for action to create more jobs and reduce unemployment, and to increase standards of living and strengthen social cohesion (Box V.1).

Box V.1. **The OECD Jobs Strategy**

- Set macroeconomic policy such that it will both encourage growth and, in conjunction with good structural policies, make it sustainable, *i.e.* non-inflationary.
- Enhance the creation and diffusion of technological know-how by improving frameworks for its development.
- Increase flexibility of working-time (both short-term and lifetime) voluntarily sought by workers and employers.
- Nurture an entrepreneurial climate by eliminating impediments to, and restrictions on, the creation and expansion of enterprises.
- Make wage and labour costs more flexible by removing restrictions that prevent wages from reflecting local conditions and individual skill levels, in particular of younger workers.
- Reform employment security provisions that inhibit the expansion of employment in the private sector.
- Strengthen the emphasis on active labour market policies and reinforce their effectiveness.
- Improve labour force skills and competences through wide-ranging changes in education and training systems.
- Reform unemployment and related benefit systems – and their interactions with the tax system – such that societies' fundamental equity goals are achieved in ways that impinge far less on the efficient functioning of the labour markets.
- Enhance product market competition so as to reduce monopolistic tendencies and weaken insider-outsider mechanisms while also contributing to a more innovative and dynamic economy.

… have been made country-specific…

As an important part of the follow-up to the *OECD Jobs Study*, policy recommendations have been developed for implementing the Jobs Strategy in individual countries, taking into account the specific institutional and political background in each. By spring 1997, a first round of such country-specific recommendations had been derived for almost all Member countries and published in *OECD Economic Surveys* and the country-specific experiences with the Jobs Strategy were summarised in OECD (1997). Since then, progress in implementing the first-round of country-specific recommendations has been reviewed in the context of OECD's continuous surveillance process.[1] As part of this process, recommendations have in some cases

* This chapter is an abbreviated version of the paper *The OECD Jobs Strategy: Progress Report on Implementation of Country-Specific Recommendations*, which was presented to the 1998 OECD Ministerial Council Meeting on 27-28 April and has been issued as *OECD Economics Department Working Paper* 196.

1. Moreover, full sets of country-specific recommendations for another two countries, the Czech Republic and Hungary, have been derived.

been withdrawn or modified in the light of policy and other developments. The surveillance process has been undertaken by the OECD's Economic and Development Review Committee, which contains representatives of all OECD countries and under whose responsibility *OECD Economic Surveys* are issued.

… and this chapter reviews countries' progress in implementation

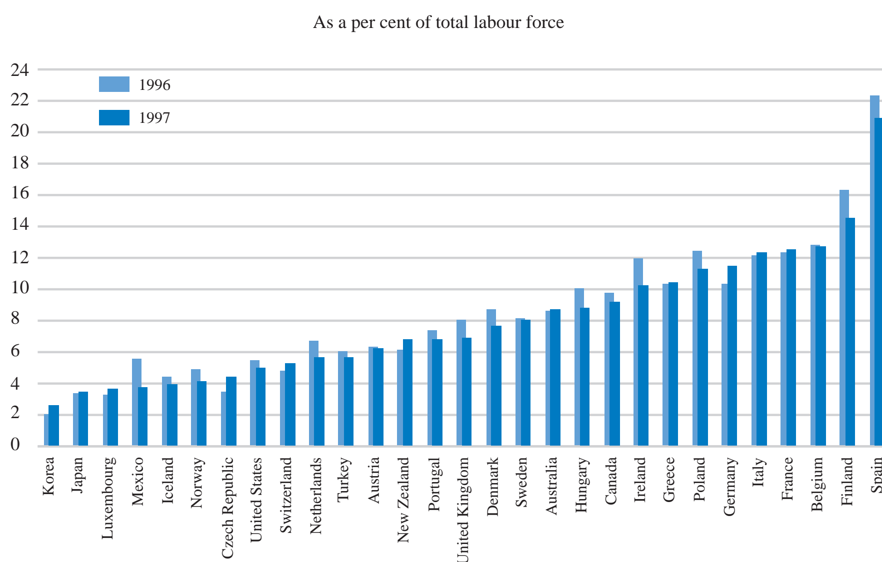
This chapter reviews some recent labour market developments, including countries' progress in reducing structural unemployment, and their macroeconomic background. It also gives an interim report on the progress made in implementing the first round of structural policy recommendations and thereby updates the analysis in OECD (1997).

Recent developments in labour markets

Unemployment rates became less dispersed…

As already mentioned in Chapter I "General Assessment of the Macroeconomic Situation", unemployment declined slightly in 1997 in the OECD area as a whole, but still touched 7.2 per cent of the labour force on average, or some 35 ½ million persons (national definitions). Unemployment rates fell in more than half of the OECD countries, but they rose in ten countries (Figure V.1). As a result of these changes, the dispersion of unemployment rates across countries decreased though it remained

Figure V.1. **Unemployment rates,[1] 1996-97**



1. Commonly used definitions.

substantial.[2] Thus, unemployment declined substantially in some high-unemployment countries, including Finland, Ireland, Poland and Spain. The United Kingdom, Denmark, Hungary, Mexico and the Netherlands also experienced sizeable declines. By contrast, unemployment increased by more than one per cent of the labour force in Germany, and significant increases were also recorded in the Czech Republic, Korea, New Zealand and Switzerland – though levels of unemployment remained relatively low in these countries.

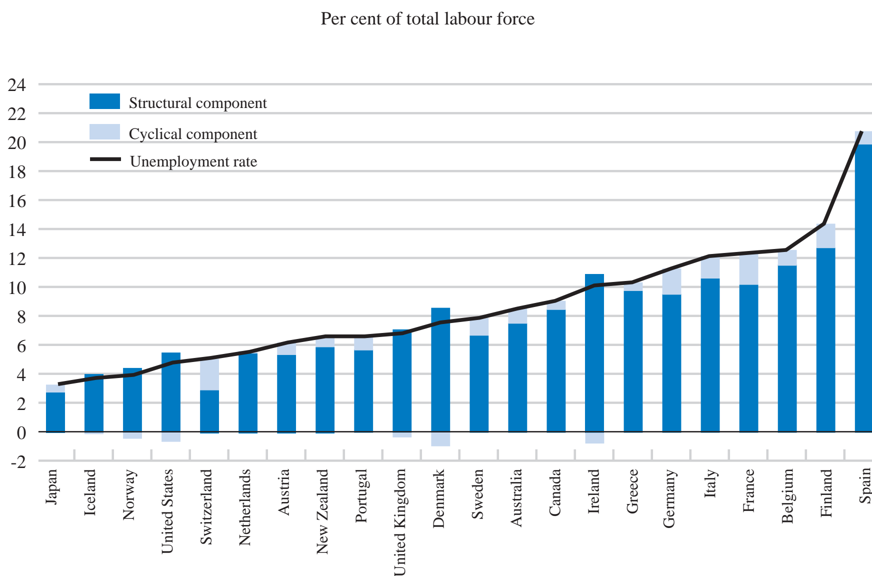
2. International comparisons and calculations of dispersion are in principle best done using standardised unemployment rates. However, standardised unemployment rates are not available for all OECD countries.

... and include a cyclical component in many countries

Based on OECD Secretariat estimates of structural unemployment rates for 22 OECD countries, actual 1997 unemployment rates included a cyclical component in the majority of countries (Figure V.2). Indeed, in some of the major continental European countries cyclical components were substantial. However, in a number of other countries, estimated cyclical components had either disappeared (United States, United Kingdom, Denmark, Iceland, Ireland, Norway) or become very small (Netherlands). Nevertheless, the inherent uncertainties associated with a decomposition of unemployment into cyclical and structural components need to be kept in mind when interpreting these indicators.

Figure V.2. **Structural and cyclical components of unemployment rates,[1] 1997**

Per cent of total labour force



1. Based on commonly used unemployment definitions. Structural unemployment data are based on OECD Secretariat estimates of the non-accelerating wage rate of unemployment (NAWRU).

Some countries reduced structural unemployment over the 1990s...

Looking at developments over the 1990s, six countries stand out as having been able to reduce structural unemployment in what seems to be a significant way (Table V.1). In addition to the United Kingdom, Ireland, the Netherlands and New Zealand, which were already identified last year as having significantly reduced structural unemployment, Denmark and Australia have been added to the list.[3] Lower structural unemployment in itself implies a major step forward but also carries with it derived benefits for, *inter alia*, government budget balances (see Chapter IV "Forces Shaping Tax Policy").

Changes in estimated structural unemployment rates over the 1990s have tended to be associated with changes in the same direction of actual unemployment rates, which underlines the importance of getting both macroeconomic and structural policies

3. The identification of the four former countries was contained in OECD (1997), which also describes the criteria and methods used. Compared to the data presented in that publication, estimated trends and levels of structural unemployment have changed for a few other countries. These changes reflect the inclusion of information for 1997 and the review of previous estimates of structural unemployment, not least as a result of additional or revised data. The most pronounced changes since OECD (1997) are as follows: the level of structural unemployment has been revised down (up) over the whole period for Finland and Ireland (Greece), and revised up for the earlier part of the historical period for Portugal. The 1997 estimate is considerably lower (higher) than the 1996 estimate in OECD (1997) for Australia and Spain (Belgium).

Table V.1. Structural unemployment in the OECD countries, 1990-97[a]

As a per cent of total labour force

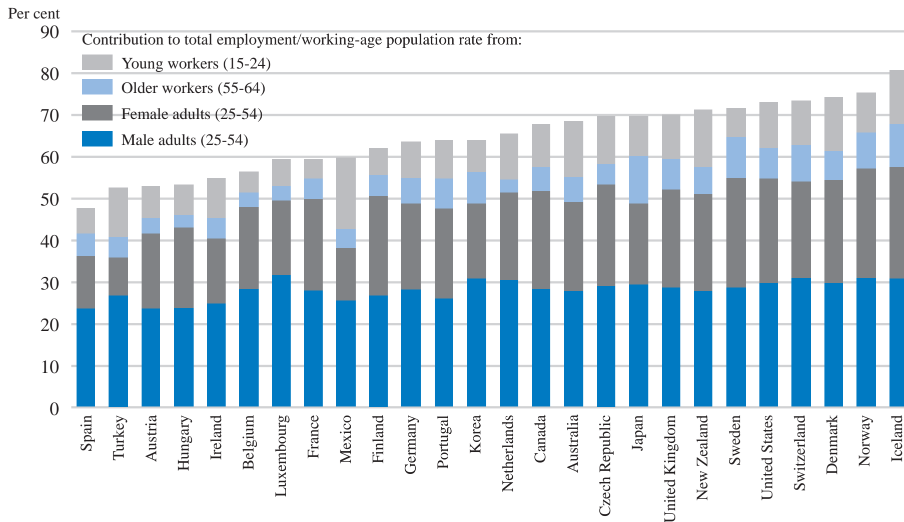
In the nineties the structural unemployment rate has…		1990	1997
… increased:	Finland	7.0	12.8
	Sweden	3.2	6.7
	Germany	6.9	9.6
	Iceland	1.5	4.0
	Switzerland	1.3	3.0
	Greece	8.2	9.8
	Italy	9.7	10.6
	France	9.3	10.2
	Belgium	11.0	11.6
	Austria	4.9	5.4
… remained fairly stable:	Japan	2.5	2.8
	Norway	4.2	4.5
	Spain	19.8	19.9
	Portugal	5.9	5.8
	United States	5.8	5.6
	Canada	9.0	8.5
… decreased:	Denmark	9.2	8.6
	Australia	8.3	7.5
	New Zealand	7.3	6.0
	United Kingdom	8.5	7.2
	Netherlands	7.0	5.5
	Ireland	14.6	11.0
	OECD structural unemployment rate[b]	6.8	7.1
	OECD actual unemployment rate[b]	6.0	7.5

a) Based on commonly used definitions of unemployment. Structural unemployment data are based on Secretariat estimates of the non-accelerating wage rate of unemployment (NAWRU) made for the *OECD Economic Outlook*, 63, 1998. A change is considered significant (in absolute terms) if it exceeds one standard-deviation. The latter was calculated for each series and country over the 1986-97 period.
b) Weighted averages of the countries reported in the table.
Source: OECD Secretariat.

right. A number of other features of developments through the 1990s are also worth highlighting :

- Countries where unemployment fell tended to have rising employment rates and vice versa.
- The countries with falling or stable unemployment rates tended to be the ones where participation rates and population growth contributed strongly to the growth of the labour force. This illustrates that strong labour force growth is no hindrance to lower unemployment but, frequently, an accompanying feature.
- Across countries, the differences in the strength of employment trends was almost completely accounted for by differences in private sector employment growth, illustrating that private sector employment is the key to overall employment growth.
- As a result of these and previous employment trends, employment rates differ strongly across countries. In this regard, it is notable that the cross-country differences do not stem from different employment rates for prime-age males, who are frequently seen as the typical labour market insider group (Figure V.3). By contrast, the contributions from women and from young and older workers seem to account for most of the cross-country variation in overall

Figure V.3. **Decomposition of the employment rate, 1996**



employment rates, pointing to the importance of labour market conditions that enable non-core groups to seek and obtain gainful employment.

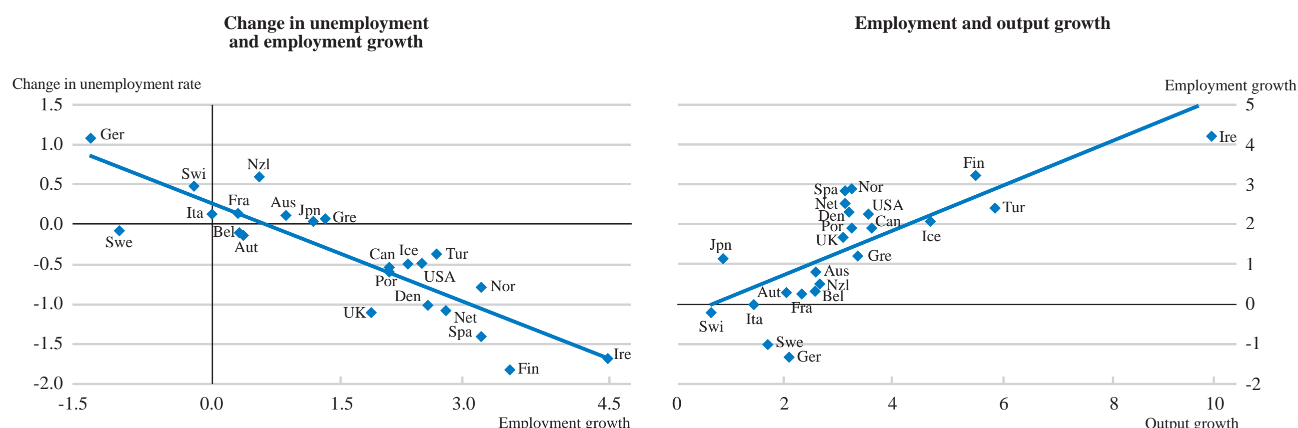
… against somewhat different backgrounds

Some of the labour market outcomes just mentioned were somewhat divergent across the six countries which experienced a downward trend of structural unemployment over the 1990s. Thus, falling unemployment occurred against the backdrop of strongly rising employment in Ireland, the Netherlands, New Zealand and, to a lesser extent, Australia. By contrast, the contribution from employment growth to the decline in unemployment over the period 1990-97 was very limited in Denmark, and zero in the United Kingdom. Available evidence also suggests that trends in real wages and in the dispersion of wages and incomes have differed significantly across the six countries. A comprehensive assessment of labour market trends over the 1990s would need to take these and other developments into account but is outside the scope of this chapter. Moreover, it needs to be borne in mind that while the six countries demonstrate that it is feasible to durably reduce high unemployment, other countries managed to avoid a rise in structural unemployment in the first instance. And some of the countries where structural unemployment has gone up nevertheless maintain relatively low levels of unemployment.

Lower unemployment in 1997 was associated with employment and output growth

The generally positive association between robust employment growth and falling unemployment is borne out by developments in 1997 (Figure V.4, left panel). Countries with high employment growth tended to be the ones where output grew strongly (Figure V.4, right panel). But differences in productivity growth also contributed to different employment growth across countries. In this context it may be noted that low productivity growth is not necessarily a negative outcome. In countries which undertake structural reforms to reduce high unemployment, rapid employment growth is desirable even if it appears to be associated with lower productivity growth. This may be the case, for example, where structural reforms result in increased employment of low-productive labour or results in the use of less capital-intensive production methods. By contrast, in countries where the scope for rapid employment growth is limited because unemployment is already low, low productivity growth unambiguously means slow growth of living standards.

Figure V.4. **Unemployment, employment and output growth, 1997**
Per cent or percentage points



The macroeconomic background to these employment and unemployment outcomes are described elsewhere in this Economic Outlook. The projections for the coming 18 months suggest, as discussed in previous chapters, that unemployment may stay largely unchanged for the area as a whole, but could fall in Europe, though it will remain high given that it is to a large extent structural.

Interim review of structural policy progress

There are encouraging developments…

OECD Economic Surveys of 21 Member countries have included a review of progress in implementing the country-specific recommendations derived in the previous round of surveys.[4] Following these reviews, and taking into account the update on structural unemployment and macroeconomic conditions presented above, the main conclusions which had been drawn after the first round of reviews, and which are summarised in Box V.2, seem to remain valid. Nevertheless, it should be underlined that this chapter only integrates policy developments and recommendations analysed in *OECD Economic Surveys*. Thus, policy developments subsequent to the most recent survey are not covered, and countries which have not been covered by a survey since the first round of recommendations were given, are not considered.

… and policies have made good, if variable, progress…

Many of the countries which have undergone a follow-up review seem to have made progress in implementing the structural policy recommendations given in the first round of reviews on implementing the Jobs Strategy. Taking a broad overview of progress, the following features stand out:[5]

– A lot of action has been taken over the review period. Using the first round recommendations as a bench-mark, countries pursued action in the direction indicated by the recommendations in two-thirds of the cases.

4. First-round recommendations were derived for two new Member countries, the Czech Republic and Hungary. The reviews for these countries noted that various benefits were too generous and needed to be reduced. Moreover, it was recommended that Hungary reform social security contributions by workers and move towards decentralisation of wage bargaining. A general easing in employment protection, and specifically a loosening of notification requirements, was recommended in both countries. The reviews of the Czech Republic and Hungary echoed the recommendations given to other countries for more evaluation of active labour market policies. Improvements to the education system also received substantial attention, with improvements seen as needed at the secondary and tertiary levels. In addition to these recommendations, the Czech Republic was urged to ease rent controls and Hungary to enhance the links between basic scientific research and industry and the diffusion of new technology to traditional sectors and smaller firms.
5. A detailed review of individual countries' progress is presented in OECD (1998).

Box V.2. **Lessons from Implementing the OECD Jobs Strategy**

- High and persistent unemployment has been the result of both conjunctural and structural forces, and it can be durably reduced.
- Many countries have made progress in implementing the Jobs Strategy, but progress has been uneven both between countries and between different areas of policy.
- The central issue dividing the more comprehensive reformers from the less comprehensive is differences in judgement about potential conflicts between better labour market performance and concerns for equity and social cohesion.
- There are significant synergies between structural reforms in different fields.
- Macroeconomic conditions and their interactions with structural forces are important for labour market outcomes.
- Overall, the Jobs Strategy remains an effective response to labour market problems in Member countries, and the Economic and Development Review Committee has encouraged countries to press on with its implementation.

Source : OECD (1997).

– Very few policy moves went in the contrary direction to that recommended. Indeed, only seven of the 21 reviewed countries took any action in the opposite direction to that recommended and, in most cases, did so only for a single recommendation.
– Across different policy areas, countries moved forward on a relatively large proportion of the recommendations relating to the general business climate which focused, in particular, on strengthening competition in product markets, promoting entrepreneurship and enhancing the creation and diffusion of technology.
– Progress was slower, in this sense, for recommendations relating to education and training policies as well as to labour market reforms, which also was the area where most contrary action was concentrated.
– Within the area of labour market reforms, the lowest follow-through rate concerned policies related to wage formation and industrial relations. By contrast, action was taken on a larger proportion of the recommendations relating to early retirement and invalidity benefits as well as active labour market policies.

… but some key issues are unresolved in labour markets…

A feature which had been noted already after the first round of reviews seems to be confirmed : many countries are anxious about policy reforms which, at least in the shorter term, risk directly leading to a wider dispersion of incomes and antagonising insider groups. Thus, few countries were willing to reduce unemployment benefit replacement rates or their duration, although many tightened eligibility conditions for unemployment insurance, early retirement and disability. Many countries were unwilling to loosen employment protection, but countries did take action to increase working-time flexibility and the use of part-time work and fixed-term contracts. More decentralised wage bargaining went forward in many countries, but loosening up on minimum wages and allowing for wider wage distributions generally did not. And many countries made at least some reforms with a view to making active labour market programmes more effective.

… and policies towards the business climate…

The same pattern was repeated for policies to enhance the business climate. Most countries were willing to undertake broad measures that affected the rules of the game or were likely to improve productivity, but were less willing to take actions which would negatively affect subsidies and rents earned by narrow interest groups except, strikingly, in regard to the state sector. Thus, most countries for whom it was recommended tightened competition law and enforcement and moved forward with privatisation of government-owned firms and the opening up of the government sector

to greater contestability. By contrast, less progress was made in cutting subsidies and state interventions, liberalising shop hours and opening government procurement.

… and progress in education were also uneven

While progress in education and training does not easily lend itself to the same kind of reasoning, it was nevertheless uneven across areas. A number of countries took action on secondary education, and in particular vocational education, whereas policy initiatives along the lines of first-round recommendations were more scant at the primary and tertiary levels.

Overall, the Jobs Strategy remains on track

This interim review has strengthened the conclusion reached after the first round of reviews by the Economic and Development Review Committee : the Jobs Strategy is an adequate response to current labour-market problems and, where implemented over a broad range of policy areas and given sufficient time to work, it is capable of delivering. The mounting evidence that following the Jobs Strategy leads to improved labour-market outcomes and the rising number of countries which have done so and experienced declining structural unemployment should provide an incentive to action in countries which have so far made little progress. The case is getting stronger, that they too could benefit from implementing the Jobs Strategy. This may give rise to some cautious optimism concerning the future.

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VI. THE RETIREMENT DECISION

Introduction

Declining birth rates and increasing longevity have produced a significant increase in the share of elderly in the population of most OECD countries over the past three decades. The trend is likely to accelerate sharply in the next decade, as the baby boom generation begins to reach retirement age. The OECD Secretariat has recently concluded a comprehensive study on the implications of ageing and on possible remedies to meet future challenges (Box VI.1). It shows that unless there are major changes in policy, the increase in the number of retirees relative to persons active in the labour force will reduce growth in material living standards and put public budgets under mounting pressure.

The OECD study highlights the importance of raising the average age at which people retire from the labour market as a crucial element in meeting the ageing challenges. The average age of retirement has declined markedly in the majority of the

Box VI.1. **Maintaining prosperity in an ageing society: principles for achieving reforms**

At the meeting of the OECD Council at Ministerial Level in May 1995, the Ministers invited the Secretary-General to initiate a comprehensive research effort on the implications of ageing populations and to examine how societies could best respond to any adverse effects. A preliminary report was presented in 1996. Subsequently, the OECD Secretariat has examined a number of broad areas: macroeconomic issues, the retirement decision, incomes of older people, financial markets, employability of older workers, health and long-term care arrangements, and ways and means to implement ageing policies.

The policy recommendations based on this work were presented to Ministers at their meeting in April 1998. Seven principles were identified to guide reforms:

- Public pension systems, taxation systems and social transfer programmes should be reformed to remove financial incentives to early retirement, and financial disincentives to later retirement.
- A variety of reforms will be needed to ensure that more job opportunities are available for older workers and that they are equipped with the necessary skills and competence to take them.
- Fiscal consolidation should be pursued, and public debt burdens should be reduced. This could involve phased reductions in public pension benefits and anticipatory hikes in contribution rates.
- Retirement income should be provided by a mix of tax-and-transfer systems, advance-funded systems, private savings and earnings. The objective is risk diversification, a better balance of burden-sharing between generations, and to give individuals more flexibility over their retirement decisions.
- In health and long-term care, there should be greater focus on cost-effectiveness. Medical expenditure and research should be increasingly directed to ways of reducing physical dependence, and explicit policies for providing care to frail older people should be developed.
- The development of advance-funded pension systems should go hand-in-hand with that of the financial market infrastructure, including the establishment of a modern and effective regulatory framework.
- Strategic frameworks should be put in place at the national level now in order to harmonise these ageing reforms over time, and to ensure adequate attention to implementation and the build-up of public understanding and support.

More specific recommendations were presented for each of these principles.

A summary of the analysis leading to the OECD policy recommendations on ageing is provided in *Maintaining Prosperity in an Ageing Society*. The main analytical documents prepared by the OECD are published as working papers, and are available on the Internet at *www.oecd.org*.

OECD countries over the past three decades, despite improvements in life expectancy and the health status and of older people. Should the retirement age stabilise at the current low levels, or fall even further, the adverse implications of ageing populations would be amplified. On the other hand, if past trends in the average retirement age among older workers were to be reversed, the ageing problem would be mitigated. Such a reversal would be unlikely if past trends were only driven by stronger preferences for leisure at older ages. However, this chapter shows that incentives embedded in public old-age pension systems and other income support systems have encouraged early retirement, and that recent reforms have been insufficient to remove the bias against work at older ages.[1]

Labour force attachment of older workers: past trends and scenarios for the future

The average age of retirement has fallen…

There has been a striking fall in the average age at which people retire from the labour market in most OECD countries (Figure VI.1). In the 1960s and early 1970s, males retired from the labour market after the age of 65 in virtually all Member countries: activity rates for the 55-64 year age groups were only marginally lower than those of prime-age males and a sizeable part of males aged 65 and over were participating in the labour market. By 1995, a quarter of the countries depicted in Figure VI.1 had an average retirement age below 60 for males, and less than half of the male population aged 55-64 was participating in the labour market. By contrast, Japan and Iceland still had average retirement ages above 65. While historically lower than that for men, the average age of retirement of women has followed a similar pattern; in 1995, more than half of the OECD countries had an average age of retirement below 60 for women.

… and, although the elderly dependency ratio is still low…

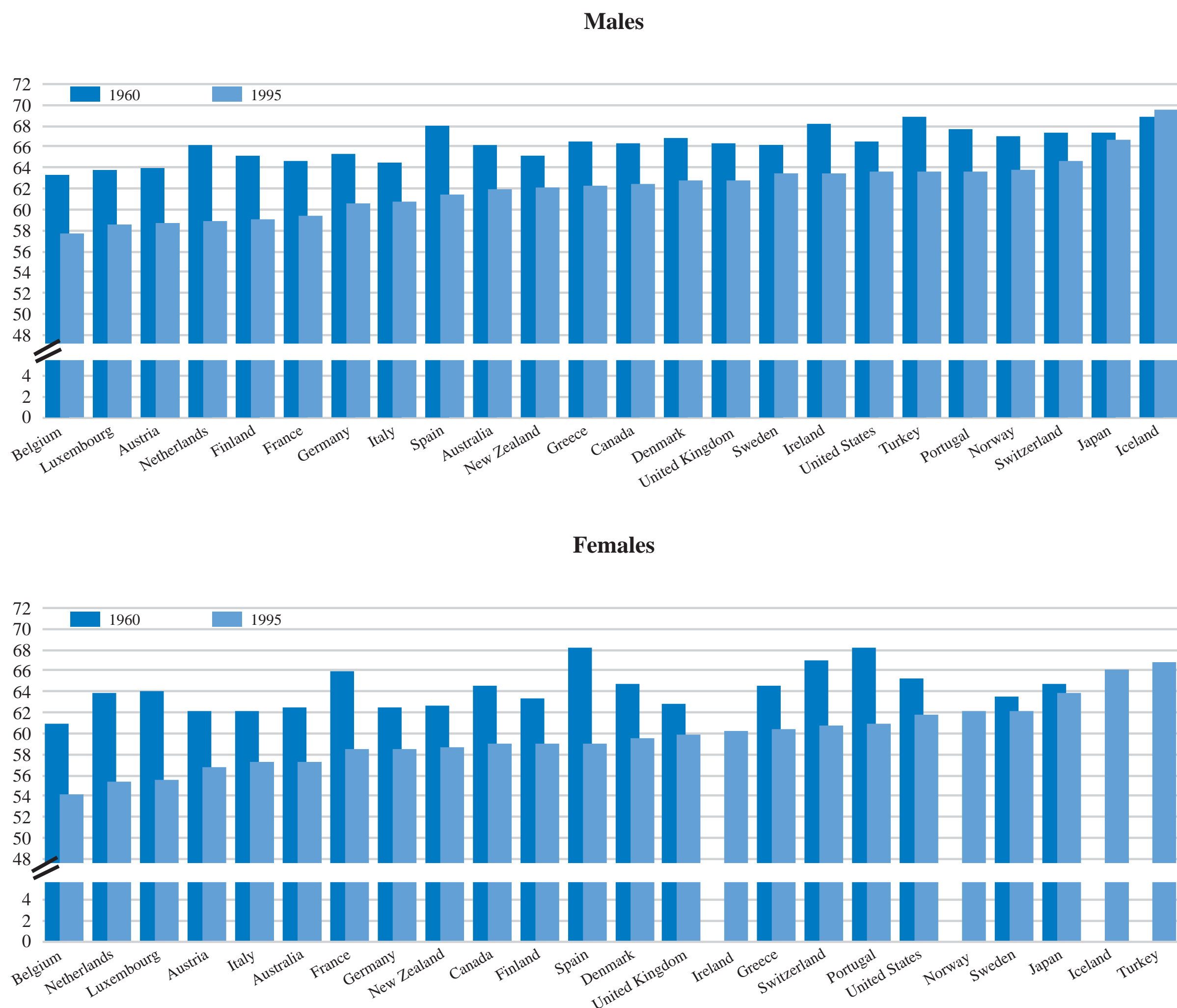
The weakening attachment of older people to working life has been reflected in a notable increase in the retired-person dependency (RPD) ratio[2] – the ratio of retirees to active population – in most of the OECD countries (Figure VI.2). In 1960, the ratio was 20 per cent for the OECD area as a whole, *i.e.* there were two retirees for every ten persons in the labour force. Thanks to the sharp increase of the OECD labour force since then, reduced activity rates of older workers have not translated into major increases in the retirement burden. Indeed, the OECD area-wide RPD ratio was only 30 per cent in 1995, ranging from a low of 23 per cent in Japan to a high of 40 per cent in Italy.

… it will increase dramatically in the next decades…

The ageing of the population will entail significant increases in the RPD ratio after 2010. If participation rates remain at their mid-1990s levels (Scenario 1 in Figure VI.2), there will be almost 6 retirees for every 10 people in the labour force by the year 2050 in the OECD area as a whole. At current participation rates, no OECD country will escape an increase in the retirement burden, and some countries could even expect to see the number of retirees coming close to the number of active persons (Germany and France) or even exceeding it (Italy and Spain). Such a development would inevitably put adverse pressures on material living standards of OECD populations.[3]

1. This chapter draws upon a recent working paper of the OECD Economics Department (Blöndal and Scarpetta, 1998).
2. The *retired person dependency ratio* captures the combined effects of demography, age-specific activity rates and trends in retirement. The RPD ratio has been calculated for each country and over time as follows. A retiree is defined as a person (55+) who is no longer economically active. The total number of retirees includes inactive people older than 64, and early retirees. The number of early retirees has been estimated considering the gradual reduction of activity rates with age (*i.e.* the reduction in participation rate between the 50-54 and the 55-59 age groups is used to estimate the number of early retirees aged 55-59). Retirement is not directly related to the entitlement to old-age pensions but withdrawal from the labour market at an older age often give rise to non-employment benefits of long duration.
3. The living standards measured by consumption per capita are likely to continue to rise, but at a lower pace than populations have come to expect. See Turner *et al.* (1998).

Figure VI.1. **Estimates of the average age of retirement, 1960-95**



... unless there is a reversal in past labour-force participation trends of older workers

An effective way to contain the rise in RPD ratios would be to increase the age at which people retire from the labour market. As shown in Figure VI.2, the increase in RPD ratios could by significantly reduced if the fall in male participation rates that occurred over the past three decades was gradually reversed (Scenario 2), thus taking the average retirement age of males back to 65 or above. By way of illustration, if such a reversal were to be accompanied by a continuation of the rise of female participation rates until they match those of males in 2030 (Scenario 3), the ratio of retirees to active people would remain almost unchanged from current levels in a few countries (including Japan and the United Kingdom) or rise much more modestly than if female activity rates remain unchanged. This may be an extreme assumption but it shows the required changes in participation behaviour to limit significantly the rise in the retirement burden.

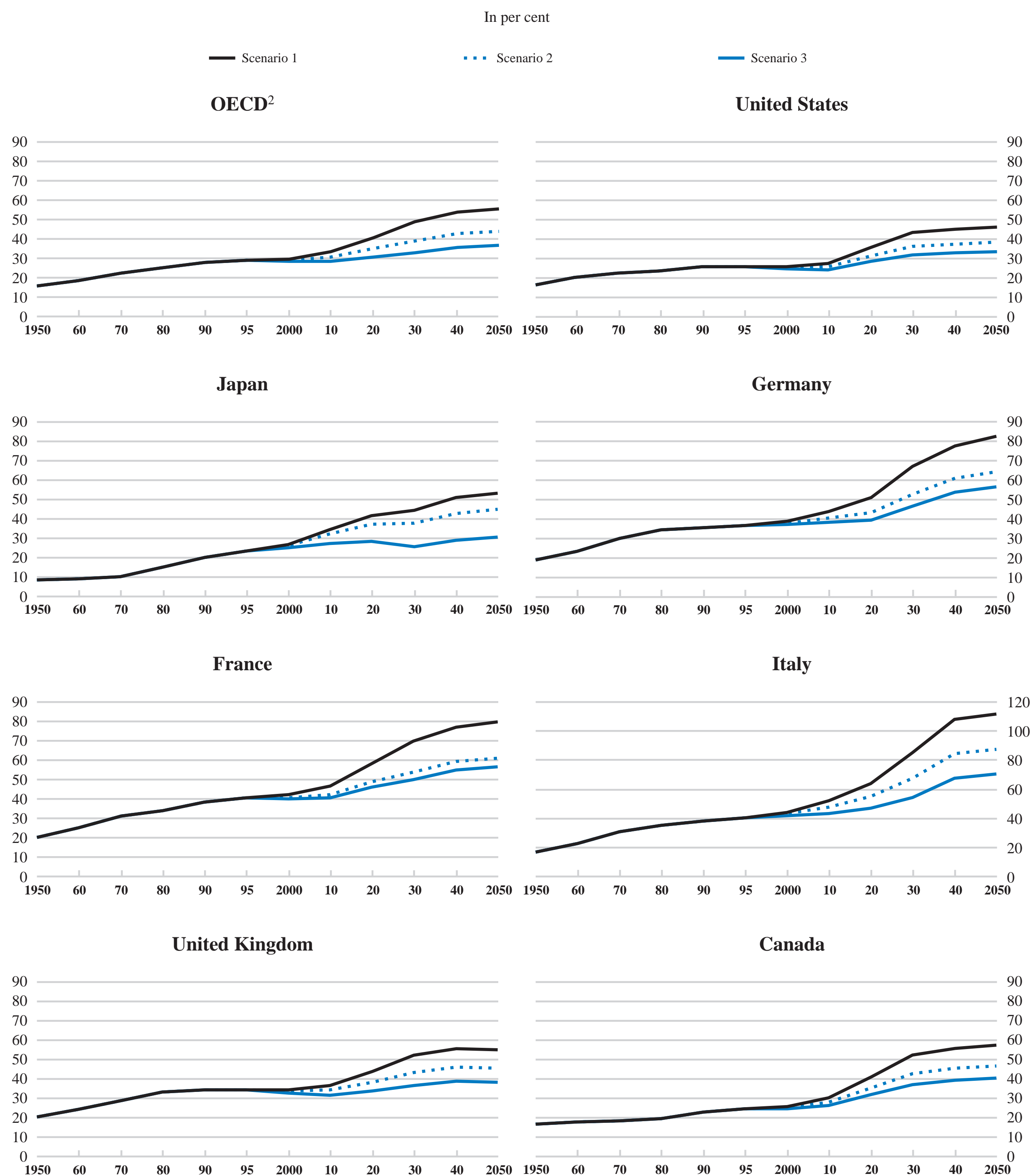
The role of social security systems in the retirement decision

A number of factors have contributed to the fall in retirement age

The drop in labour force participation of older workers in the past could be related to several distinct factors. It could reflect increased demand for leisure as societies become more affluent. It could also be associated with growing difficulties in

Figure VI.2. Retired persons dependency ratio[1]

In per cent



1. Ratio of retired persons to active persons.
2. Average of OECD countries excluding Czech Republic, Hungary, Korea, Mexico and Poland.

Scenario 1: male and female participation rates for all age groups constant from 1995 onwards.
Scenario 2: older male participation rate (50+) gradually increasing from 1995 to reach the levels of 1960 in the year 2030, female participation rates constant from 1995 towards.
Scenario 3: male participation rates as in scenario 2; female participation rates (25+) gradually increasing from 1995 to reach male participation rates (1995) in the year 2030.

labour markets, older workers facing uncertain and difficult prospects deciding to, or being forced to, withdraw from work altogether. Moreover, voluntary occupational pension arrangements have also played a role in some countries. But early retirement is also likely to be strongly related to changes in social security systems, which have made early withdrawal from the labour market possible and indeed encouraged retirement at relatively young ages by making continued work financially unattractive.

Old-age pension systems[4]

The old-age pension system has played a major role…

All OECD countries have established public pension schemes to support people in their old age, often supplemented with mandatory private schemes. Typically people contribute to such schemes during their working life in exchange for income support on retirement and/or benefits to surviving dependents. Public pension schemes have generally been based on a pay-as-you-go principle, with pension benefits being only weakly related to life-time contributions.

… the standard age has fallen in some countries…

The majority of OECD countries have kept the standard entitlement age unchanged over the past three decades (Table VI.1). In 8 countries, however, the standard age has been lowered and this has arguably contributed to discourage participation among older workers, as one year of work beyond the standard age typically implies one year's worth of pensions being foregone with little or nothing in exchange. Pensions are foregone because it is often not possible to combine receipt of pensions with full-time work, either as a result of direct restrictions on work for pensioners or because pensions are reduced with earned income so that a full-time worker on average earnings would not be entitled to any pension.

… early retirement options have been introduced…

Several countries allow pensions to be accessed prior to the standard age under certain conditions. Four European countries (Austria, Germany, Italy and Greece) have introduced seniority pensions since the early 1960s for those who have a long contribution history and who have reached a certain age.[5] Seven countries permit older citizens to obtain pensions before the standard age, subject to a permanent actuarial reduction in benefits. This was already possible in the United States and Sweden in the early 1960s, but was introduced later in Japan, Canada, Finland, Greece and Spain. In none of these countries is the adjustment factor sufficiently large to be actuarially neutral, so there is an incentive to retire as soon as pensions can be drawn.

… replacement rates have been increased…

The level of pension relative to the previous wage – the replacement rate – is arguably another element influencing the retirement decision. Workers are more likely to withdraw from the labour market as soon as they have reached pensionable age if benefits are close to wages. Gross pension replacement rates have increased in most OECD countries since the early 1960s (Table VI.1). They have risen by more than 20 percentage points in 10 out of the 19 countries for which data are available, while remaining stable or declining in only in 5 of them.

… and pension accrual rates have been reduced

Retirement decisions of older workers should be sensitive to the gains in old-age pensions from working for an additional period. Thus, if the pension accrual rate is zero there are no penalties from withdrawing from the labour market, whereas if it is

4. The description of old-age pension systems in the following paragraphs refers to 1995. Since then, many countries have decided on, or started implementing, important reforms. However, since reforms are being phased in gradually, pension rules applicable to people close to retirement have not changed significantly.
5. As discussed in Box VI.3, seniority pensions have been recently reformed in Italy and Germany.

Table VI.1. **Old-age public and mandatory pension system: change since 1960s**

	Standard age of entitlement[a]		Gross replacement ratios Summary indicator[b]		Pension accrual rate[c]	
	1961	1995	1961	1995	1967	1995
Australia	65 (60)	65 (60)	19.1	40.9	0	0
Austria	65 (60)	65 (60)	79.5	79.5	13	12
Belgium	65 (60)	65	72.6	67.5	32	15
Canada	70	65	31.3	51.6	23	0
Czech Republic	–	60 (57)		53.2		1
Denmark	67	67	35.9	56.2	2	1
Finland	65	65	34.9	60.0	10	4
France	65	60	50.0	64.8	25	12
Germany	65	65	60.2	55.0	13	11
Greece	65 (60)	62 (57)		120.0		25
Hungary		60 (56)		54.6		1
Iceland	67	67		93.0		10
Ireland	70	66	38.6	39.7	0	0
Italy	60 (55)	62 (57)	60.0	80.0	24	10
Japan	60 (55)	60 (58)	24.6	52.1	5	3
Luxembourg	65	65		93.2		19
Netherlands	65	65	29.0	41.2	9	9
New Zealand	65	62	32.0	61.3	0	0
Norway	70	67	25.3	60.0	17	9
Poland		65 (60)		53.7		9
Portugal	65	65 (62.5)	85.0	82.6	15	10
Spain	65	65		100.0	0	0
Sweden	67	65	53.8	74.4	21	0
Switzerland	65 (63)	65 (62)	28.4	49.3	12	11
United Kingdom	65 (60)	65 (60)	33.4	49.8	0	10
United States	65	65	39.1	56.0	0	0

a) Standard age of retirement for women in parenthesis.
b) The summary indicator of gross replacement rates is an average of four cases: Two earnings levels (i.e average and two-thirds of average) and two household compositions (*i.e.* a single worker and a worker with a dependent spouse). For all cases it is assumed that the employee starts work at the age of 20 and that he has uninterrupted work until the standard age of entitlement to public pensions. The earnings profile over the working life is assumed to be flat and earnings re-valued in line with changes in average earnings.
c) Increase in old-age pensions for a 55 year-old male by working for 10 more years, in percentage points of the gross replacement rate.

high there are incentives for workers to continue working. Pension accrual rates at older ages differ significantly across OECD countries (Table VI.1). In a few countries the level of pensions increases over the whole of the potential working life, whereas in some others pensions are not related to the length of employment or contribution records. In between are countries where full pensions are earned relatively quickly, implying zero pension accrual rates for older workers. In fact, in almost half the countries for which data are available for 1995, a 55 year-old male worker could expect no or an insignificant increase in his pension by working for ten additional years. This is in striking contrast with the practice in the 1960s, when expected pension replacement rates could be increased by more than 20 percentage points in several OECD countries by working for ten additional years.

Other non-employment benefits

But other benefit schemes have also played a role

Increased disincentives to work at older ages embedded in pension systems have been compounded by changes in other benefit systems, notably unemployment-related benefits and disability benefits. These schemes were not originally intended to support people in retirement: disability schemes were introduced to

provide income support to people incapacitated for health reasons; and unemployment benefits were originally designed to offer temporary income support for active job seekers who were out of a job. However, changes in eligibility conditions have *de facto* turned these schemes into early-retirement programmes in a number of OECD countries.

The easing of entitlement to disability benefits has mostly been informal, but there have also been statutory changes in some OECD countries. An explicit labour-market criterion in granting disability pensions was written into law in several European countries in the 1970s. In some other countries (including Austria and Norway), a labour market criterion appears to have been applied, albeit not with any explicit basis in law. In all these countries, disability benefits have been more readily granted when unemployment was high or rising or when there were particular difficulties in local labour markets. However, even in countries where eligibility is supposed to be assessed against rigid medical criteria (*e.g.* United States, Japan, France, the United Kingdom and Canada), there is evidence that inflows into disability tend to be higher in times of labour market strains.[6]

A large number of OECD countries have made it possible for older unemployed workers to draw benefits until the pensionable age or allowed them to get access to old-age pension at an early age. Several countries have relaxed entitlement conditions for older workers' receipt of ordinary unemployment insurance benefits, mainly by exempting them from active job search. In some other countries, older workers with a long spell of joblessness can have access to old-age pension at an early age, thus dropping out of the labour force. Where relaxed entitlement conditions have been combined with generous benefit levels, either unemployment-related or old age pension benefits, exits into retirement via a spell of joblessness have become financially attractive.

The implicit tax on continued work

The incentives to continue to work at older ages embedded in public income-support systems can be summarised as an implicit tax rate.[7] Continuing to work can imply costs in terms of contributions paid and foregone pensions or other benefits, while it may result in permanently higher pensions after retirement. When the sum of discounted gain in pensions over the whole retirement period is equal to the cost of continued work, the social security system is neither encouraging nor discouraging continued work and the implicit tax rate is zero. However, if the costs are higher than the sum of discounted gains in pensions, the social-security system is implicitly taxing continued work and the implicit tax rate is the difference between costs and benefits divided by gross earnings. Similarly, when the sum of discounted gains exceeds the costs, the social-security system is subsidising continued work.

Pension systems in most OECD countries currently impose an implicit tax on continued work at older ages…

Judging from the estimates presented in Table VI.2, old-age pension systems in almost all OECD countries imposed an implicit tax on work from the age of 55 to 64 on average in 1995. The tax rates were typically very high after the earliest age at which pension can be accessed, as the sum of discounted gains in pensions was

6. For the United States, see Bound and Waidmann (1992). For the United Kingdom, see Holmes and Lynch (1990).
7. The concept of the implicit tax on continued work has been proposed by Gruber and Wise (1997) in the context of the NBER International Project on Retirement. The implicit tax (or subsidy) on continued work is the average annual variation in the social security wealth – relative to gross earnings – obtained by postponing retirement from 55 to 64 years of age. The social security wealth is the sum of the discounted value of expected benefits (either pensions or other non-employment benefits) minus the discounted cost of obtaining these benefits. See Blöndal and Scarpetta (1998) for more details.

insufficient to offset both contributions paid and foregone pensions. Tax rates were generally much lower prior to minimum pension ages, and a few countries provided small subsidies to continued work until this age. The very high average implicit tax rate in Italy in 1995 was related to the fact that seniority pensions became available even prior to the age of 55 and that pensions were comparatively generous. Average tax rates of 20 to 34 per cent were to be found in countries where the standard or minimum entitlement age was around the age of 60, while single digit tax rates were common in countries where there was no opportunity to access pensions prior to the age of 65.

… and the availability of other benefits increases the implicit tax considerably

The availability of *de facto* early retirement benefits prior to the minimum pension age added considerably to the overall tax on continued work over the 55-64 age span in many countries. In this case, costs associated with continued work up to the minimum age are not confined to contributions paid, but also foregone benefits (disability, unemployment-related or special early retirement). Moreover, the common practice of crediting periods spent in such income-support programmes for pension purposes implies that there are no gains in ultimate pensions by continuing to work. For example, the availability of unemployment-related benefits without any requirement for active job search after the age of 50 implied that the average implicit tax on work in Denmark exceeded 50 per cent in 1995, whereas the old-age pension system alone did not impose any tax. The implicit tax in the Netherlands went from single digit to more than 50 per cent once it is taken into account that unemployed workers aged 57.5 could obtain unemployment benefits until pensionable age. In most countries, the implicit tax rate was even higher when it was an option to use disability schemes as early retirement schemes from the age of 55, and very high implicit tax rates were often associated with special early-retirement schemes.

Table VI.2. **Implicit average tax rate on work from 55 to 64, 1967-95**[a]

Per cent

	1967	1995	
	Old-age pension	**Old-age pension**	**Overall**[b]
Australia	0	0	21
Austria	31	34	34
Belgium	–2	23	37
Canada	–15	6	6
Denmark	0	0	51
Finland	0	22	42
France	2	14	49
Germany	4	14	32
Iceland	. .	1	1
Ireland	5	14	32
Italy	30	79	79
Japan	10	28	28
Luxembourg	. .	29	65
Netherlands	5	8	57
New Zealand	0	9	27
Norway	3	15	15
Portugal	5	4	33
Spain	6	18	45
Sweden	–9	18	18
Switzerland	–2	0	0
United Kingdom	6	5	15
United States	8	12	12

a) The implicit tax (or subsidy) on continued work (see text) is the average annual variation in the social security wealth relative to gross earnings as a result of postponing retirement from 55 to 64 years of age. The social security wealth is the sum of the discounted value of expected benefits (either pensions or other non-employment benefits) minus the discounted cost of obtaining these benefits. See Blöndal and Scarpetta (1998). Figures are relative to annual earnings and refer to a single individual at average wage.

b) Old-age pension and unemployment-related benefits.

The implicit tax has increased over time

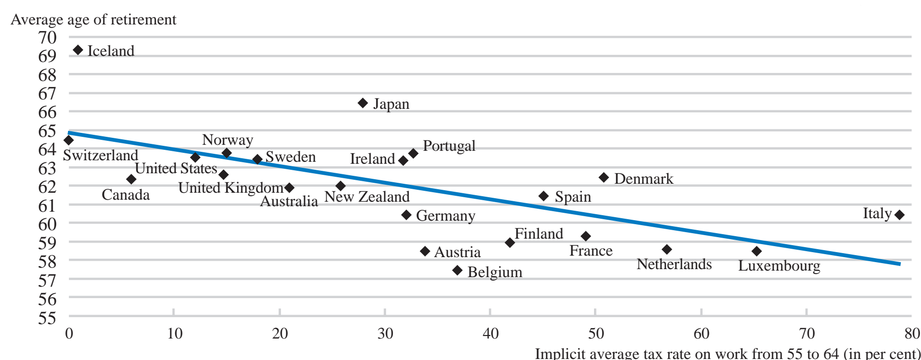
As could be expected from the discussion above, implicit tax rates on continued work after 55 have steepened significantly in recent decades. Indeed, in 1967 pension systems in several countries were close to being neutral with respect to the retirement decision over ages 55 to 64, and a few countries encouraged work over this age span by an implicit subsidisation. As entitlement conditions had not been relaxed in unemployment-related and disability systems to make it possible to use them as early-retirement systems, such systems were not taxing continued work. The broad trend towards stronger incentives in the old-age pension system to retire early masks considerable differences across countries. Increased implicit taxes on continued work have been particularly high in Italy, France, Finland and Sweden, whereas they have been broadly unchanged in the United Kingdom, Australia and Portugal.

Impact on participation rates of older workers

Participation is low when the implicit tax is high

Figure VI.3 suggests a clear relationship between the average retirement age and the implicit tax rate on continued work across OECD countries in 1995. Countries where continued work was heavily taxed either because of the old-age pension and/or the unemployment-related benefit systems were typically the same countries where the average age of retirement of males is comparatively low, and *vice versa*. Thus, this simple correlation corroborates previous findings: incentives to retire early have a potentially strong effects on activity rates of older people.[8]

Figure VI.3. Implicit tax rates on continued work and average age of retirement, males, 1995



Note: The implicit tax rates (see text) take into account incentives in both old-age pension and unemployment-related benefit systems.

Empirical results also confirm that changes in social-security systems have played an important role in driving down the labour-force attachment of older workers.[9] These results suggest that an increase in the average implicit tax on continued work from the age of 55 to 64 by 10 percentage points would lead to a drop in older male participation rates of about 3.5 percentage points. On this basis, the increase in the implicit tax rate embedded in the old-age pension system since the late 1960s could

8. See Gruber and Wise (1997).
9. These results are derived from a reduced-form equation of older male participation rate using cross-section and time-series data for 15 OECD countries over the period 1971-1995. See Blöndal and Scarpetta (1998).

explain up to a 10 percentage point drop in the participation rate of older males in Italy, France and Sweden. If other non-employment benefits were included in the assessment of the implicit tax, the overall impact of the changes in the incentives could be estimated at more than 10 percentage point drop in male participation rate in Denmark, the Netherlands and Spain.

Recent reforms

Reforms have been introduced…

Several OECD countries are in the process of phasing in changes in their pension systems or have decided major changes that will be implemented in the future. Reforms have either involved changes to the traditional pay-as-you-go systems or increased reliance on advance-funded arrangements, or both. Although the main motivation for these reforms has been cost containment and financial balance in the face of ageing populations, they are expected to have substantial effects on work incentives and thus on the capacity of the reforming countries to meet the "real" burden of ageing (Box VI.2).

Box VI.2.

Moving to an actuarially neutral pension system: effects on older male participation rates

Simulations by the Secretariat suggest that eliminating the implicit taxation on continued work at older ages could significantly increase labour-force participation of older workers.[1] The cross-country variability of the participation rates of males aged 55-64 will be markedly reduced, with most countries reaching a participation rate of at least 60 per cent (France, Finland and the Netherlands are notable exceptions). The largest increase would be in Italy, where the move towards a neutral system could bring the participation rate back to its levels of the 1950s and 1960s.[2] France, Finland and the Netherlands would also experience marked increases in their participation rates, especially if other income support schemes could no longer be used as early retirement programmes. However, the simulation suggests that their participation rates would remain at the lower end of the OECD range, even after such a reform. In the other European countries, the labour supply of older male workers would increase to around 65 per cent of the older male population, while in the United States and Japan it could approach 70 per cent and 90 per cent of the older male population, respectively. Lack of data makes it impossible to estimate participation-rate equations for the 65-69 year-olds. Yet, the generally very high tax rates on continued work after 64 suggest that a move to a neutral system could have sizeable effects for this age group.

1. These policy simulations are based on a reduced-form equation of older male participation rates, which was estimated using panel data for 15 OECD countries over the 1971-1995 period. See Blöndal and Scarpetta (1988) for further details.
2. As discussed in the main text, recent reforms in Italy will indeed gradually bring the pay-as-you-go system close to an actuarially neutral system.

… by modifying the pay-as-you-go systems…

Reforms of the traditional pay-as-you-go public old-age pension systems have usually implied changes to several of the basic parameters determining pension benefits, including:

- a lengthening of the reference period used in determining the value of pensions (*e.g.* France, Finland, Greece, Poland, Portugal, United Kingdom, Spain and Sweden);
- indexation of benefits to net wages (*e.g.* Austria, Germany and Japan) or prices (*e.g.* France and Italy) instead of gross wages;
- an increase in the standard age of entitlement to public pensions in general (*e.g.* Italy, Japan, New Zealand and the United States) and for women in particular (*e.g.* the United Kingdom);

– an increase in the minimum age of entitlement or required years of contribution to seniority pensions *(e.g.* Belgium and Italy);
– a lengthening of contribution periods required for full pension (*e.g.* France and the United Kingdom);
– a greater flexibility in the age at which benefits can be accessed with actuarial adjustment (*e.g.* Germany, Italy and Sweden);
– an increase in contribution rates (*e.g.* Japan and Portugal).

Except for the last change listed above, these reforms have generally gone in the direction of reducing the incentives to early retirement. Box VI.3 provides details of pension reforms in selected countries.

… but without eliminating the implicit tax on continued work

Notwithstanding these reforms, traditional pay-as-you-go systems will still impose a significant tax on continued work at older ages in most countries. For example, in the United States the average implicit tax rate on work from 55 to 69 will have fallen only from 18 to 14 per cent once the reforms are fully implemented; in Japan the average tax rate will be unchanged as the reduction for ages 60-64 is offset by higher taxes on work from ages 55 to 59; in Germany the rate will drop from 38 to 28 per cent when there is a possibility of accessing pensions at the age of 60; in France it is practically unchanged when it is taken into account that early retirement can still take place via unemployment benefit and special early retirement systems; and in the United Kingdom the reforms have taken the average implicit tax rate down only from 16 to 13 per cent. Thus, removing the tax on continued work requires much more drastic changes to pay-as-you-go systems than have been decided so far.

A few countries are shifting towards defined contributions and private schemes…

More fundamental changes to public pension systems have involved strengthening the link between life-time contributions and pension benefits. Arrangements where contributions are fully reflected in pension benefits in an actuarially neutral way do not distort the work-retirement decision insofar as each additional year of contributions will be compensated by greater pension benefits upon retirement. The link between lifetime contributions and benefits has been reinforced in a number of OECD countries, including Italy, Hungary, Mexico, Poland and Sweden, by shifting from a defined-benefit to defined-contribution systems. Since the latter transfer the risk of low-income upon retirement to individuals, these reforms have generally been accompanied by the introduction of means-tested benefits for those who do not otherwise qualify for a pension or whose pension falls below some poverty threshold. Moreover, workers who have already contributed to defined-benefit schemes for a long period are generally exempted from the reform or are offered the option to choose between the old and the new system. The move towards contribution-based schemes has also been accompanied by greater flexibility in the retirement decision. After the minimum retirement age (57 in Italy, 62 in Hungary and Poland), workers will be allowed to withdraw from the labour market at the age of their own choice: those retiring early will do that at the expenses of a permanently lower pension, while those retiring later will be correspondingly rewarded.

… using different approaches

Different approaches have been used to move towards a contribution-based pension system. Some countries, including Hungary, Poland and Sweden, have shifted from a defined-benefit pay-as-you-go system to a mixed public-private system which includes a pay-as-you-go tier and a privately-managed fully-funded compulsory tier. Mandatory contributions finance the two pillars in different proportions depending on the country. Moreover, in some cases, favourable tax treatment will encourage workers to contribute to an optional fully-funded third tier. The pay-as-you-go first pillar is generally based on the principle of Notional Defined Capital in which retirement benefits

Box VI.3.

Pension reforms and implicit tax: country examples

A number of OECD countries are in the process of reforming their old-age pension systems. The major features of these reforms in some selective countries and the potential impact on the incentives to retire can be summarised as follows:

United States The 1983 reform, which will be fully implemented in 2022, included the raising of the standard entitlement age to public pensions from 65 to 67. Moreover, the actuarial adjustment factor for each year of work beyond the standard age has been increased from 5 to 8 per cent, while the pension system will still allow access to pension at 62 but with a downward adjustment factor of 5-6.6 per cent for each year of retirement taken from 62 to 67. These reforms implied that the implicit tax on continued work was broadly unchanged for ages 62 to 64 but fell notably for ages 65 to 69.

Japan The 1994 reform, which will be fully implemented in 2025, raised the standard eligibility age for the basic component of pension payments from 60 to 65 for employees, access at the age of 60 still being possible but with an actuarial adjustment yet to be decided. Moreover, it envisaged that the level of contribution rates be raised incrementally until the long-run stability of the system is achieved; this, however, would imply an increase from 14.5 per cent in 1995 to around 30 per cent according to official projections. On the assumption that the actuarial adjustment factor will be similar to that currently applied for the self-employed, the reform will reduce disincentives to work for ages 60 to 64, but the increase in pension contributions implies that the implicit tax increases significantly prior to the current retirement age of 60.

Germany Reforms in 1992 and later, which will be fully effective after the year 2004, introduced an actuarial reduction applicable to seniority pensions from the age of 63 (for males) and actuarial increases for deferred retirement. The adjustment factors are 3.6 per cent per year of early retirement in addition to reductions due to fewer contribution years; and 6 per cent for each year of retirement after 65, in addition to increases due to a longer contribution history. Moreover, old-age pensions available to some categories of workers at the age of 60 (including unemployment pensions) will also be subject to actuarial reduction. This reform reduces the implicit tax on continued work for ages 60 to 64 and 67 to 69, but the system will continue to discourage work after the age of 55.

France The 1993 reform, which will be fully effective in the year 2008, included an increase in the contribution period for full pension from 37.5 to 40 years. For an employee who has contributed since the age of 20, this reform gives strong incentives to work until the age of 59 whereas there is an implicit tax on working from 57 to 59 in the current system. However, as it is still an option to retire via the ordinary unemployment benefit system and special early-retirement schemes, the implicit tax is unchanged when these possibilities are taken into account. The lengthening of the reference period used to calculate pensions will most likely reduce pension replacement rates, and thus the implicit tax on continued work after the age of 60. Nonetheless, there will still be major disincentives to work after the age of 60.

Italy The 1992, 1995 and 1997 reforms will significantly change the public pension system: *i)* the standard retirement age will be gradually raised to 65 for men and 60 for women (by 2002); *ii)* the earliest age for seniority pension will be gradually raised (54 currently) and this type of pension will be abolished in the year 2013; and *iii)* pensions will be gradually determined by contributions over the entire working life. These reforms, when fully implemented in 2035, imply that the pension system will be fully contribution based and broadly neutral (see main text).

United Kingdom The 1986 reform, which will become fully effective in 2028, reduced the annual accrual rate in the State Earnings Related Pension Scheme (SERPS) from 1.25 to 0.41 per cent. However, the original intention of the SERPS was that maximum replacement rate should be 25 per cent, implying that accrual rates after 20 years of contributions would be zero. The reform thus increased the pension wealth accrual after 20 years of contributions, but disincentives still remain.

will be closely linked to the appropriately indexed virtual capital accumulated by each individual during working life. The second pillar operates as a fully-funded capitalisation system. Individual pension accounts are managed by private funds under government supervision and, upon retirement, workers will buy an annuity with the accumulated contributions.

Other countries have moved in to funded pension systems without introducing a two-tier mandatory scheme. Thus, Mexico has transformed the previous pay-as-you-go system into a fully-funded capitalisation system in which mandatory contributions finance individual pension accounts managed by private fund administrators. In contrast, the pay-as-you-go system will be maintained in Italy, but pension benefits will be gradually determined by the Notional Defined Capital, the contributions being capitalised at the rate of real GDP growth. The stock of contributions can be transformed into annual pensions from the age of 57 onwards, with adjustments reflecting life expectancy and expected GDP growth rates.

Reforms of other non-employment benefit systems are required

A few OECD countries have also embarked on reforming their non-employment benefit systems, with an increased targeting on people in need. The Netherlands, after the abolition of the labour-market criterion in 1987, has taken further steps to tighten the disability system, including stricter medical reviews, lower benefits and replacing the criteria from ability to perform previous job to work in any occupation. The minimum age for eligibility for early disability and unemployment pensions was recently raised in Finland, while some tightening has also occurred in Italy, Australia and Norway.

The experience of countries that have recently reformed their social security systems is indicative of the close interactions that exist between the different income support programmes: tightening one programme may result in a greater use of other programme. For example, the tightening of the disability system in the Netherlands coincided with an increase in claimants of unemployment and other social welfare benefits, and this might be particularly relevant for older workers as they have benefits of long duration.[10] Also, the tightening of the disability system in Norway went hand in hand with an easing of entitlement conditions for special early-retirement benefits, and substitution between the two schemes appears to have taken place. In general, reforms to reduce disincentives to work need to look at all possible early retirement programmes together in order to reduce the danger that benefit claimants migrate from one system to another.

Concluding remarks

There is clear evidence that old-age pension systems have had a marked impact on the retirement behaviour, often discouraging labour force participation among older workers. Although the observed trend to early retirement may in part reflect a rising demand for leisure as societies become prosperous, changes in social security systems have made continued work at older ages financially unattractive. The disincentives to work are particularly strong after the earliest pensionable age: the increase, if any, in pension entitlements due to an additional year's work is often insufficient to cover the extra pension contributions and foregone pension payments. A number of factors have contributed to the observed increases in the implicit tax on work after the age of 55 over recent decades, including the lowering of standard retirement ages, higher pension

10. This issue is discussed in Lindeboom (1998).

replacement rates, flatter pension accruals at older ages, and higher pension contribution rates. Incentives to retire early are amplified in countries where other income-support schemes – which were originally designed to deal with other contingencies – have been used to finance early retirement.

Recent reforms in old-age pension systems have gone in the direction of reducing the incentives to early retirement by changing several of the basic parameters determining pension benefits. Most of these changes are to be phased in gradually and the reformed pension systems will be fully operational in the first decades of the next century. However, only in a few cases will these reforms completely eliminate incentives to early retirement and further actions will most likely be required in the future. Actions have also been taken to tighten the access to disability benefits by abolishing the labour market criterion and focusing on stricter medical reviews. In contrast, no major action has yet been taken to reform unemployment-related benefit systems for older workers. More generally, the removal of disincentives to work may need to be accompanied by labour market reforms that promote job opportunities for older workers.

Removing the incentives to early retirement could pose a considerable challenge to OECD labour markets. The labour supply of older workers would rise significantly, and it might be difficult to absorb this increase in countries with high structural unemployment. The adjustment would be eased if reforms of pensions and other income-support systems for the elderly were to be accompanied by measures to increase job opportunities in general, including elimination of measures and practices that discriminate against older workers. The reforms discussed above could themselves contribute to increase job opportunities for older workers by inducing *inter alia* changes in their wage determination, participation in training, mobility, and working-hour schedules. However, the more broad-based reforms of labour and product markets along the lines advocated in the OECD *Jobs Strategy* would make the transition to increased participation of older workers in the labour market both easier and quicker.

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VII. THE ECONOMICS OF CLIMATE CHANGE

The issue of climate change – specifically the effects of global warming due to increasing atmospheric concentrations of human-made emissions of so-called greenhouse gases – is the subject of renewed interest, in large part owing to the adoption of the Kyoto Protocol on 10 December 1997 (Box VII.1). Policies to slow the rise in concentrations by controlling greenhouse gas emissions raise a number of economic issues. This chapter reviews some of these issues based on work done at the OECD; more detailed accounts of this work can be found in *Global Warming* (OECD, 1995) and the special issue of *OECD Economic Studies* (OECD, 1992).

Although there have been significant recent advances in both the science and economics of climate change, the key conclusions of this work remain largely valid. These can be summarised as follows. Developing countries will grow rapidly and become significantly more industrialised over the coming decades, implying that they will contribute an increasing proportion of global greenhouse gas emissions. As a result, these countries will have to be included in any agreement that hopes to stabilise either emissions or atmospheric concentrations of greenhouse gases. Second, this need for abatement efforts from developing countries raises the difficult issue of international equity: how to share the burden of emission abatement, in particular between OECD and developing countries. Third, given agreed emission abatement targets, it is economically efficient to equalise marginal abatement costs across countries, firms and plants. This could be implemented through a common tax on carbon emissions or a global system of tradable carbon emission permits. Equalising marginal abatement costs, however, would mean that countries where emissions cuts can be made most cheaply – including many developing countries and, in particular, China – would be required to do the most abatement and, in the absence of explicit or implicit international transfers, bear much of the cost.

The next section reviews evidence on costs of a global agreement to reduce CO_2 emissions and illustrates why regional differences in costs and benefits will be a central concern in shaping further world-wide action. The third section analyses strategies to minimise the aggregate costs of imposing emissions reductions. The fourth section reviews the experience of OECD countries with taxes and tradable permits.

Box VII.1. **From Rio to Kyoto: a growing concern about climate change**

In 1995, more than 150 countries adopted the UN Framework Convention on Climate Change at the Earth Summit in Rio de Janeiro. Annex I countries (OECD countries, except Mexico, Korea and Turkey, plus Russia, Belarus and the countries of central and eastern Europe) committed to stabilising their CO_2 emissions. This Convention was a response to mounting scientific evidence collected by the Intergovernmental Panel on Climate Change (IPCC), which was established in 1988 by the UN Environment Program and the World Meteorological Organisation in order to produce assessment reports written and reviewed by about 2000 scientists and experts world-wide. The general conclusion of the second IPCC report, published in 1995, is that "the balance of evidence suggests a discernible human influence on climate".

(continued on next page)

Box VII.1 (*continued*). **From Rio to Kyoto: a growing concern about climate change**

Subsequently, it became clear that industrialised nations would fall short of their commitments adopted in Rio, and the main objective of the Third Conference of the Parties to the Convention, held in Kyoto in December 1997, was to agree legally binding quantitative targets. The result was a protocol which, for the first time, commits industrialised nations to stabilise their emissions of greenhouse gases. This protocol involves the following major provisions:

- Annex I countries as a group will cut their greenhouse gas emission by about 5 per cent relative to 1990 levels. These commitments have to be met in the 2008 to 2012 period (the first commitment period). The reduction commitments are specified country by country. The Protocol mentions that they have to be met by countries, individually or jointly. The reduction targets range from an increase in emissions of about 10 per cent in Iceland to reductions of 8 per cent in the European Union. The United States would reduce its emissions by 7 per cent and Japan by 6 per cent. The Russian Federation and eastern European countries would stabilise their emissions at their 1990 levels which, given the reforms that these countries are undertaking, could be achieved without further measures.
- The Protocol covers six greenhouse gases: carbon dioxide, methane, nitrous oxide and three synthetic fluorinated compounds.
- The Protocol allows for emission trading among Annex I countries. Emissions reductions can be "banked", in the sense that countries that more than meet their commitments in the first commitment period can use the surplus reductions for future commitment periods.
- The Protocol makes provision for joint implementation through a "Clean Development Mechanism"; abatement investments financed by an Annex I country would count against the target of the former.
- Net emissions changes from land-use change and forestry are included in the Protocol for activities undertaken since 1990.
- The Protocol will enter into force 90 days after 55 Parties accounting for 55 per cent of total CO_2 emissions of Annex I countries in 1990 have ratified it. Future meetings will define relevant rules and guidelines for emission trading and ways to verify the compliance to agreed commitments.

The costs of a world-wide programme to reduce CO_2 emissions

The effects of climate change are uncertain

The considerable uncertainty surrounding both costs and benefits of greenhouse gas emission abatement greatly complicates policy assessment. An important source of uncertainty is the very long time periods over which climate change is expected to occur. Climate change and its effects may appear in the second half of the next century, and virtually nothing is known for sure about economic conditions and technological opportunities that far ahead. In addition, our knowledge of the links between emissions and atmospheric concentrations of greenhouse gases, and of the effects of climate change is still very incomplete, although improving.

The analysis is restricted to anthropogenic emissions of carbon dioxide (CO_2), mainly emissions from fossil-fuel combustion. Carbon dioxide accounts for more than one-half the total effect of greenhouse gases on climate change, but other gases are also important and have been explicitly included in the Kyoto Protocol. A major contribution of the OECD has been to compare the results of several global economic models under standardised assumptions (Box VII.2).[1] The economic costs of abating CO_2 emissions were assessed by contrasting a "business-as-usual" (BAU) scenario in which no abatement efforts are undertaken with alternative abatement scenarios. The abatement scenarios were not chosen to duplicate any particular agreement (and certainly not the Kyoto Protocol), nor were they intended as specific policy advice.

1. A similar exercise was conducted by the IPCC (1996).

Box VII.2. **The OECD model comparison project**

Early surveys of the economic costs of reducing CO_2 emissions highlighted large differences in results, without being able to explain such differences in a satisfactory way. The OECD model comparisons project was an attempt to understand better why results differ by standardising key assumptions and emission-reduction targets and conducting some limited sensitivity analyses. The OECD project proceeded in close co-operation with a more comprehensive exercise by the Energy Modelling Forum of Stanford University (EMFl2). Six global models participated in the OECD project (see Dean and Hoeller, 1992, for details): the Carbon Rights Trade Model (CRTM); the Edmonds and Reilly model (ERM); the OECD GREEN model; the International Energy Agency (IEA); the Manne and Richels Global 2100 Model; the Whalley and Wigle Model.

All were macroeconomic models with specifications of energy sectors that are substantially simpler than those of dedicated energy-sector models. Key economic assumptions for the "Business-as-Usual" (BAU) scenario and a set of common simulations for reducing CO_2 emissions ensured some standardisation across models.

Business-as-usual (BAU) assumptions

1. World population rises from 5.3 billion in 1990 to 9.5 billion in 2050 and to 10.4 billion by 2100, by which time it is hardly growing at all (World Bank projections); nearly all of the growth is in China and other developing countries;
2. output growth slows throughout the next century from 2.5 per cent per annum in the 1990s in OECD countries to only 1 per cent by 2100, and from 4 per cent to less than 3 per cent in developing countries;
3. oil prices are $26 per barrel in 1990, rise by $6 each decade in real terms to reach $50 in 2030, and are unchanged thereafter.

Reduction scenarios

Three of the scenarios were specified in terms of reductions relative to the BAU in the rate of growth of emissions in each region by, respectively, 1, 2 and 3 percentage points. In this way, the amount of the reduction, in percentage terms, was identical across models, although the starting points (the BAU), and thus the resulting emissions levels and costs, varied. This method isolated the differences between model structures, providing insight into the economic and technical factors leading to different predictions. The fourth scenario was a stabilisation of emissions at 1990 levels in each region, which would be most stringent for those regions where BAU emissions growth is most rapid (China, for example) and least stringent for the OECD.

For reference, a 1 per cent reduction from the BAU would approximately stabilise emissions of the OECD area and perhaps those of the former Soviet Union too (though not in all models). It implies relatively rapid growth of emissions elsewhere. A 2 per cent reduction would require absolute cuts in emissions in the OECD and the former Soviet Union and allow very low growth elsewhere. A 3 per cent reduction is relatively close to the scenario of the International Panel on Climate Change for stabilising CO_2 atmospheric concentrations by the middle of the next century. As a matter of comparison, the commitments of the Kyoto Conference would imply a 0.4 percentage point reduction of the annual growth rate of world emissions.

In all cases, the policy instrument used to achieve emission reductions was assumed to be a carbon tax levied on the carbon content of primary energy sources.

Business as usual

With unchanged policies CO_2 emissions may rise threefold by 2050

In the BAU scenario emissions growth could range from 1 to 2 per cent annually over the next hundred years. Accordingly, world-wide emissions in 2050 could lie between 10 and 20 billion tons of carbon per year, compared with about 6 billion tons now. Much of the increase in emissions would come from coal-consuming countries with large populations, such as China and India.

Key sources of uncertainty in such projections include: assumed economic growth (economic and emissions growth tend to move together); the assumed rate of exogenous efficiency improvement (roughly, the evolution of the energy-GDP ratio, all else equal); the evolution of international energy prices; and when and at what cost alternative carbon-free energy sources, referred to as "backstop technologies", will become available. Uncertainty in the BAU scenario itself is, in turn, an important source of uncertainty in estimating the costs of alternative reduction scenarios. Notably,

the commitments agreed at Kyoto are expressed relative to 1990 emissions levels, so the costs of meeting them will depend crucially on what the path of emissions would have been in the absence of abatement measures. In general, the higher this emissions path, the greater will be the required abatement efforts.

Reducing emissions growth by 1 percentage point

Reducing emissions growth by one percentage point would not stabilise emissions or concentrations...

Compared with the BAU scenario, a reduction in annual emissions growth of 1 percentage point by all countries (or regions) would stabilise the emissions of OECD countries at 1990 levels, but those of developing countries would continue to grow. Thus, world emissions would grow by 0.5 to 1 per cent per year, depending on assumptions about economic growth and energy efficiency. Concretely, lower emissions growth could be brought about by tighter regulation, taxation of carbon or energy, or a system of tradable emissions permits. The last two are examined below.

The abatement efforts needed to reach such a target path for emissions would have to intensify over time, at least until the carbon-free "backstop" became available; thus, carbon tax rates or the price of emissions permits would have to rise to induce further abatement. This is because initial cuts in carbon emissions come relatively cheaply through substitution of high-carbon fuels, such as coal, for low-carbon fuels, such as natural gas. As such substitution possibilities become fully exploited, further cuts become more costly and higher taxes are needed to induce them. Likewise, assuming that each region makes the same percentage cuts implies that abatement efforts and costs will vary across regions. Those that rely relatively extensively on high-carbon energy – such as China, India and Russia – can reduce emissions relatively cheaply relative to those which have already substituted extensively away from coal – notably the OECD countries. As discussed below, such equi-proportionate emissions cuts are economically costly relative to a programme in which more of the abatement takes place in countries that can abate cheaply.

Abating emissions would reduce real income, or GDP, by distorting resource use and economic activity. This should not, however, be seen as a net loss to society as a whole, because abatement would also bring benefits in terms of less global warming. Emissions abatement and global warming would generate both transition costs and longer-term costs once a new equilibrium had been reached. Ideally, abatement would be carried to the point where the difference between its benefits and its costs and were maximised.

... and could cost up to 2 per cent of GDP

The economic costs of emission reductions, as projected by the models in the OECD comparison project, took the distortionary costs, but not the transition costs, into account; the benefits of less global warming were not taken into account. Depending on the underlying assumptions enumerated above, by 2050 the assumed emissions cuts would entail costs ranging from 0.6 to 1.7 per cent of GDP in OECD countries and from 1.2 to 2.3 per cent in non-OECD countries. Overall, the level of world GDP would be lower by 0.9 to 1.8 per cent in 2050.[2] It is worth emphasising the importance of the assumed existence of the "backstop" technology; in the absence of such a technology, the economic costs of abatement could be much higher.

2. More recent studies yield an even wider range of cost estimates (Azar, 1996; Repetto and Austin, 1997).

It is also worth emphasising that cuts in the growth of 1 percentage point relative to the BAU would stabilise neither emissions nor atmospheric concentrations of greenhouse gases. Stabilising emissions at 1990 levels, which would be more ambitious than cuts of 1 per cent, could cost 5 per cent of GDP in some developing countries, according to simulations with the OECD GREEN model. Even this, however, would not be sufficient to stabilise atmospheric concentrations of greenhouse gases at the benchmark level of twice the pre-industrial concentration.

The role of global participation

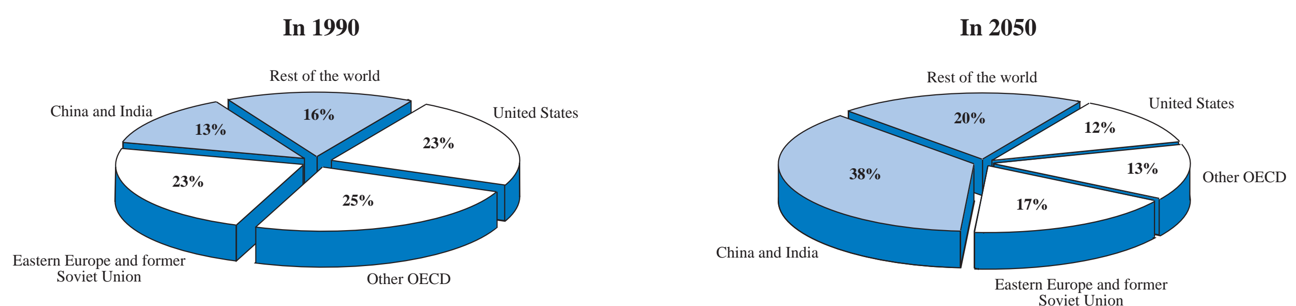
Developing countries will account for increasing amounts of CO_2 emissions

Figure VII.1 shows the distribution of future emissions as projected by the OECD GREEN model, and illustrates the increasing importance of developing countries. Emissions of CO_2 from OECD countries are now almost half of world emissions, but by 2050 would account for only 25 per cent; developing countries would account for around 60 per cent. More recent data suggest that these projections are optimistic in the sense that emissions growth from developing countries appears to be higher than earlier projected. If this higher growth were to continue, developing countries would account for a larger proportion of emissions and, of course, global emissions would grow more rapidly as well.

Therefore, OECD countries alone cannot stabilise global emissions

One implication of these emissions projections is that, in practice, it is unlikely that industrialised countries alone will be able to stabilise world-wide emissions of greenhouse gases. In addition, the effectiveness of action by industrialised countries alone could possibly be reduced by so-called carbon leakage effects. Carbon abatement in industrialised countries would increase the comparative advantage of other countries in the production of energy-intensive goods, which therefore shift to countries not making such efforts. As a result, the abatement efforts in industrial countries would be partly offset by induced higher emissions elsewhere. This effect would require still more stringent controls in industrial countries if the global target were to be met. The amount of carbon leakage depends on a number of key supply and substitution elasticities, and estimates vary substantially (OECD, 1995).

Figure VII.1. **Annual CO_2 emissions: the increasing importance of developing countries**



Source: OECD GREEN model simulations.

Reducing the costs of controlling emissions

Equal emissions cuts by each region would be a costly way of meeting abatement targets

The policy of equi-proportionate emissions reductions by region or country, which was described in the previous section, is a relatively costly way of achieving a global emissions target. Some policy reforms could both reduce emissions and improve economic efficiency. These are referred to as "no-regrets" policies because they would be worth implementing even if global warming were to turn out to be no threat. Substantial costs could also be saved if emissions reductions were timed to minimise transition costs, notably the obsolescence of capital, and to take advantage of the possibility that cheaper abatement technologies may be developed in the future. Finally, equalising the marginal cost of abatement across countries or regions would ensure that total costs were minimised for a given amount of global abatement. The logic of this last point is straightforward: if marginal costs are not equal, then reducing abatement a little in a high-cost country and raising it an equal amount in a low-cost one would reduce overall costs. This logic applies equally to firms and plants within a country.

"No-regrets" Policies

Reform of subsidies and overcoming barriers to the use of energy-efficient technologies can both reduce emissions and raise welfare

The clearest case for a "no-regrets" policy is reform of energy subsidies. This priority is recognised in Article 2 of the Kyoto Protocol, which specifies a progressive removal of subsidies and reform of taxes as a means of achieving reduction commitments. Removing subsidies would reduce fossil-fuel use and, therefore, CO_2 emissions, while at the same time eliminating an allocative distortion. Results from the OECD GREEN model indicate that removing subsidies would reduce emissions by 18 per cent in 2050 compared with the BAU level and would increase world real income by 0.7 per cent. (Transition costs, however, were not taken into account.) To some extent, countries have already begun to reap such gains: in particular, reforms in China, the central European countries and Russia have helped to close the gap in those countries between domestic and world energy prices.

Emission reductions could also be achieved if the structure of existing energy taxes better reflected the carbon content of fuels. Currently, oil and gas typically face high implicit carbon taxes while coal receives subsidies (Hoeller and Coppel, 1992). Rebalancing existing taxes according to the carbon content of each fossil fuel could reduce OECD emissions by 12 per cent and lower the economic cost associated with existing energy taxes from 0.4 to 0.1 per cent of GDP.

Another "no-regrets" policy would be to encourage technologies that raise energy efficiency. A number of these are already commercially available: improvements in insulation, refrigeration and lighting control; the use of electric vehicles; increased use of public transportation and telecommuting; and reduced vehicle weight. The extent to which this is truly a "no-regrets" policy depends in part on why such technologies are not already in wider use. On one view, firms and households would have already adopted them if they were, in fact, less costly. In this case, inducing their adoption would not truly be "no regrets". On the other hand, there may be numerous market failures inhibiting the adoption these technologies, including inadequate information regarding alternative costs, principal-agent problems (those paying are not those making the decisions about what technology to adopt) and capital-market imperfections (some cannot borrow to pay for the up-front cost of installing the new technology). Overcoming such market failures would both raise welfare and reduce greenhouse gas emissions.

The timing of abatement

Phasing in abatement would reduce costs, but at greater long-term risk

Costs of meeting emissions goals also depend on the distribution of reductions through time. Abatement costs will probably fall over time because abatement technology will improve and alternative low-carbon sources of energy will become available or less costly. Phasing in abatement could also reduce costs by allowing natural depreciation of existing capital equipment. On the other hand, delaying action involves risks, since it would result in higher atmospheric carbon concentrations, all else equal. Early reductions may therefore be justified as risk management, and the possibility of unexpected and catastrophic consequences from global warming adds weight to this argument. Although models have been used to assess the costs of alternative time paths of emission reductions, the results are subject to a great deal of uncertainty. In addition to the sources of uncertainty already mentioned regarding model simulations, the relative costs of such paths also depend on the likelihood of cost-reducing abatement technologies being discovered, the social discount rate used and, in view of the risk-management issue, the degree of risk aversion assumed.

Equalising marginal emissions costs

Using economic instruments can minimise the cost of meeting abatement targets

Since the marginal cost of greenhouse gas abatement differs widely across countries and regions, the equi-proportionate cuts of the scenario discussed above is a costly way to meet a global emissions-reduction goal. Equalising marginal abatement costs would mean those countries or regions with lower costs would abate more. Such an outcome could be implemented either through a uniform world-wide tax on carbon emissions, or through a global market for tradable emissions permits with a single price for all countries.

As part of the OECD comparison project, a scenario was constructed in which global emissions growth was cut by 2 percentage points, relative to the BAU, but marginal abatement costs were equalised across regions. The cost of this scenario, as judged by three models, were compared with the costs of the same global reduction but involving equi-proportionate cuts for all regions (Table VII.1). All three models pointed to cost savings from equalising marginal costs, with the OECD GREEN model reporting the largest gain: by 2050, trading emissions would reduce the aggregate cost by about one-third. Estimated cost savings reflect assumptions about the *ex ante* differences in marginal abatement costs across regions (the larger these differences, the greater the saving), and on the pace at which backstop technologies come into play (the later they appear, the greater saving).

Table VII.1. **Cost of alternative abatement strategies**

Per cent of GDP

	Edmonds-Reilly **Model ERM**		**OECD GREEN**		Manne-Richels Global 2100 **Model MR**	
	[1]	[2]	[1]	[2]	[1]	[2]
2020	1.9	1.6	1.9	1.0	n.a.	n.a.
2050	3.7	3.3	2.6	1.9	n.a.	n.a.
2100	5.7	5.1	n.a.	n.a.	8.0	7.5

[1] Equi-proportionate reductions.
[2] Equalisation of marginal costs of abatement.
Source: OECD (1993).

Least-cost abatement is likely to result in a burden on developing countries

A programme of equalising marginal abatement costs also has much different distributional implications from one of equi-proportionate cuts, for any given global target (Oliveira-Martins *et al.,* 1992). For the target of a 2 percentage point reduction in emissions growth relative to the BAU, simulations of GREEN suggest that OECD countries – which have high marginal abatement costs – would contribute 22 per cent of the total abatement in the former case, rather than 32 per cent in the latter. As a result, the loss of GDP in OECD countries would be reduced by more than a third. By contrast, equalising marginal costs would mean greater abatement by developing countries, and their costs could increase relative to a programme of proportional emissions reductions.

Thus, redistributive measures will be needed if global costs are to be minimised

As a result, these countries may prefer a programme similar to equi-proportionate cuts (or even one in which the burden falls more than proportionally on OECD countries) because it would lower their costs even though it would increase global costs. This point raises the issue of burden sharing, which is addressed in the next section in the specific context of carbon taxes and tradable emission permits.

Carbon taxes and tradable emissions permits

Taxes and permits in theory

Carbon taxes and tradable permits are two tools for achieving emission goals

It is increasingly accepted that economic instruments are more effective than regulations for controlling pollution externalities, including those associated with greenhouse gas emissions. In a nutshell, economic instruments allow firms and households to meet environmental goals in a least-cost way, whereas regulations often lock in technologies or market practices that turn out to be inefficient.

The two economic instruments most actively considered in the context of global warming due to CO_2 emissions are carbon taxes and tradable permits to emit carbon.[3] Carbon taxes would raise the cost of emitting, thereby providing an incentive to abate. If carbon taxes were uniform (per ton of carbon emitted), then this incentive would act to equalise the marginal cost of abatement across countries, industries, firms and plants. The same incentive would operate in the case of permits, but would be less direct. Permits would be issued allowing emissions of a fixed amount of carbon, with the total amount equal to the emission-reduction target. Decisions on abatement would depend on the market price of the permits: at any price, those with relatively high abatement costs would prefer to buy permits and increase emissions, whereas those with low costs would find it profitable to sell permits and abate more. In a well functioning market, this process would continue until marginal abatement costs in each country (and industry, and so forth) equalled the world price of permits.

But they differ in terms of how the costs of abatement are distributed

Thus, both taxes and permits would yield the same economically efficient outcome, at least in theory. They differ in other respects, however. Consider first the issue of the distribution of the burden of abatement costs: equalisation of marginal

3. Energy taxes have also been proposed. But compared with carbon taxes, they would tend to shift the burden away from high-carbon energy sources, such as coal, to low-carbon ones, such as natural gas and even hydroelectric and nuclear power. From the point of view of climate change, therefore, they would be more costly.

abatement costs would result in developing countries bearing more of this burden than would equi-proportionate reductions, and even the latter might impose an unacceptable burden on them. This burden could be shifted, however, through a system of international transfers, which would probably have to be quite large. Such transfers could be implemented in either a tax or a permit system. In the case of a carbon tax, they would have to be explicit. In the case of permits, however, redistribution would be implicit in the initial distribution and subsequent sale of permits. The effects of an abatement programme on national incomes would then depend on both the amount of abatement undertaken (which would affect GDP) and the explicit or implicit transfers (Box VII.3).

They also differ because of uncertainty about the costs of abatement...

A second difference between taxes and permits involves uncertainty. The marginal abatement costs of countries, industries, firms and plants are not known to governments with certainty and there are obvious incentives for emitters to exaggerate them. A carbon tax adds a known amount to the cost of emitting and thus would pin down the marginal costs of abatement. However, the amount of abatement cannot be known with certainty *ex ante*: for example, if marginal costs rose faster than governments had expected, then the point at which the marginal cost of abatement

Box VII.3.

Alternative schemes of cost redistribution

Redistribution of the costs of greenhouse gas abatement may be crucial to achieving international agreement and, in any case, is bound to figure prominently in negotiations of any such agreement. The figures in the table are based on a scenario in which major emitters (Annex I countries plus China and India) cut their annual emission growth rate by 0.5 percentage points on average (equivalent to the amount needed to stabilise emissions of Annex I countries). This is assumed to be achieved by applying a uniform carbon tax or a system of tradable permits.

The first panel in the table reports the real income effects of a uniform carbon tax applied without any redistribution of tax revenues, which is equivalent to a "harmonised tax" in which each participating country/region keeps its own tax revenues. Without redistribution, China and India would incur the largest real income losses. The central panel of the table compares alternative initial allocations of tradable permits. Under the "grandfathering" rule, developing countries would lose more than under the scenario with no redistribution. The "redistributive" rule favours poor populated countries, like China and India. The right-most panel shows the effects of an alternative scheme of redistributing part of the revenues of an international carbon tax fund.

Real income changes and international redistribution

	No redistribution	Tradable permits		Carbon tax with redistribution[3]
		Grandfathering[1]	Redistribution[2]	
OECD	–0.25	–0.30	–1.00	–0.69
Former Soviet Union and Eastern Europe	0.27	1.80	–2.05	–2.27
China and India	–1.08	–1.60	3.30	2.03
Rest of World	0.06	0.07	0.04	0.04
Annex I	–0.20	–0.10	–1.10	–0.84
Major emitters	–0.35	–0.36	–0.35	–0.35
WORLD	–0.25	–0.25	–0.25	–0.25

1. Permits allocated on the basis of past country/region's emission shares.
2. Permits allocated in inverse proportion to country/region's GDP per capita, scaled by population size.
3. 75 per cent of tax revenues are diverted and redistributed according to population size.

Source: Based on Coppel and Lee(1995).

equalled the tax would be reached at a lower level of abatement than planned. By contrast, limiting emissions through permits would make the level of abatement much more certain, as it would simply be the number of permits issued, enforcement issues aside. However, the cost of achieving that abatement would not be certain.

And public-sector involvement is different

A third difference involves the role of the public sector. In both cases, there are important issues of monitoring and enforcement (tax collection in one case and emissions in excess of permits held in the other). However, for a tradable emissions permit system to deliver the desired result, there must be an active and efficient secondary market for permits. As discussed in the next sub-section, the limited practical experience with permits suggests that a relatively large number of traders and minimal governmental regulation of trades both help to ensure a "deep" market and low transactions costs.

The experience with taxes and permits

Some European countries have carbon/energy taxes

The experience in OECD countries with taxes explicitly designed to reduce CO_2 emissions is limited: Denmark, Finland, the Netherlands, Norway and Sweden have introduced carbon or energy taxes. Mixed carbon/energy taxes have been applied in some cases, and all schemes have many exemptions, often concerning electricity, heavy industries and companies with high energy intensity or operating on competitive international markets. The fact that most countries have implemented differentiated taxes across sectors and users is an important departure from the principle of a uniform tax that would minimise overall abatement costs.

The United States has implemented tradable permits, notably for sulphur dioxide emissions

There is essentially no experience with tradable permits in the context of CO_2 emissions, and experience in other areas is restricted to the United States. The largest and most successful programme is the US sulphur dioxide (SO_2) allowances programme, started in 1995, which aimed to cut emissions by 40 per cent relative to 1980 levels. In Phase I, which concerns 110 coal-fired electricity generators, transactions costs have been low and substantial trading has taken place, both between and within companies. Two other programmes – emission-reduction credits (covering a range of air pollutants) set up in 1990 and water effluent permits begun in 1997 – have been rather less successful.

A key difference between the SO_2 programme and the others is the degree of government involvement in the permit-trading market. In the SO_2 programme, the government plays essentially no role beyond issuing the permits initially and ensuring compliance. But in the emission-reduction credit programme government approval was needed for trades. Such approval took between five and twelve months to obtain and 40-per cent of proposed trades were rejected. Likewise, each trade needed government approval in the water-effluent programme. This approval process appears to have raised transactions costs to the point where little market activity occurred and so little savings were realised. Another difference is the number of participants. In the case of the water-effluent programme in particular, there were few participants, which limited the number of trades and may have led to strategic or monopolistic trading actions.

US experience suggests permits work best when transactions costs are low and markets liquid

Finally, so-called joint implementation projects, which are provided for under Article 6 of the Kyoto Protocol, are a limited form of emissions trading. Joint implementation projects are bilateral agreements in which one party finances emission-reducing investments in another in exchange for a relaxation of its own abatement efforts. Experience with such projects has been limited to small pilot

projects between countries (Mexico and Norway; Netherlands, Poland and India). The Kyoto Protocol allows such projects between "legal entities", not just countries. A major problem with such schemes is that credits to the party that reduces emissions are made on the basis of an assessment of the emission reduction specific to a given investment and relative to a baseline. Such an assessment is highly uncertain and subject to a large deal of contention. Thus, transactions costs are likely to be high unless investor confidence is reinforced by monitoring, information-gathering (clearinghouse, brokers, and the like) and indemnifying institutions.

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VIII. THE INFLUENCE OF EMERGING MARKET ECONOMIES ON OECD COUNTRIES' INTERNATIONAL COMPETITIVENESS

Several emerging market economies in Asia have experienced massive exchange rate depreciations…

The financial crisis that started in mid-1997 in Southeast Asia has resulted in massive currency depreciations in a number of emerging market economies in Asia (Table VIII.1). Given the increasing importance of these economies in world trade, this has raised the issue of whether this could lead to a major redistribution of competitiveness gains and losses across OECD and non-OECD countries, resulting in substantial current-account adjustment. In the past, potential competitiveness gains deriving from nominal exchange rate depreciations have often tended to be eroded by rising inflation.[1] Nevertheless, there is a widespread sentiment that recent developments might have reinforced the absolute cost advantage that these economies might already enjoy relative to OECD countries, making them even more competitive internationally.[2]

Table VIII.1. **Changes in Asian emerging market economies exchange rates since mid-1997**[a]

Per cent

	vis-à-vis **US dollar**	*vis-à-vis* **Japanese Yen**	*vis-à-vis* **Deutschemark**
China	0	13	5
Chinese Taipei	–15	–3	–10
Hong Kong, China	0	13	5
Indonesia	–76	–73	–75
Korea	–40	–32	–37
Malaysia	–32	–22	–28
Philippines	–32	–24	–29
Singapore	–11	1	–7
Thailand	–40	–32	–37

a) Changes between 1 July 1997 and 18 March 1998.

… which may reinforce their absolute cost advantage

Although estimates of absolute cost levels in the manufacturing sector are available for a limited number of countries only, they do suggest that over the 1975-96 period, Chinese Taipei and Korea in particular have been able to maintain significantly lower levels of unit labour costs than any other industrialised countries for which data exist, despite a substantial deterioration since the late 1980s (Table VIII.2). Moreover, it is likely that labour cost levels in most other emerging market economies in East Asia are also lower than in more mature economies. Among OECD countries, the United States has generally been holding a cost advantage over its main OECD trading

1. For more details, see Durand *et al.* (1998).
2. In principle, competitiveness is a relevant concept only for firms which can gain and lose market shares, and in the latter case, may eventually go out of business. It is not really a relevant concept for countries, because, as argued by P. Krugman (1996), countries cannot go out of business and therefore should not care about "competitor countries". There are nonetheless reasons for a country to be concerned with shifts in market shares at the sectoral level, because such shifts may imply changes in the sectoral composition of output and in living standards. It clearly cannot be an objective of policy to prevent losses in sectoral market shares, as this type of policies cannot be pursued in all countries at the same time, but policies must ensure that the economy is flexible enough to adjust to these shifts at minimum costs and to reallocate resources in order to ultimately improve living standards.

Table VIII.2. **Relative levels of unit labour costs in manufacturing**

USA = 100

	1985	1990	1996
United States	100	100	100
Japan	74	116	169
Germany [a]	71	144	166
France	96	154	163
Italy	60	114	101
United Kingdom	100	158	148
Canada	84	118	102
Australia	98	118	145
Belgium	75	135	156
Denmark	97	205	218
Korea	29	51	58
Netherlands	65	122	120
Spain	49	108	100
Sweden	82	158	160
Chinese Taipei	41	70	70

a) West Germany.

Source: OECD calculations based on 1990 PPPs. For details on the methodological aspects, see OECD (1993).

partners.[3] Since the late 1980s, this favourable cost differential has even tended to widen against Japan and the European Union (EU) taken as a whole, reflecting the depreciation of the US dollar *vis-à-vis* other major OECD currencies.

The emergence of new competitors in world markets

Given the difficulty in obtaining and constructing reliable data on comparative levels of unit labour costs for a sufficiently large number of countries, most analyses on international competitiveness focus on variations in relative costs or prices. While this does not permit a comparison of *levels* of relative competitiveness across countries, it provides an indication of whether a country has become more or less competitive than its trading partners over a particular period. For some time now, the OECD Secretariat has calculated and published indicators based on relative unit labour costs and export prices for the manufacturing sector, as well as relative CPIs.[4] The principles guiding the construction of these indicators were that they should encompass most sectors exposed to competition, all markets where competition takes place and as many competitors as possible. In practice, the OECD indicators covered the manufacturing sector (taken as a proxy for the tradeable sector) or the whole economy, competition in all markets, and competitors from most OECD countries as well as three Asian newly industrialising economies (Chinese Taipei, Singapore and Hong Kong, China). In order to analyse the potential implications of the recent financial crisis in Asia, other emerging market economies whose shares in world trade have increased over the past decades have now been included in the calculation of the OECD Secretariat competitiveness indicators.

The emergence of new competitors in Asia…

While OECD countries continue to dominate world trade, accounting for about three quarters of both world merchandise exports and imports (60 per cent if intra-EU

3. Figures in Table VIII.2 refer to west Germany only. For developments in unit labour costs in east Germany, see OECD (1997). See also Hooper (1996) and Hooper and Vrankovich (1996).
4. For a methodological review of the measures of international competitiveness calculated by the OECD, see Durand and Giorno (1987).

trade is excluded), over the past two decades a number of countries outside the OECD area have become increasingly important players (Table VIII.3). This reflects a major redistribution of both exports and imports within the non-OECD area. From the mid-1970s to the time of the sharp fall in oil prices in 1986, OPEC was by far the largest non-OECD exporter and importer. Since then, however, OPEC's importance in world trade has diminished substantially. In contrast, emerging economies in Asia – China, in particular – have seen their share in word trade expanding steadily, especially in manufacturing. By 1996, Korea, China and other Asian emerging market economies taken as a group had a higher share in world merchandise exports than the United States, at about 23 per cent, compared with 13 per cent in 1985.[5]

Table VIII.3. **Shares in world merchandise trade**

Per cent

	Imports		Exports	
	1985	**1995**	**1985**	**1995**
United States	24.1	19.5	15.0	15.4
Japan	8.7	8.5	12.4	11.7
European Union[a]	22.2	18.9	22.7	19.4
Rest of OECD[b]	14.6	13.6	16.0	14.2
Total OECD[b]	69.6	60.4	66.1	60.7
China	2.8	3.3	1.9	3.9
Chinese Taipei	1.3	2.6	2.1	3.0
Hong Kong, China	2.0	4.9	2.1	4.6
Indonesia	0.7	1.0	1.3	1.1
Korea	2.1	3.4	2.1	3.3
Malaysia	0.8	2.0	1.1	2.0
Philippines	0.4	0.7	0.3	0.5
Singapore	1.7	3.1	1.6	3.1
Thailand	0.6	1.9	0.5	1.5
Total of above countries	12.4	22.9	13.1	23.0
Total non-OECD countries[c]	30.4	39.6	33.9	39.3

a) Excluding intra-EU trade.
b) Excluding Korea.
c) Including Korea.
Source: IMF, *Direction of Trade Statistics* (1996).

… has altered the pattern of OECD countries' competition…

The greater importance of emerging Asia in world trade of manufactured goods has had major implications for the pattern of competition of the three major OECD regions. Table VIII.4 reports figures representing market shares held by competitors of the three major OECD regions on all their common markets, including the domestic market, weighted by the importance of these markets for each region. These figures can thus be interpreted as an indication of the relative weight of each competitor in the pattern of competition facing each major OECD economy on their domestic market as well as on third markets. While in 1970 competition on world markets exerted itself essentially among OECD countries, this is no longer the case. For instance, competition from emerging Asia represented about 6 to 8 per cent of overall competition on world markets for the United States and Europe and about 11 per cent for Japan in 1970. It now accounts for more than 20 per cent for Europe, about 25 per cent for the

5. This includes Asian emerging market economies' intra-trade which represents less than one quarter of these countries' total trade (compared with almost two thirds for the European Union).

Table VIII.4. The importance of emerging market economies in the determination of major OECD regions' pattern of competition[a]

Per cent

	1970			1995		
	United States	Japan	European Union	United States	Japan	European Union
China	0.0	2.0	1.6	5.9	13.2	5.8
Chinese Taipei	1.8	2.4	0.7	4.9	5.9	4.1
Hong Kong, China	3.2	1.5	2.8	1.8	1.3	2.0
Korea	1.2	2.1	0.2	3.4	7.1	1.6
Indonesia	0.0	0.3	0.1	0.8	2.8	1.0
Malaysia	0.5	2.0	0.3	2.2	2.6	1.5
Philippines	0.4	0.3	0.1	0.8	1.0	0.4
Singapore	0.2	0.1	0.3	2.7	2.5	2.6
Thailand	0.3	0.6	0.1	1.5	3.9	1.6
Total of above countries	7.7	11.3	6.3	24.0	40.3	20.7
Argentina	0.5	0.4	1.8	0.2	0.2	0.6
Brazil	0.5	0.6	1.0	1.3	1.0	1.9
India	0.7	1.7	1.4	0.8	1.1	1.6
Mexico	2.3	0.5	0.7	8.0	0.4	1.0
Russia	–	–	–	0.4	0.6	0.8
Memorandum items						
United States	–	44.1	44.1	–	27.1	31.8
Japan	20.6	–	13.8	22.2	–	21.6
European Union	35.7	29.7	–	22.0	22.4	–
Other countries	32.0	11.7	30.9	21.1	6.9	20.0
Total	100.0	100.0	100.0	100.0	100.0	100.0

a) Figures represent the weights used in the calculation of effective exchange rates. They are based on a double trade weighting system which, for each country, takes into account relative market shares held by its competitors on their common markets, including the home market, as well as the importance of these markets for the country in question. For further details, see Durand *et al.* (1992).

United States and more than 40 per cent for Japan. Among Asian emerging countries, competition facing OECD regions has increased most from Chinese Taipei and Korea in the late 70s and in the 80s, and especially from China since 1990. China is now half as important as a competitor for Japan as either the United States or the European Union. Other emerging market economies outside Asia have also become sizeable competitors for the OECD countries. This is especially the case of Mexico for the United States.

A more detailed analysis of the pattern of competition for the major OECD regions can be obtained by decomposing overall competition according to individual markets. Such a decomposition (presented in Table VIII.5 for 1995) shows that for the United States, the pattern of competition is dominated by the home market (*i.e.* by competition facing US producers on their own market – see bottom line of the panel on the United States). On this market, exporters from Asian emerging countries have become increasingly important as competitors to US producers. Indeed, competition from Asian emerging market economies is similar to that from Canada and Mexico combined and now larger than that from Japan and Europe. The other most important markets for the determination of competition facing the United States are the "other OECD countries", which consist mainly of Canada and Mexico, and the non-OECD countries. In the "other OECD" market, domestic producers tend to be the main competitors for US exporters, while on the non-OECD market, competition from EU exporters is the most important followed by that from East Asian economies.

Table VIII.5. **Decomposition by market of the pattern of competition of the three major OECD regions,[a] 1995**

Per cent

	United States				
Markets	**Japan**	**European Union**	**Other OECD**	**Domestic**	**Non-OECD**
Competitors					
United States	0.0	0.0	0.0	0.0	0.0
Japan	57.4	11.3	7.1	22.3	26.4
European Union	12.4	58.1	9.3	21.1	41.5
Other OECD[b]	4.0	11.5	78.0	28.2	6.5
Emerging Asia[c]	25.1	16.7	4.9	26.6	20.0
Other non-OECD	1.1	2.4	0.7	1.9	5.5
Total	100.0	100.0	100.0	100.0	100.0
Weight of each market	4.0	9.3	18.0	56.1	12.6

	Japan				
Markets	**United States**	**European Union**	**Other OECD**	**Domestic**	**Non-OECD**
Competitors					
United States	56.3	15.5	26.5	25.7	21.6
Japan	0.0	0.0	0.0	0.0	0.0
European Union	11.9	55.4	22.0	21.6	39.6
Other OECD[b]	15.9	10.9	39.4	7.0	6.9
Emerging Asia[c]	14.9	15.9	10.8	43.8	29.6
Other non-OECD	1.1	2.3	1.3	1.8	2.3
Total	100.0	100.0	100.0	100.0	100.0
Weight of each market	22.0	11.4	8.9	27.5	30.2

	European Union				
Markets	**United States**	**Japan**	**Other OECD**	**Domestic**	**Non-OECD**
Competitors					
United States	55.9	14.4	14.1	27.9	26.3
Japan	12.4	56.1	8.2	19.4	28.3
European Union	0.0	0.0	0.0	0.0	0.0
Other OECD[b]	15.8	3.9	71.1	19.7	11.6
Emerging Asia[c]	14.8	24.6	5.7	28.8	29.2
Other non-OECD	1.0	1.0	0.8	4.2	4.7
Total	100.0	100.0	100.0	100.0	100.0
Weight of each market	12.5	3.6	13.5	35.0	35.4

a) The table should be interpreted as follows : for the United States, in 1995, the domestic market was the principal market determining competition facing US producers (56.1 per cent); in this market, Japan's market share was 22.3 per cent. Similarly, the EU market had a weight of 9.3 per cent in the determination of competition facing US exporters, and on this market, competition from EU producers for US exporters represented 58.1 per cent of overall competition.

b) Korea is included in emerging Asia.

c) Includes: China; Chinese Taipei; Hong-Kong, China; Indonesia; Korea; Malaysia; the Philippines; Singapore and Thailand.

For Japan, the share of the domestic market in the determination of overall competitiveness is much less important than in the case of the United States. On this market, the share of exporters from Asian emerging countries has increased dramatically, and is now by far the largest. Other important markets determining Japan's competition include the non-OECD countries and the United States. On the US market, US producers are by far the most important ones. While on the non-OECD market, which includes mainly other countries in Asia, Japan's main competitors are EU exporters and domestic producers, and interestingly enough, non US exporters.

The pattern of EU competition is dominated by the domestic and the non-OECD markets. The importance of the latter has tended to decline however, mainly reflecting diminishing EU exports to non-OECD countries outside Asia. On all non-OECD markets, producers and exporters from Asian emerging countries now represent important

competitors for EU countries. On the domestic market, main competition for EU producers in 1995 came about equally from emerging Asia and US exporters.

… although much depends on the similarity of export structures with OECD countries

The above analysis, while providing insights into how competition in manufacturing among major trading partners has evolved over time, should nonetheless be interpreted as representing possible, rather than actual, changes that have occurred over the past decades. Indeed, the calculations underlying the figures cited above are based on bilateral trade in aggregate manufactured goods. As such they do not allow for any degree of substitution between different categories of manufactured goods.[6] This caveat may be particularly important when looking at competition emanating from emerging market economies. Indeed, while the degree of intra-trade for similar products is generally high for OECD countries, this is not necessarily the case of trade between OECD and non-OECD countries.[7] In that respect, it is also useful to compare the composition of manufactured exports in OECD and non-OECD Asian countries. Two groups of non-OECD Asian countries seem to emerge. In the first group, which includes China, Indonesia and Hong Kong, China, exports are concentrated in products with relatively low technological content such as textile, footwear, toys and other consumer goods (Figure VIII.1). In 1995, these products accounted for almost 50 per cent of these countries' merchandise exports. In contrast, in the second group of countries, which includes Chinese Taipei, Malaysia, Singapore and Thailand, exports consist more of high to medium-to-high technological goods, in particular computers, electrical and communication goods which represent more than 50 per cent of these countries'total exports. The structure of Korea's exports lies in between the two groups identified above with about 23 per cent of its exports consisting of textile and apparel and about 35 per cent of electrical and electronic products. Exports from the second group of countries, and to a lesser extent from Korea, would therefore appear to enter more directly in competition with OECD countries' exports than exports from the first group. Among the major three OECD regions, Japan seems to be the most likely to be affected, given its export structure, and the European Union the least.

Changes in indicators of international competitiveness

Trends in nominal and real effective exchange rates are affected by the inclusion of new emerging market economies

The characteristics of competition facing OECD countries described above and their evolution over time are those embodied in the weighting pattern used in the calculation of indices of nominal and real effective exchange rates reported in Figure VIII.2.[8] For the majority of countries, relative CPIs and indices of relative manufacturing unit labour costs move broadly together and show less variability over time than corresponding nominal effective exchange rates. Competitiveness indicators based on unit labour costs in the manufacturing sector tend, however, to have more pronounced trends than those based on consumer prices and higher short-run volatility reflecting the offsetting effect of exchange rate movements on CPIs via import prices. Trends in both indicators since 1985 for OECD countries as well as for the EU aggregate,[9] indicate that several periods can be distinguished:

– despite significant bilateral movements, there has been a simultaneous nominal effective appreciation of the three major OECD regions'currencies

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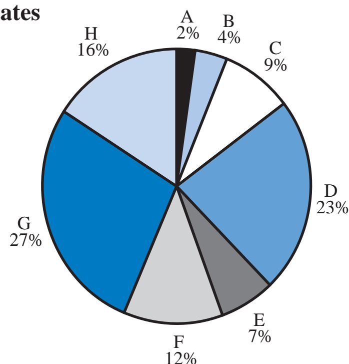
6. The method for calculating the weights presented here derive from the Armington framework (1969), with the simplification that there is no substitution among manufactured goods, and that there is no pricing-to- market strategy from the part of competitors.
7. See OECD (1994).
8. Historical data for manufacturing unit labour costs for emerging market economies extend only through 1996. Thereafter, data are based on OECD Secretariat's estimates. Unit labour costs are therefore more appropriate for examining longer-term trends, while CPI data, which are readily available for the most recent period, are more relevant for the analysis of the latest developments in competitiveness. See Durand *et al.* (1998) for a description of the sources of data. See also Turner and Golub (1998).
9. See Durand *et al.* (1998) for details on how an aggregate EU exchange rate has been calculated.

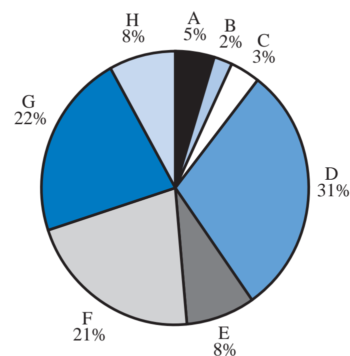
Figure VIII.1. **Structure of manufactured exports in selected OECD and non-OECD Asian countries, 1995**

As a per cent of their total manufactured exports

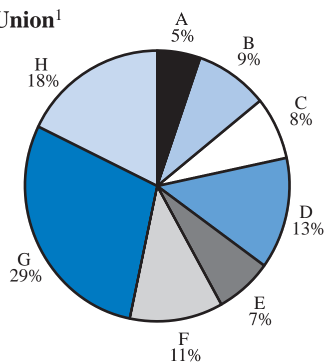
United States



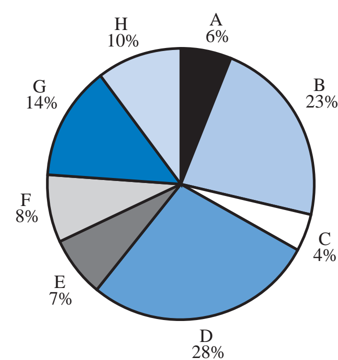
Japan



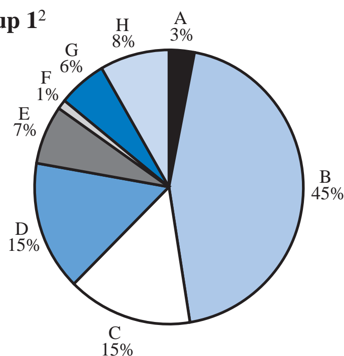
European Union[1]



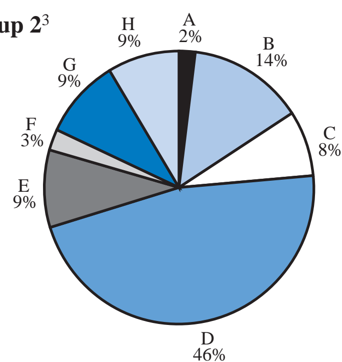
Korea



Asia Group 1[2]



Asia Group 2[3]



A: Basic metal industries.
B: Textiles, apparel and leather.
C: Wood and paper products.
D: Electronic products.
E: Electrical machinery.
F: Motor vehicles.
G: Machinery, equipment and transport equipment.
H: Chemical products.

1. Excluding intra-EU trade.
2. Asia Group 1 includes: China; Hong Kong, China; India and Indonesia.
3. Asia Group 2 includes: Chinese Taipei; Malaysia; Singapore and Thailand.

Source: Centre d'études prospectives et d'informations internationales: CHELEM Database.

Figure VIII.2. Nominal and real effective exchange rates

Indices in US$ terms; 1991 = 100

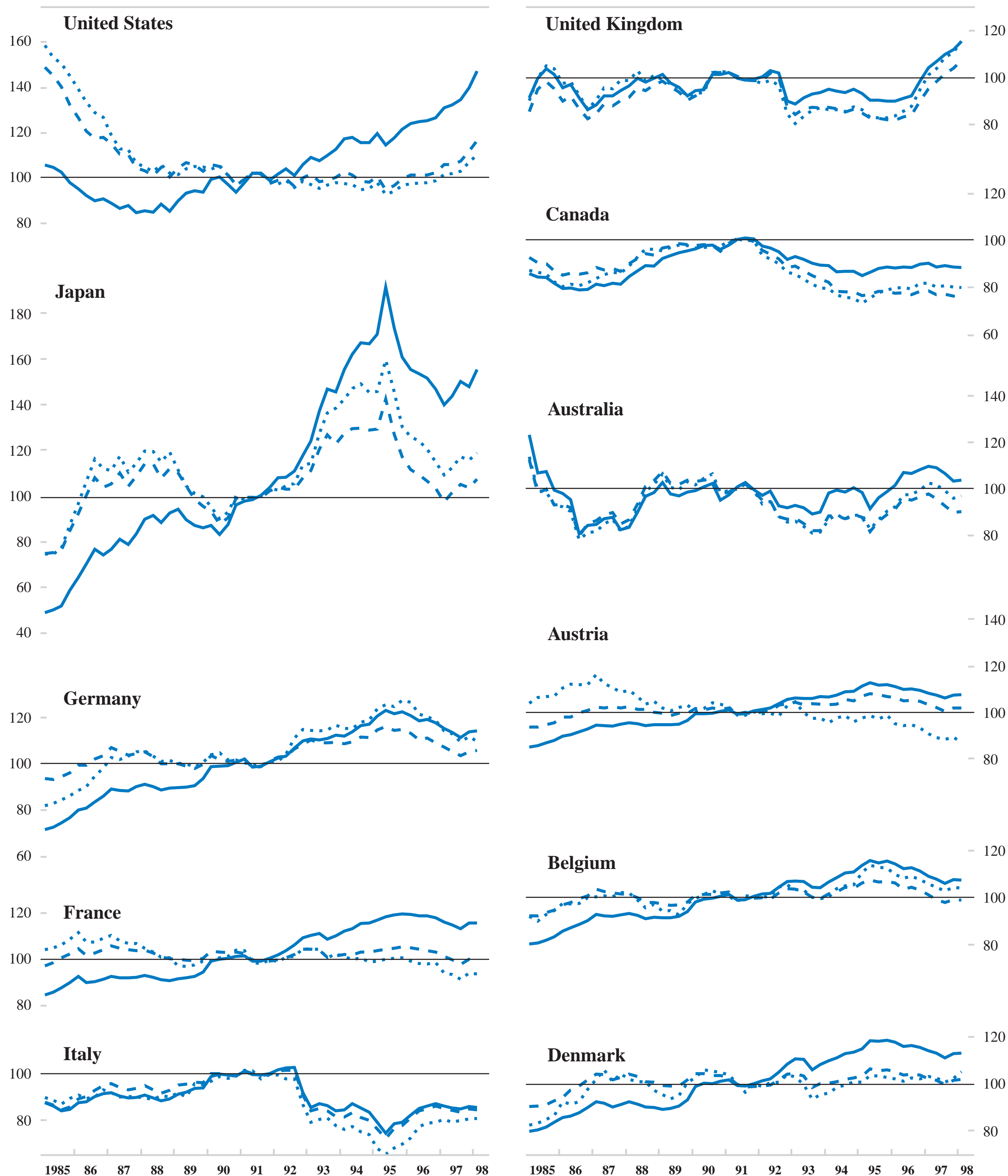
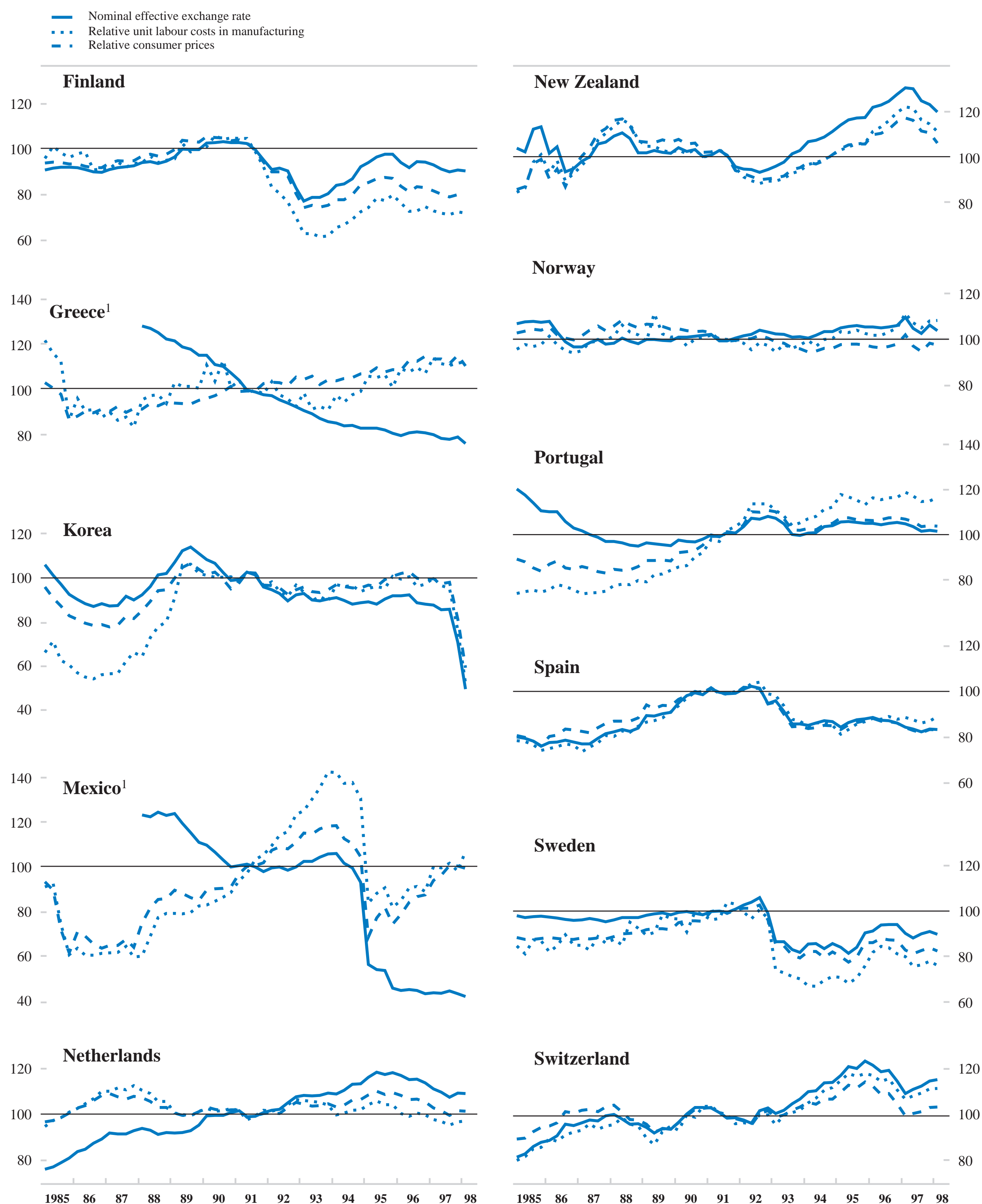


Figure VIII.2 *(cont'd)*. **Nominal and real effective exchange rates**
Indices in US$ terms; 1991 = 100



1. For Greece and Mexico, data for nominal effective exchange rates are available before 1988, but their amplitudes do not fit the common scale used for this figure.

between the late 1980s and early 1995. This was accompanied by very large depreciations in many emerging market economies over this period ;
- on the other hand, over the same period, the Japanese yen and, to a lesser extent, some EU currencies have appreciated in real effective terms, while the US dollar has depreciated ;
- this trend was reversed between early 1995 and mid-1997, with the Japanese yen and EU currencies depreciating in nominal and real effective terms and the US dollar appreciating ;
- since mid-97, all OECD countries' nominal and real effective exchange rates have appreciated, as the result of the massive depreciations in the currencies of emerging market economies in Asia. By mid-March, the nominal effective appreciation amounted to 11, 15 and 3 per cent for the United States, Japan and the European Union, respectively. In Japan and the European Union, however, this appreciation has only partially unwound earlier depreciations.

The decomposition of competitiveness indicators, according to OECD and emerging Asian competitors indicates that trends in relative costs and prices between 1991 and mid-1997 remained largely dominated by cost and price movements within the OECD area. However, there are a number of episodes where developments *vis-à-vis* Asian emerging market economies have affected trends in OECD countries' overall competitive positions (see Figure I.3 in Chapter I).

Movements in US competitiveness *vis-à-vis* Asian emerging market countries between 1995 and mid-1997 have to some extent worked to reduce the overall competitiveness losses registered by the United States over that period. Indeed, there was no reversal in the trend of improved US competitiveness *vis-à-vis* emerging Asia when the competitive position of the United States *vis-à-vis* other OECD competitors deteriorated markedly. To a large extent, this reflects the exchange rate policies followed by most Asian emerging market economies during that period, to maintain close ties between their currencies and the US dollar.

Such ties have also tended to reinforce the influence of the movements in the dollar exchange rate on Japan's competitive position. Thus, the appreciation of the yen exchange rate between 1991 and mid-1993 corresponds to a period of loss in Japanese competitiveness *vis-à-vis* both the OECD and emerging Asia, while the reverse holds for the period between early 1995 and early 1997. On the other hand, the devaluation of the Chinese yuan during 1993-94 was responsible for some deterioration in Japan's overall competitiveness.

For the European Union as a whole, as well as for EU countries individually, currency movements within the European Exchange Rate Mechanism (ERM) have had the major influence on overall competitiveness trends between 1992 and 1994, as a number of European currencies depreciated both against the Deutschemark and other core ERM currencies and against currencies outside the EU. Nevertheless, between late 1995 and mid-1997, improvements in the EU overall competitiveness have reflected ERM currencies' depreciations against the dollar but also a marked improvement in EU competitive position *vis-à-vis* emerging Asia.

Since mid-1997, the massive depreciations of the Korean and non-OECD Asian currencies have led to large deteriorations in the competitive positions of the three major OECD regions *vis-à-vis* Asian emerging market economies. For the United States, this added to the deterioration of competitiveness *vis-à-vis* other OECD countries. On the other hand, for Japan, the loss of competitiveness *vis-à-vis* emerging Asia has more

than offset the improvement *vis-à-vis* other OECD countries since the third quarter of 1997. In contrast, the EU overall competitive position thus far appears to have been less affected by currency movements in East Asia.

Implications for trade and foreign direct investment developments

As noted above, the measures of international competitiveness encompass competition in both domestic and external markets. They can *de facto* be seen as representing a weighted average of import and export competitiveness. These indicators therefore are relatively well suited to analysing trends in trade balances, although they are of course not the only determinant of these trends.

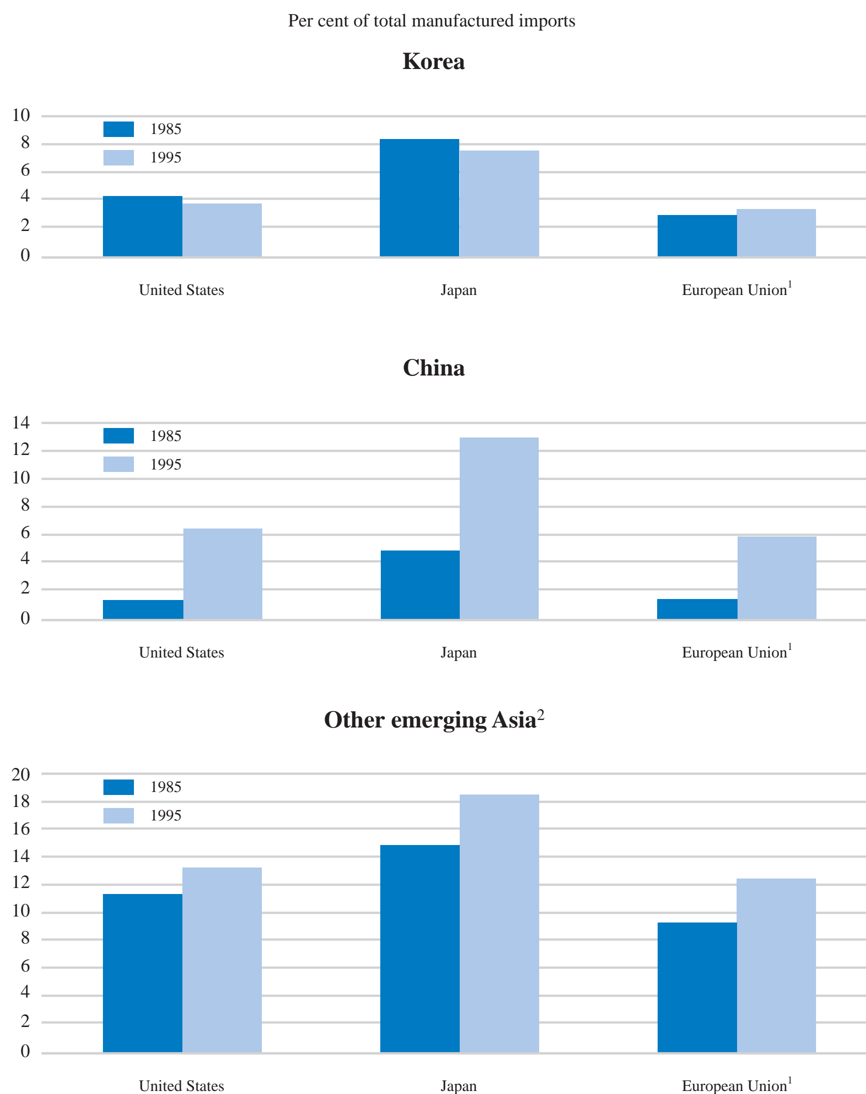
There appears to be a fairly good link between changes in competitiveness and in export market shares

For a number of countries there appears to be a fairly good correlation[10] (allowing for time lags) between significant movements in indicators of OECD countries' international competitiveness and gains and losses of export market shares.[11] The real effective depreciation of the US dollar between 1985 and 1995 has been accompanied by substantial cumulative market share gains. Conversely, the deterioration in Japan's competitiveness was followed by large export market share losses since 1985. Among European Union countries, the correlation between competitiveness and export performance appears to have been the greatest in Italy, Sweden and to a lesser extent Germany. In France, Belgium and the Netherlands both competitiveness and export performance have remained remarkably stable since 1985. In a number of other European countries (*e.g.* Switzerland, Germany and the United Kingdom), there appears to be a trend deterioration in export performance. This generally can be associated with losses in competitiveness *vis-à-vis* Asian emerging market countries, but also *vis-à-vis* Spain and Portugal which have registered large market share gains since joining the European Community.[12]

The rising importance of Asian emerging market countries as world exporters also reflects improvements in their aggregate competitiveness, although for a number of them, export market share gains have been achieved in spite of a marked deterioration in their competitive position (*e.g.* Singapore, and Hong-Kong, China). These developments, however, have to be seen against the background of the low levels of unit labour cost mentioned earlier. While reflecting third market gains, emerging Asia's improved trade performance also results, at least to some extent, from a deterioration in the relative import competitiveness of OECD countries. This is illustrated by the impressive increase in China's share in the Japanese market, from 4 to 13 per cent between 1985 and 1995 (Figure VIII.3). China also gained market shares in the US and EU markets, although the rise was less dramatic than in Japan, from less than 2 per cent to around 6 per cent. China is now the fourth biggest foreign supplier in the United States while Korea, China and other Asian emerging countries taken as a group account for about 23 per cent of US manufactured imports, *i.e.* more than either Japan or the EU. This group of countries has also by far surpassed the United States as the principal supplier of the Japanese market. The penetration of Chinese and other Asian emerging countries' imports in the European Union market is now just a little below that of the United States once intra-EU trade is excluded.

10. Simply regressing manufacturing export performance on contemporaneous and lagged indicators of competitiveness over the period 1975-98 generally produces R-squared above 0.5. See Durand *et al.* (1998).
11. The current pattern of trade balances of OECD countries is also reflecting an important absorption effect. For that reason, this section analyses the link between real effective exchange rates and export performance only.
12. See Durand *et al.* (1998).

Figure VIII.3. **Shares held in manufactured imports of the three major OECD markets**



1. Excluding intra-EU trade.
2. Includes Chinese Taipei; Hong Kong, China; Indonesia; Malaysia; the Philippines; Singapore and Thailand.
Source: Centre d'études prospectives et d'informations internationales: CHELEM Database.

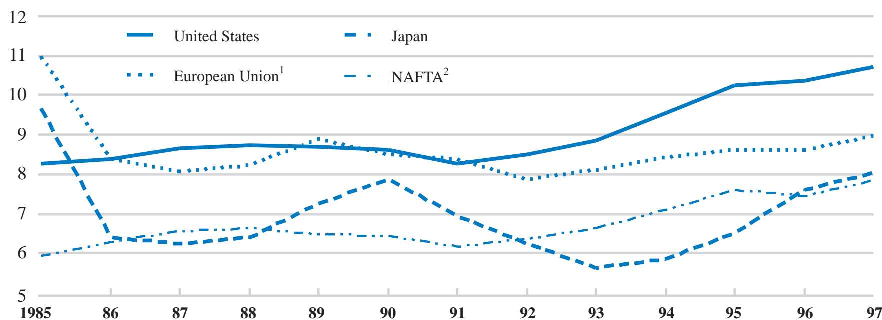
Recent changes in competitiveness may add to present bilateral trade imbalances…

Notwithstanding the higher import penetration of China and other Asian emerging economies on the Japanese market, Japan's overall trade openness indicator, as measured by the ratio of merchandise imports to GDP, despite fluctuations, was no higher recently than it was in the mid-1980s (Figure VIII.4). This is also more or less the case for the European Union (once intra-EU trade is excluded) and for the United States until the late 1980s. Since the early 1990s, however, the import penetration ratio has tended to increase in the United States.

Overall, the changes in international competitiveness and related trade performance described above have contributed to the large shifts in major OECD regions'

Figure VIII.4. **Import penetration in major OECD regions**

Ratio of merchandise imports to GDP



1. Excluding intra-EU trade.
2. Excluding intra-trade between countries participating in the North American Free Trade Agreement (NAFTA).

bilateral trade balances,[13] especially with Asian emerging market economies. By 1996, China was running a trade surplus *vis-à-vis* all three OECD regions, and other non-OECD East Asian countries had a substantial surplus *vis-à-vis* the United States (Table VIII.6). In contrast, in 1985 trade between the United States and China was virtually balanced, while Japan and the European Union had a surplus *vis-à-vis* China. In 1996, the combined US deficit *vis-à-vis* China and other Asian emerging countries amounted to around $80 billion, compared with a deficit of $50 billion *vis-à-vis* Japan.

Table VIII.6. **Bilateral trade balances**[a]

US$ billion, customs basis

1985

	United States	Japan	European Union	Korea	China	Other Asia[b]
United States	–	–49.8	–26.0	–4.7	–0.4	–26.8
Japan	40.6	–	12.9	3.0	6.0	0.3
European Union	12.5	–14.6	–	–0.6	2.5	–2.4

1996

	United States	Japan	European Union	Korea	China	Other Asia[b]
United States	–	–50.4	–19.9	3.3	–42.4	–34.4
Japan	33.3	–	13.7	13.4	–18.6	56.6
European Union	–7.2	–27.0	–	4.2	–16.2	–0.3

a) Due to time lags and other statistical problems, there may be large differences in bilateral customs basis imports and exports according to reporting countries.
b) Includes: Chinese Taipei; Hong Kong, China; Indonesia; Malaysia; the Philippines; Singapore; and Thailand.
Source: IMF, *Direction of Trade Statistics* (1997).

The recent massive depreciations of the Korean and non-OECD East Asian currencies are likely to add to the present imbalances *vis-à-vis* emerging Asia. There are however large uncertainties as regards the order of magnitude of competitiveness-induced trade changes. First, the pass-throughs of changes in nominal exchange rates

13. Some care has to be taken in focusing analysis on bilateral balances, given that the fundamental nature of the international trading system is multi-lateral and multi-product.

into trade prices are particularly uncertain in the face of such large depreciations. Moreover, competitiveness gains might be reversed if the large nominal depreciations of Asian currencies prove temporary or translate into higher rates of inflation, as seems to be the case already for some of these countries. Second, a number of exporters in the affected countries seem to face financing constraints due to the underlying weak situation of the banking sectors. Third, the reservation made earlier regarding the fact that OECD and non-OECD East Asian countries have a different export structure also imply that potential exports may only slowly, if at all, translate into actual exports.

… and affect the location of foreign direct investment

Real effective exchange rates also play a role in the determination of the scale and location of foreign direct investment.[14] In particular, empirical evidence suggests that the strong appreciation of the yen between 1985 and early 1995 has been a major determinant of Japanese direct investment in Asia and the United States.[15] The effective appreciation led to a growth in capital outflows, as Japanese multinational companies tried to take advantage of the relatively cheaper factor costs in host economies. In addition, it raised the relative wealth of Japanese firms, leading to an increase in purchases of foreign assets. Studies on the determinants of US and Japanese foreign direct investment flows in the European Union during the 1980s and early 1990s also show that the real exchange rate has been an important explanatory variable.[16] Recent exchange rate changes, if lasting, may therefore have important implications for future foreign direct investment flows, especially in Asia.

While there is widespread evidence of a positive relationship between inward direct investment and export performance, empirical research on the impact of outward investment on exports remains largely inconclusive, the effects varying significantly between countries and the time period under consideration. On balance, the evidence from early cross-sectional studies and panel studies with a limited time dimension suggests a complementary relationship between exports and outward direct investment, owing to an increased demand for intermediate products and the expansion of distribution facilities. However, more recent time-series studies obtain stronger evidence of a substitution effect between foreign affiliates production and domestic exports, suggesting that the relationship may change over time, possibly reflecting the maturity of investments.[17] Given a negative relationship between foreign direct investment and exports, this could reinforce the response of trade flows to changes in competitiveness.

14. Factors influencing foreign direct investment flows include: relative factor costs and factor endowments; local market size; scale economies and the presence of firm-specific assets, such as managerial and production expertise and process innovations, which can act as "joint" inputs across plants for a firm operating in different countries; national and regional barriers to trade and non-trade barriers such as technical standards; different tax regimes; the development of distribution channels abroad and the provision of after-sales service facilities; the quality of infrastructure, research capacities, the level of education and training of the labour force. See, for example, Barrell and Pain (1997*a*).
15. See Sianesi (1995). This study analyses Japanese FDI outflows directed to Malaysia, Thailand and Indonesia during 1973-1992. See also Cushman (1988).
16. See, for example, Aristotelous and Fountas (1996).
17. See Barrell and Pain (1997*b*); Barry and Bradly (1997); and Blomström *et al.* (1997). A recent MITI study on the impact of Japanese overseas business activities in manufacturing on the balance of trade estimates that the positive impact of foreign affiliates on Japan's trade surplus has gradually declined from a peak of 2.7 trillion yen in 1992 to an insignificant amount (100 billion yen) in 1995, due to the increased export substitution effect. This corresponds to about 60 per cent of the overall decline in Japanese trade surplus.

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