OECD
ECONOMIC OUTLOOK

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OECD ECONOMIC OUTLOOK

65

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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– *to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and*

– *to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.*

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FOREWORD

This edition of the *OECD Economic Outlook* analyses the prospective economic developments in OECD countries over 1999 and 2000 and provides recommendations on the economic policies needed to ensure sustained economic growth. In addition, this volume reports the OECD Medium-Term Reference Scenario, which extends the short-term projections to 2004. The detailed country notes provide an assessment of the economic situation and the outlook for each Member country and certain non-member economies. The policy assessments presented in this edition 65 are based on projections that were finalised on 4 May 1999 and published in a preliminary edition of the *OECD Economic Outlook* in mid-May.

In addition to these issues, a number of other themes are dealt with in more depth in five special chapters:

– *Labour Market Performance and the OECD Jobs Strategy.* This chapter discusses labour-market performance in the OECD countries over the 1990s and relates it to progress made in implementing the OECD Jobs Strategy. It suggests that a comprehensive programme of reforms, along the lines of the Jobs Strategy, can significantly improve labour-market conditions. But policy makers must stay the course in implementing reforms: it takes time for their effects to materialise in the labour markets.
– *Policy challenges arising from climate change.* Most OECD countries have signed the Kyoto Protocol committing themselves to specific emissions targets of "greenhouse gases" for the period 2008-12. This chapter looks at the policies required to meet these commitments, the associated costs, and the role of international trading of emissions allowances in minimising these costs. It also looks further ahead, addressing the question of encouraging developing countries to agree to restrain their emissions growth. Even if these policies succeed, some climate change is likely; the chapter discusses some of the issues involved in adapting to it.
– *The recent experience with capital flows to emerging market economies.* This chapter analyses the factors behind the recent episodes of capital-flow volatility, focusing on key differences in capital markets institutions and supervision between emerging and mature OECD countries. The analysis confirms that a sound financial system and macroeconomic stability are prerequisites for a successful integration with global capital markets. It also considers the extent to which currency pegs can be used as a stabilisation tool and suggests that while the imposition of capital controls as an emergency measure may yield some short-term benefits, improved crisis management in a multilateral setting would be more appropriate.
– *Causes of the recent widening of OECD current-account balances.* This chapter analyses the main factors underlying the recent widening in current-account imbalances. It shows that import contraction in the Asian crisis countries has had a major impact on OECD exports, especially from Japan. In addition, increased current-account imbalances of both Japan and the United States can be largely explained by differences in relative demand patterns and corresponding saving-investment imbalances, and such imbalances may persist over the medium term.

– *Trends in market openness.* This chapter reviews trends in market openness indicators and barriers to international trade and investment. Protectionist trade policies, especially on industrial goods, have gradually been scaled back over the past 40 years. Against this background, market openness has increased significantly, although changes have been uneven across sectors and countries. For instance, barriers to trade in agriculture remain pervasive in most OECD countries. In very recent years there are concerns that recourse to some trade policy instruments, such as anti-dumping initiations and technical barriers to trade are being misused. This chapter also discusses the role of domestic policies in restricting market access.

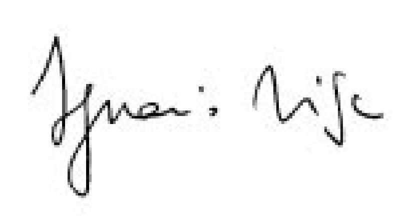

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TABLE OF CONTENTS

Boxes

Tables

Figures

Conventional signs

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

Summary of projections[a]

Seasonally adjusted at annual rates

	1998	1999	2000	1998 I	1998 II	1999 I	1999 II	2000 I	2000 II
				Percentage changes from previous period					
Real total domestic demand									
United States	5.1	4.2	1.9	5.8	4.4	5.1	2.0	1.9	1.7
Japan	–3.5	–1.2	–0.3	–4.3	–2.7	–0.7	–0.7	–0.1	–0.4
Germany	3.1	1.7	2.2	4.8	1.8	1.3	2.4	2.0	2.4
European Union	3.5	2.2	2.5	4.7	2.3	2.1	2.4	2.5	2.7
Total OECD	2.7	2.6	2.1	3.0	2.3	2.9	2.1	2.1	2.1
Real GDP									
United States	3.9	3.6	2.0	4.0	3.8	4.2	2.0	2.0	1.9
Japan	–2.8	–0.9	0.0	–3.9	–2.0	–0.8	0.0	0.0	–0.1
Germany	2.8	1.7	2.3	3.5	1.5	1.4	2.7	2.1	2.5
European Union	2.8	1.9	2.4	3.0	2.2	1.6	2.3	2.4	2.6
Total OECD	2.3	2.2	2.1	2.1	2.1	2.4	2.1	2.1	2.1
				Per cent					
Inflation[b]									
United States	1.0	1.1	1.5	0.9	0.9	1.2	1.1	1.5	1.7
Japan	0.4	–0.7	–0.6	1.7	–1.7	–0.2	–0.7	–0.4	–0.7
Germany	0.9	0.9	1.3	1.5	0.5	1.0	1.0	1.4	1.4
European Union	1.8	1.7	1.7	1.8	1.6	1.8	1.7	1.7	1.7
Total OECD *less* high inflation countries[c]	1.3	1.1	1.3	1.6	0.6	1.4	1.1	1.4	1.4
Total OECD	3.1	2.4	2.2	3.4	2.2	2.7	2.2	2.2	2.1
				Per cent of labour force					
Unemployment									
United States	4.5	4.2	4.4	4.5	4.5	4.2	4.2	4.4	4.5
Japan	4.1	4.9	5.3	4.0	4.3	4.8	5.1	5.2	5.4
Germany	11.2	10.7	10.0	11.5	10.9	10.7	10.6	10.2	9.8
European Union	10.5	10.1	9.8	10.7	10.3	10.2	10.1	9.9	9.7
Total OECD	7.1	7.0	7.0	7.1	7.0	7.0	7.0	7.0	7.0
				Per cent of GDP					
Current balances									
United States	–2.7	–3.4	–3.5	–2.5	–3.0	–3.3	–3.5	–3.5	–3.4
Japan	3.2	3.0	3.5	3.1	3.3	2.8	3.3	3.4	3.6
Germany	–0.2	0.0	0.2	–0.2	–0.1	0.0	0.1	0.2	0.3
European Union	1.1	1.0	1.0	1.0	1.1	0.9	1.0	1.0	1.0
Total OECD	–0.1	–0.5	–0.5	0.0	–0.2	–0.5	–0.5	–0.5	–0.4
				Per cent					
Short-term interest rates[d]									
United States	4.8	4.5	4.5	5.0	4.5	4.4	4.5	4.5	4.5
Japan	0.7	0.3	0.4	0.8	0.7	0.3	0.2	0.3	0.4
Euro area	3.9	2.7	2.6	4.1	3.8	2.9	2.6	2.6	2.6
				Percentage changes from previous period					
World trade[e]	4.5	3.9	5.6	2.7	2.4	3.9	5.7	5.7	5.6

a) Assumptions underlying the projections include:
– no change in actual and announced fiscal policies;
– unchanged exchange rates from 26 April 1999; in particular \$1 = Y 119.15 and \$1 = 0.942 euro;
– the cut-off date for other information used in the compilation of the projections was 4 May 1999.

b) GDP deflator, percentage changes from previous period.

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

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

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

EDITORIAL

The global economic situation looks more favourable than it did six months ago

The economic situation for the world and the OECD area as a whole now looks more favourable than it did six months ago. Calm and confidence have returned in financial markets as the worst fears about the ramifications of the Russian crisis last August have not been realised and the crisis in Brazil has largely been confined to the region. Equity markets have recovered and remain buoyant in most OECD countries and risk premia have diminished. Furthermore, some Asian crisis countries, notably Korea, appear to have started to recover more rapidly than expected earlier. In part, the relative stability in financial markets follows reductions in interest rates by monetary authorities in most OECD countries, policy actions in several non-OECD economies and major efforts by financial institutions to reduce their excessive exposure to risks in emerging markets.

Against this background, in the absence of renewed financial tensions, economic activity in the OECD area is now projected to expand at about 2¼ per cent in 1999 and 2 per cent in 2000. Inflation is expected to be low nearly everywhere and area-wide unemployment to remain broadly stable, though with considerable variation across countries. While this projection for the OECD area as a whole is broadly similar to that published in the December issue of the *OECD Economic Outlook*, the balance of risks seems no longer to be clearly on the downside.

Although the outlook differs across the major OECD regions

The economic situation and outlook, however, vary markedly across the major OECD regions and year-average profiles mask significant changes during the course of the projection period:

– In the *United States*, economic activity has remained exceptionally buoyant with rapid growth, low unemployment and virtually no sign of inflationary pressure. Much of the unexpected strength in domestic demand has reflected rising stock prices. Assuming no further increases from present equity price levels, output growth may average about 3½ per cent this year and decline to around 2 per cent in 2000, mainly reflecting waning wealth effects on household spending and slower investment growth in response to declining capacity utilisation and softer profits.

– Reflecting sluggish exports and weak business sentiment, growth in much of the *European Union* has been slowing since the end of 1998. However, high levels of consumer confidence and the expected gradual recovery in export markets, as imports of crisis countries stop shrinking, are projected to support an acceleration in growth during the course of 1999 to average about 2 per cent and to reach about 2½ per cent in 2000. Nevertheless, the output gap is expected to remain large in Europe as a whole over the coming years.

– In *Japan*, the recession deepened during the latter part of last year, but recently there have been a few positive signs that the economic situation is no longer deteriorating. These include a lower risk premium, some recovery in business confidence and progress in dealing with financial sector problems. However, with ongoing corporate restructuring, no pick-up in aggregate domestic demand is projected for 1999 and real output might decline by nearly 1 per cent for the year as a whole, before stabilising next year.

Outside the OECD area, economic prospects are mixed

Outside the OECD area, economic performance has been mixed and the immediate outlook remains poor, although some improvement is in prospect for 2000. While conditions appear to be stabilising in emerging Asia, recovery in most of the economies affected by the crisis will only gather pace next year, and in China growth is projected to slow somewhat, although it will remain high. Elsewhere, Brazil is experiencing a contraction in real GDP, which will adversely affect the rest of Latin America, and output in Russia is projected to continue falling this year.

A number of downside risks still remain in many non-OECD regions

Overall, while the risks to the outlook appear more evenly balanced, a number of downside risks still remain. These relate in large part to uncertainties as to whether the improvement in financial market conditions is temporary or indicative of more lasting resilience to shocks. To the extent that global financial markets have become more resilient to adverse conditions, further crises in emerging markets are less likely to have a major impact on future OECD prospects. However, the withdrawal of foreign investors from many emerging market economies has imposed high financial costs, which, in some countries, are adding to downward pressure on activity and, in Brazil, are complicating efforts to stabilise the fiscal situation. Until foreign investors regain confidence in these economies, recoveries are likely to remain moderate, with positive trade spillovers equally moderate. In addition, while the direct economic impact of the Kosovo conflict appears small at present for the countries in the region not directly affected by war or massive refugee flows, there are uncertainties about the overall economic consequences if the crisis continues.

But there are also positive and negative risks surrounding prospects in the OECD and policy requirements differ across regions

To a greater extent than several months ago, some of the main risks – both positive and negative – and uncertainties surrounding the current projections emanate essentially from present and projected economic conditions in the OECD area itself. In this context, policy requirements differ in the three major OECD regions.

In the United States, given low inflation and large uncertainties regarding the degree of slack in the economy...

In the *United States*, the main issue is whether the virtuous circle in which the economy has been operating can continue for much longer. A number of temporary factors that have damped import prices, such as lower oil and commodity prices, excess capacity elsewhere, and the appreciation of the dollar have facilitated the combination of rapid output growth with low inflation. But other factors of a more structural nature might have also played a role. In particular, the rapid expansion of productivity in advanced technology industries has lowered prices and thereby boosted the growth of the capital stock in other sectors of the economy, perhaps indicating some upward shift in the level of potential output. However, definitive signs of an underlying structural improvement in the supply side have so far proved difficult to identify.

... no immediate change is called for in the stance of monetary policy

Historically high equity price earning ratios, very low household savings and a widening current account deficit are signs of growing imbalances in the US economy. A downward change in sentiment would have negative and, in these circumstances, possibly disproportionate consequences on the economic outlook. Within this context of low inflation and uncertainty, US monetary authorities can afford to wait for clear signs of a modification in the inflation situation before changing the present stance of policy, and budgetary policy should keep its longer-term orientation towards sound public finances.

In the euro area, the appropriate policy mix consists of supportive monetary conditions...

In view of the very low levels of inflation and increasing signs of slowing activity, many European central banks reduced their official interest rates in early April. In the *euro area*, following the successful launch of the euro, the first move by the newly established European Central Bank can be interpreted as providing assurance to the public of its symmetric response to inflation and deflation risks. The present easy stance of monetary policy seems appropriate for the euro area as a whole. It may, nevertheless, pose problems in some countries where signs of overheating have already surfaced.

... continued fiscal consolidation and vigorous structural reforms

In principle, such problems could be overcome by adjusting fiscal policy in individual countries. However, countries facing inflation risks are generally also among those that already register relatively strong structural fiscal positions. Elsewhere in the area, fiscal positions are weaker and it is important that countries take advantage of any cyclical improvement to make further progress on budget consolidation. Improved budget positions are required in order to provide adequate scope for fiscal stabilisers to fully operate in the event of a prolonged slowdown in economic activity. More fundamentally, structural reforms will have to be pursued more vigorously in order to raise the euro area's economy adaptability in product and labour markets and reduce its susceptibility to shocks.

In Japan, where there is little more traditional macroeconomic policies can do to boost aggregate demand...

In Japan, the outlook remains bleak. Although the current easy orientation of policies should not be reversed prematurely, there is little more that traditional macroeconomic policies can do to boost activity. Money-market interest rates are now virtually at their zero nominal floor and earlier fiscal stimuli have led to a large build-up in government debt. Non-conventional macroeconomic policies, such as the partial monetisation of the budget deficit are unlikely to achieve much without generating large negative pressures on the exchange rate.

... ensuring a sustained recovery requires addressing key structural problems

So far, the effectiveness of expansionary policies has been muted by ongoing structural problems, in particular in the financial sector. Substantial progress in resolving financial sector problems has been achieved, but dealing with the overhang of real estate assets and removing other impediments to financial intermediation is essential to recovery in the short term. Ensuring a sustained recovery over the medium term will also require facilitating labour market adjustments while accelerating the pace of corporate restructuring as well as urgently addressing key structural problems elsewhere, in particular reforming a wide range of regulations that currently hold down longer-term growth prospects.

OECD countries should resist protectionist pressures and keep their markets open

Reflecting both the impact of the Asian crisis and cyclical divergences across the main OECD economic areas, imbalances in current account positions have tended to widen over the past two years. This has raised concerns about related increases in protectionist sentiments. So far, trade disputes have been confined to a few, highly visible, areas covering a very small fraction of global commerce. Notwithstanding the projected closer synchronisation of business cycles in major OECD regions, external imbalances are expected to persist for some time and concerns have been expressed that protectionist pressures may thus strengthen. If protectionist measures are implemented, prospects for sustained growth would be damaged and the adjustment process taking place in emerging markets adversely affected. Moreover, protectionist policies are unlikely to have much effect on current account imbalances as ultimately restoring more balanced positions depends on securing changes in aggregate saving and investment. In this context, it is important that OECD countries avoid implementing trade policies that restrict market openness to international trade and investment.

11 May 1999

I. GENERAL ASSESSMENT OF THE MACROECONOMIC SITUATION

The global situation and the outlook for the OECD area

Calm has returned to world financial markets…

Calm and confidence have returned to world financial markets as the worst fears about the ramifications of the Russian crisis last August and prospects for the global economy have not been realised. Equity markets have recovered and remain buoyant in most OECD countries, foreign exchange markets outside Brazil have been calm, and the launch of the euro has gone smoothly. In Japan, the credit crunch may have started to ease as concrete steps to deal with the banking problems have begun and the public sector has assumed increasing amounts of credit risk. Financial markets have so far not been significantly disturbed by the conflict in Kosovo, although the effects on countries in the region are already serious and will intensify if the crisis continues.

… but the performance of the global economy has been mixed

Against this background, the performance of the global economy has been mixed. On the positive side, strong non-inflationary growth has continued in the United States; the crisis in Brazil has largely been confined to South America; and the contraction of activity in emerging Asia appears to have come to an end. On the other hand, the European expansion has slowed somewhat; the Japanese economy only now appears to be bottoming out and clear signs of recovery are not yet apparent; there is little prospect of strong growth in emerging markets in the near future; and concerns have been expressed that global deflation could become a problem. Overall, the modest growth that both the OECD area and the world economy have been experiencing since last year is continuing (Table I.1).

Table I.1. Output growth projections

Percentage increase in real GDP over previous period

	Current projection				Revisions since November 1998[a]			
	1997	1998	1999	2000	1998	1999	2000	Cumulative revision 1998-2000
United States	3.9	3.9	3.6	2.0	0.4	2.1	–0.2	2.3
Japan	1.4	–2.8	–0.9	0.0	–0.2	–1.1	–0.7	–2.0
European Union	2.7	2.8	1.9	2.4	0.0	–0.3	–0.1	–0.4
Euro area	2.5	2.9	2.1	2.6	0.0	–0.4	–0.1	–0.5
OECD	3.3	2.3	2.2	2.1	0.1	0.5	–0.2	0.4
Memorandum items:								
Non-OECD area[b]	5.2	2.4	2.7	4.1	–	–	–	–
World[b]	4.0	2.3	2.4	2.9	–	–	–	–

a) See *OECD Economic Outlook* 64, December 1998.
b) Constructed from OECD and IMF projections for non-OECD regions, using 1997 GDP weights in world GDP based on 1997 purchasing power parities.

Oil prices have risen and falls in commodity prices are coming to an end

One important force shaping developments in OECD countries has been the sharp decline in oil and non-oil commodity prices in 1998 (Table I.2). This contributed to continuing disinflation and helped to sustain growth of disposable incomes in most of the OECD area outside Asia although a number of commodity exporting countries, including Canada, Mexico, New Zealand and Norway were adversely affected. This decline now appears to be coming to an end. Following the concerted action in March among major oil producing countries to curtail supply, oil prices rebounded and by early May stood more than 50 per cent above their levels at the end of last year. Compliance with the new production ceilings seems likely to be more widespread than under the agreement in force over the past year, but high world stocks will operate to limit upward price movements. OECD import prices are projected to average just over $ 15 per barrel in the second half of 1999 and are assumed to remain constant in real terms during 2000. Although no significant recovery of non-oil commodity prices is projected during the next 18 months, these may bottom out in the course of 1999 as demand and activity in Asia stabilise and recovery there gets under way.

Table I.2. **Oil and non-oil commodity prices**

Per cent change

	1997	1998	1999	2000
OECD import oil price (c.i.f.)	–7.0	–34.3	15.6	5.4
Non-oil commodity prices[a]	0.8	–14.0	–9.9	–0.1
Memorandum item:				
OECD import oil price (c.i.f., $/barrel)	19.14	12.58	14.54	15.33

a) Total commodity price index, excluding energy, Hamburg Institute for Economic Research. OECD projections for 1999 to 2000.

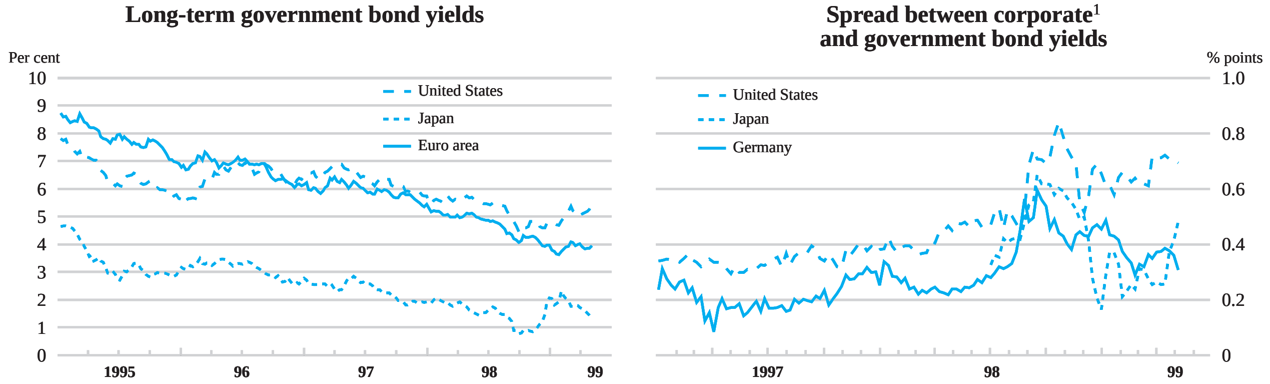
Interest rates should remain low…

Official interest rates have been cut in most of the OECD area since late last year, which has led to generally lower money market rates, and volatility has declined in both debt and equity markets. Nominal long-term interest rates in both the United States and Europe reached their lowest levels for the past three decades in late 1998 or early 1999, although rates on government bonds have rebounded somewhat recently (Figure I.1). Credit spreads for the higher quality borrowers have fallen from their peaks of September-October, but they remain above the exceptionally low levels prevailing a year ago. In Japan, the overnight call rate has been driven close to zero and three-month money market rates have fallen to below ¼ per cent. Nevertheless, despite the progress that has been made in alleviating the credit crunch, credit supply remains restricted because of the continuing problems of the banking sector and the yield curve has steepened as long-term interest rates have risen. In an environment of low inflation, policy-controlled interest rates throughout most of the OECD are assumed to remain broadly unchanged during the projection period (see Box I.1) and long-term interest rates are projected to fluctuate around current levels with some slight upward drift in Europe.

… a stronger dollar and a weaker euro will play a stabilising role…

The continuing strength of the US economy has surprised many market participants. This has been reflected in some firming of the dollar, notably against the euro since its launch in January. Overall, changes in exchange rates since last autumn should broadly contribute to some slowing of activity in the United States and be supportive of stronger growth in Europe. These changes will be less helpful for

Figure I.1. **Financial market indicators**



1. United States: AAA-rated paper; Japan and Germany: all non-bank corporations. Option-free fair-market yields.
Source: Bloomberg.

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

Fiscal policy assumptions are based on measures and stated policy intentions, where these are embodied in well-defined programmes. Details of assumptions for individual countries are provided in the corresponding country notes in Chapter II, "Developments in Individual OECD Countries". Generally speaking, the outlook is for fiscal stances, as measured by changes in structural budget balances, to be fairly neutral. An exception is Japan, where fiscal policy is highly expansionary in 1999. On the assumption that no supplementary budget is introduced this year, fiscal policy will be fairly neutral in 2000. Policy-controlled interest rates are assumed to be set in line with the stated objectives of the national authorities with respect to inflation (and, in some cases, to supporting activity) or exchange rates. In the case of the United States, this is interpreted to imply that policy determined interest rates will remain steady over the projection period as the economy starts to slow and inflation remains low, and in Japan, where the scope for further easing is virtually exhausted, short-term interest rates should remain very low. The stated primary objective in the euro area[1] is the maintenance of price stability over the medium term, where price stability is defined as an annual increase of the harmonised index of consumer prices below 2 per cent. In an environment where price stability has been achieved and activity remains below potential, the European Central Bank is assumed keep its key policy rate unchanged at 2½ per cent throughout the remainder of 1999 and 2000.

The projections assume unchanged exchange rates from those prevailing on 26 April 1999; in particular, one US dollar equals ¥ 119 and € 0.942. The fixed exchange rate assumption is modified for Hungary, Poland and Turkey to allow for continuous depreciation, reflecting the OECD interpretation of "official" exchange rate policies.

Following the rise in oil prices since March, the dollar price of OECD oil imports (c.i.f.) is estimated to average $ 13.83 per barrel in the first half of 1999. During the second half of 1999, the rise in oil market prices is likely to be fully reflected in the prices of oil imports in OECD countries, which are expected to average $ 15.25 per barrel. Non-oil commodity prices declined by nearly 17 per cent in dollar terms in the second half of 1998 and they are projected to decline further by 10 per cent on average in 1999. During 2000, both oil and non-oil commodity prices are assumed to move in line with OECD manufactured export prices.

The cut-off date for information used in the projections was 4 May 1999.

1. Germany, France, Italy, Austria, Belgium, Finland, Ireland, Luxembourg, Netherlands, Portugal and Spain, which have been participating in European Economic and Monetary Union since 1 January 1999.

Japan, however, since, notwithstanding the strengthening of exchange rates in several crisis countries in Asia, the yen has appreciated somewhat in effective terms since the projections reported in *OECD Economic Outlook* 64 were finalised last November.

... while fiscal policies may be fairly neutral in many countries

Fiscal policy may be less of a force in shaping the outlook than it was a few years ago. For the OECD area as a whole, the general government financial deficit may widen slightly over the projection period (by around ¼ percentage point of GDP), primarily reflecting a worsening position in Japan (Table I.3). The United States is projected to record fiscal surpluses close to 2 per cent of GDP over the next two years. Members of the European Union (EU) are committed to Stability and Convergence programmes announced last year. The fiscal position in EU countries may therefore improve slightly by 2000, notwithstanding somewhat weaker growth prospects than embedded in official budget projections. In Japan, on the other hand, a large fiscal stimulus is on course for 1999, and, given the weak cyclical position, the fiscal deficit may rise to 9 per cent of GDP in 2000, even on the technical assumption that no supplementary budget is introduced this year.

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

Per cent of GDP

	1996	1997	1998	1999	2000
United States					
Actual balance	–0.9	0.4	1.7	1.9	1.8
Structural balance	–0.8	0.0	0.9	1.0	1.1
Japan					
Actual balance	–4.2	–3.4	–6.0[b]	–8.7	–9.0
Structural balance	–4.8	–4.0	–5.0[b]	–6.8	–6.7
European Union[c]					
Actual balance	–4.2	–2.4	–1.6	–1.6	–1.4
Structural balance	–3.4	–1.7	–1.3	–1.1	–1.0
OECD[c]					
Actual balance	–2.6	–1.2	–0.9	–1.2	–1.2
Structural balance	–2.5	–1.3	–0.9	–1.1	–0.9

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

World trade may recover somewhat, although the outlook varies across regions

The sharp slowdown in world trade that occurred in 1998 as the Asia crisis unfolded strongly affected exports from the OECD area to non-OECD countries (Table I.4). Domestic demand appears to be stabilising in the Asia crisis countries and some rebound is projected during the remainder of 1999 and 2000. This should lead to a significant rise in the region's import growth, which is projected to be running at nearly a 20 per cent annual rate by the second half of 1999. However, given the crises in Russia and Brazil, imports will be contracting in other non-OECD regions. Total OECD exports to the rest of the world will recover during the second half of this year, but their growth will only rise to 6 per cent in 2000. The strengthening in OECD area intra-trade that is in prospect is modest, and the rebound in total world trade growth will be limited to around 5½ per cent in 2000.

Table I.4. World trade summary

Percentage changes from previous period

A. Annual data

	1997	1998	1999	2000
Merchandise trade volume				
World trade[a]	10.0	4.5	3.9	5.6
of which: Manufactures	11.4	5.2	4.2	5.7
OECD exports	11.3	4.6	3.4	5.7
OECD imports	9.8	7.1	5.3	5.4
Non-OECD exports	8.5	4.5	4.7	5.9
Non-OECD imports	8.5	–2.6	0.7	6.1
Memorandum items:				
Intra-OECD trade[b]	11.2	7.3	4.7	5.4
OECD exports to non-OECD[b]	8.3	–3.3	1.2	6.0
OECD imports from non-OECD[b]	8.4	4.4	4.9	5.7
Trade prices[c]				
OECD exports	0.8	0.2	–0.7	0.7
OECD imports	1.5	–1.4	–0.3	0.9
OECD terms of trade with rest of the word	–1.3	4.3	–0.9	–0.7

B. Semi-annual data

	1998 I	1998 II	1999 I	1999 II	2000 I	2000 II
Merchandise trade volume						
World trade[a]	2.7	2.4	3.9	5.7	5.6	5.6
of which: Manufactures	2.8	3.1	3.9	5.8	5.7	5.7
OECD exports	2.4	1.6	3.2	5.6	5.6	5.8
OECD imports	6.7	4.6	5.6	5.5	5.4	5.3
Non-OECD exports	3.2	3.9	4.9	5.0	6.3	6.0
Non-OECD imports	–7.6	–3.2	–0.4	6.8	6.0	5.8

a) Growth rates of the arithmetic average of world import volumes and world export volumes.
b) Arithmetic average of the intra-OECD import and export volumes implied by the total OECD trade volumes and the estimated trade flows between the OECD and the non-OECD areas based on the 1994 structure of trade values.
c) Average unit values in local currency.

Growth in the OECD area will remain modest this year and next

During 1999 and 2000 growth in the OECD area is likely to remain modest at just over 2 per cent. This, however, masks significant shifts in regional patterns. The strong momentum of the US economy should start to abate later in 1999 as business investment slows in response to low capacity utilisation in manufacturing, high rates of house-building are not sustained and waning wealth effects restrain consumer spending. In the euro area (see Box I.2), consumer spending remains fairly buoyant and should operate to support activity. Some rebound from recent weakness is in prospect as exports recover and business investment strengthens – especially in Germany as policies, notably toward tax reform, are clarified – while interest-sensitive demand components are buoyed by low interest rates. But substantial divergences in cyclical conditions across the euro area will persist as output gaps narrow sharply or close in most countries but remain large in Germany and Italy. In Japan, on the technical assumption that there is no supplementary budget later this year, the contraction in output which occurred last year should come to an end in 1999. No sustained recovery is on the horizon, however, since private confidence is weak and corporate restructuring is gathering pace.

Box I.2. Shifting statistical ground: overhaul of the national accounts in EU countries

A number of European Union (EU) countries have recently released or will soon make available revised sets of national accounts figures. These new series are based on the 1995 European System of Accounts (ESA 95), which transposes the 1993 System of National Accounts developed under the aegis of the Inter-Secretariat Working Group on National Accounts[1] (many non-EU countries have already shifted to SNA 93 in recent years). The aim is to harmonise and improve the relevance of the national accounts, in the context of growing economic and monetary integration. The impact of this overhaul cannot yet be comprehensively evaluated, since progress from the old to the new system is uneven across countries, but where new data have been released, it is in many ways very substantial. To the extent possible, the data, estimates and projections reported in this issue of OECD Economic Outlook reflect these changes. Specifically:

- For the countries that had already switched to ESA 95 by mid-April 1999 (Denmark, Finland, the United Kingdom), the figures shown here are based on the new system.
- Some countries had introduced partial adjustments, *inter alia* as concerns public finance variables, which are reflected in figures used here (Austria, Ireland, Italy).
- Several have published their first full or partial estimates, but these data became available too late to be incorporated in this *OECD Economic Outlook* (France, Germany, Belgium, the Netherlands, Portugal and Italy, which is also in the category noted above).
- Others have not yet begun to publish new series (Greece, Luxembourg, Spain, Sweden), and for these countries as well, the former measurement standards are still being used.

As a result, cross-country comparisons should be made with more than the usual caution, and aggregate figures, notably but not only for the euro area and the European Union are provisional, hybrid estimates. There could be substantial revisions once the transition to ESA 95 is completed.

The main changes include: added prominence to chain-linked constant price estimates, in order to reflect more swiftly the impact of relative price changes on volume growth; more systematic use of accruals as opposed to cash-based measures, notably as regards interest and taxes; for households, better distinguishing between actual final consumption and consumption expenditure; improved treatment of services; a broader concept of investment, which henceforth encompasses such items as expenditures on computer software and mineral exploration (although not research and development expenditure at large) as well as purchases of military machinery, equipment and buildings which may be used for civilian purposes; applying depreciation to public infrastructure; changed treatment of some taxes, fees and subsidies; and efforts to capture the grey economy better. The switch to a more recent base year (1995) also affects the figures and, for quarterly data, so does the introduction by some countries of adjustments for the number of working days (in addition to the usual seasonal adjustments). Moreover, different samples are used in the new set-up (for instance, to measure rents or employment), which further complicates the interpretation of the changes.[2]

The transition to ESA 95 generally tends to raise the reported level of GDP, but not uniformly over time (see table above). Hence, the growth record is altered: in Germany for instance, the average annual growth rate over the five years following the 1993 recession is reduced by a quarter of a percentage point, with last year's performance cut by a full half point; likewise, France's recovery through 1997 is weaker. In contrast, the depth of the recession in the early 1990s is somewhat lessened in several countries. The use of a more recent base year generally implies a larger weight for services, which tends to smooth the measured economic cycle, given that the production of services displays more inertia than that of industrial or agricultural goods. Investment is lifted very significantly, boosting both the

1. United Nations, OECD, International Monetary Fund, World Bank and Commission of the European Communities.
2. In France, the geographical scope of the national accounts is also widened, to include some overseas territories (*départements d'outre-mer*).

The outlook across the rest of the OECD area is mixed, reflecting a diverse set of cyclical situations. In many countries, prospects are favourable. Canada, Australia, Greece, Hungary, Iceland, Poland and Sweden are likely to continue to enjoy strong, if in some cases moderately slowing, growth. Activity in Korea should rebound, and New Zealand's recovery from last year's recession should gather strength. The United Kingdom, the Czech Republic, Norway and Turkey, on the other hand, will enjoy little or no growth this year and Denmark will slow to below its potential rate. Projected recoveries in these countries in 2000 are fairly weak.

Outside the OECD area, the immediate outlook remains poor although some improvement is in prospect for 2000. While conditions appear to be stabilising in

Box I.2. Shifting statistical ground: overhaul of the national accounts in EU countries *(cont.)*

level of GDP and the ratio of capital formation to GDP. External trade flows undergo first-order changes as well: in the Netherlands in particular, their sharp increase reflects the redefinition of transit trade. Financial balances are affected: in France, the 1995 fiscal deficit ratio is increased by 0.8 percentage point (mostly owing to a reclassification of operations associated with the bail-out of the Crédit Lyonnais, a large bank); in France and Denmark, enterprise finances look less strong due to a different treatment of debt write-offs; household saving ratios are also altered, although not always in the same direction. Measures of tax pressure are affected too, with the overall burden lowered by around one percentage point in France.

Impact of the shift to ESA 95 on selected indicators[a]

In percentage points

	Impact on the levels at current prices						
Country[b]	**GDP**	**Final consumption**	**Fixed investment**	**Exports**	**Imports**	**Fiscal balance ratio[c]**	**Household saving ratio**
Belgium (1995)	0.8	–2.0	15.6	5.7	6.5	. .	. .
Denmark (1992)	5.8	2.7	23.7	4.8	5.8	–0.6	2.4
Finland (1995)	2.1	0.5	6.1	1.0	2.2	. .	. .
France (1992)	1.8	1.2	6.2	–3.4	–0.1	0.9	1.9
Germany (1998)	1.1	0.6	8.8	6.0	6.5	. .	. .
Italy (1997)	1.2	–0.1	9.1	–0.2	0.5	. .	. .
Netherlands (1998)	4.2	2.9	15.8	11.8	15.7	0.2	. .
Portugal (1995)	1.9	0.3	3.8	0.9	–1.2	. .	. .
United Kingdom (1997)	2.0	–2.5	6.6	2.4	1.0	0.0	–1.5

	Impact on the growth rate of real GDP							
	1991	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**
Belgium	0.4	0.1	0.0	0.4	0.3	–0.4	0.2	. .
Denmark	0.1	1.1	–0.7	1.5	0.4	. .	. .	. .
Finland	1.1	0.4	0.6	–0.8	–1.1	0.5	–0.5	. .
France	0.3	0.4	0.4	–0.5	–0.3	–0.2	–0.2	. .
Germany	. .	0.0	0.1	–0.4	0.5	–0.5	–0.4	–0.5
Italy	. .	. .	0.3	0.0	0.0	0.2	0.0	. .
Netherlands	. .	. .	. .	. .	. .	0.1	0.3	0.0
United Kingdom	0.5	0.6	0.2	0.1	0.1	0.4	0.1	. .

a) In some cases, the comparison is distorted by simultaneous revisions to the underlying data.
b) In parentheses is the year used for the comparison, which is typically either the benchmark year for which the accounts were first re-estimated or, where possible, a more recent year.
c) An increase means the deficit is lower under the new system and base year.

emerging Asia, recovery in the economies affected by the crisis will only gather momentum next year and growth in China will slow somewhat, although it will remain high. Elsewhere, Brazil is contracting sharply, which will adversely affect South America, and output in Russia continues to fall. However, in both cases growth should resume in 2000 at a modest rate. Hence, at the world level, growth should remain moderate in 1999, at around 2½ per cent, before rising to around 3 per cent next year as recovery in emerging Asia becomes established and the situation in other non-OECD regions begins to stabilise.

Inflation should remain very low…

Inflation will change very little from the low rates recorded in 1998 in most OECD countries (Table I.5) and among countries where inflation has been high, only

Table I.5. **Inflation and unemployment**

	1997	1998	1999	2000
		Per cent		
Inflation [a]				
United States	1.9	1.0	1.1	1.5
Japan	0.1	0.4	–0.7	–0.6
European Union	1.7	1.8	1.7	1.7
Total OECD less high inflation countries [b]	1.5	1.3	1.1	1.3
Total OECD	3.6	3.1	2.4	2.2
Employment growth				
United States	2.2	1.5	1.9	1.1
Japan	1.1	–0.6	–1.0	–0.5
European Union	0.6	1.3	0.8	0.8
Total OECD	1.5	1.0	0.9	0.9
		Percentage of labour force		
Unemployment rate				
United States	4.9	4.5	4.2	4.4
Japan	3.4	4.1	4.9	5.3
European Union	11.2	10.5	10.1	9.8
Total OECD	7.2	7.1	7.0	7.0
		Millions		
Unemployment levels				
United States	6.7	6.2	5.9	6.3
Japan	2.3	2.8	3.3	3.6
European Union	18.7	17.6	17.1	16.6
Total OECD	35.5	35.0	34.9	35.1

a) Percentage change in the GDP deflator from previous period.
b) 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, Greece, Hungary, Mexico, Poland and Turkey are excluded from the aggregate.

in Mexico and Turkey is it projected to exceed 10 per cent. However, with the possible exception of Japan, concerns about deflation appear unwarranted on the basis of the outlook reported here. One contributing factor will be the end of the decline in commodity prices and, in particular, the rebound in oil prices which has recently occurred. Another is pressure on resources in some countries, notably the United States, Australia and several smaller European economies, where economic activity has been running at high levels for some time and output gaps have largely been eliminated. Within the euro area, inflation is expected to remain low, although the 2 per cent level will be exceeded in some countries (Ireland, Portugal and Spain). In contrast, in Japan, where the output gap will widen substantially further, many measures of the price level are likely to fall slightly over the projection horizon.

… while unemployment performance will be mixed

The area-wide unemployment rate may remain broadly stable at around 7 per cent, although the total number of unemployed persons is set to rise slightly next year. There will be considerable variation across countries, as the rise in joblessness in the United States, Japan and the United Kingdom roughly matches the declines in the euro area and in most other countries. Higher unemployment in the United States should work to reduce the risk of overheating, but it will remain well below most estimates of the structural rate, and in the European Union the projected decline to around 10 per cent would leave joblessness at its lowest rate since before the recession of the early 1990s. In Japan, on the other hand, unemployment will reach its highest rate on record since the 1950s.

Current account imbalances will persist

Current account imbalances of the major OECD regions are expected to persist and, in the case of the United States and Japan to widen significantly over the projection period (Table I.6). To some degree, the increase of the US current account deficit has been occurring because the US cycle has not been synchronised with that of its major trading partners.[1] But it also reflects a growing gap in the private sector saving-investment balance that has been apparent since the early 1990s and that has more than offset the improvement in the financial balance of the general government. The rise in Japan's current account surplus, which has occurred despite a severe impact from the decline in import demand in the Asia crisis countries as well as losses in export market share, mainly reflects declines in import volumes. This reduction is mostly explained by the fall in total final expenditure associated with the sharp weakening of the cyclical position of the Japanese economy. The current account surplus of the European Union, which declined in 1998 to just over 1 per cent of GDP, will probably remain around that level during the coming two years.

Table I.6. **Current account balances**

	1997	1998	1999	2000
	Per cent of GDP			
United States	–1.9	–2.7	–3.4	–3.5
European Union	1.5	1.1	1.0	1.0
Japan	2.3	3.2	3.0	3.5
Korea	–1.5	12.6	5.7	3.5
	$ billion			
United States	–155.2	–233.4	–303.5	–320.4
European Union	118.5	89.4	80.8	88.7
Japan	94.5	120.7	124.5	142.4
Korea	–8.2	40.0	23.1	15.2
Dynamic Asian economies[a]	–0.2	50.8	49.0	42.5

a) Chinese Taipei; Hong Kong, China; Indonesia; Malaysia; the Philippines; Singapore and Thailand.

Policy considerations in an uncertain global environment

The risks and policy requirements associated with the projections have changed during the past several months as financial markets have gained confidence. While the situation in many non-OECD economies remains fragile, the main uncertainties surrounding the current projections come more from within the OECD area than from outside of it and the risks are not uniformly on the downside. The nature of risks within the OECD area differs from one region to another to a larger extent than has often been the case in the past. However, economic interdependence implies that specific risks and challenges in key countries and regions ultimately become risks and challenges for the OECD area as a whole. The remainder of this section considers some major issues and uncertainties that have a bearing on policy requirements. As background, a description of the OECD medium-term reference scenario is provided in an appendix to this chapter.

1. See Chapter VII, "Causes of the Recent Widening of OECD Current Account Imbalances".

Is the impact of the crisis in emerging markets on OECD countries waning?

The financial turbulence that began in 1997 took on a global character in 1998

Following the depreciation of the Thai baht in July 1997, financial turbulence spread widely. By last September, following the Russian crisis in August, global financial markets had become extremely fragile. Losses on Russian securities held by highly leveraged financial institutions (*e.g.* hedge funds) resulted in higher margin calls, forcing many investors to sell their holdings of emerging-market securities in general. At the same time, the Russian crisis led to a major reassessment of the risk of holding emerging-market assets. This reassessment affected not only emerging market borrowers, but many financial institutions which had exposure to them. The result was a sharp increase in risk premia, the drying up of liquidity in markets for many financial instruments and the near-default of a large hedge fund.[2] In this highly unsettled environment, a major downside risk to the world economic outlook was the possibility of another crisis in emerging markets. Given its unsustainable budget position and related financial problems, Brazil was seen as a potential trigger for instability. Indeed, a possible crisis in Brazil was an important ingredient in the downside scenario in the *OECD Economic Outlook* published last December.

But the effects of the crisis in Brazil have been muted

Against this background, the eruption of the Brazilian crisis in January had surprisingly muted effects in global financial markets. This unexpected outcome can be credited to efforts by financial institutions to reduce their exposure to risks in major emerging markets, which may have been built up on the premise that, in the last resort, such investments were backed by implicit public guarantees. In this respect, the reduction of interest rates in mature markets and the approval of a support package for Brazil led by the International Monetary Fund (IMF) in November arguably played an important role in delaying the onset of the crisis. This provided financial institutions with valuable time to reduce their vulnerability to a risk that was widely expected to materialise. Banks in the reporting area of the Bank for International Settlements (BIS) slightly reduced their loan exposure to Brazil and other emerging market economies in the third quarter of 1998 (Table I.7). Anecdotal evidence suggests that this retrenchment may have continued. As reflected in a sharp deceleration of activity in the derivatives industry in the closing months of 1998,[3] position-taking by leveraged institutions has also been pared back in response to less appetite for risk-taking and more stringent collateral requirements imposed by creditors. Moreover, institutions ill-prepared to assume the consequences of crises appear to have made an effort to hedge their positions with counter-parties that could better handle the risk. The reduced vulnerability of financial institutions has inevitably implied falling capital flows to emerging market economies and increased their borrowing costs abroad, sovereign bond spreads remaining high ever since the Russian crisis.

The Kosovo crisis has not unsettled global financial markets

Global financial markets have so far remained calm as the Kosovo crisis has evolved. While the economic impact of the crisis in the neighbourhood of the conflict zone is significant (Box I.3), weak trade and financial linkages suggest that most OECD countries are largely sheltered from serious direct adverse effects. The

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2. The hedge fund, Long-Term Capital Management (LTCM), was ultimately rescued by private institutions.
3. See Bank of International Settlements, *BIS Quarterly Review*, March 1999.

Table I.7. **External assets of banks in the BIS area *vis-à-vis* individual countries**

$ billion

	1997 December	1998 June	1998 September
Eastern Europe	105.5	115.7	108.9
of which: Russia	58.8	64.8	56.0
Latin America	306.1	320.9	314.2
of which:			
Brazil	100.2	110.3	102.5
Argentina	46.7	47.5	49.0
Chile	19.9	20.8	20.9
Mexico	74.4	75.3	74.7
Asia	447.4	394.4	373.2
of which:			
China	90.1	86.7	81.0
Indonesia	62.8	53.8	52.0
Korea	103.9	83.0	78.7
Malaysia	29.1	24.6	23.7
Thailand	79.7	65.0	60.6

Source: International Banking and Financial Market Developments, *BIS Quarterly Review*, March 1999.

three most affected Balkan countries (Federal Republic of Yugoslavia, Albania and the Former Yugoslav Republic of Macedonia) are insignificant export markets for the United States and Japan, and only 0.1 to 0.2 per cent of total exports of the European Union goes to these countries. BIS reporting banks' claims on the three Balkan crisis countries are also very small (0.25 per cent of total claims on all outside area countries in end-September 1998).

Further crises in emerging economies may not have major effects in the OECD area as a whole

While recent developments suggest that the prospects for new disturbances in emerging markets are receding, the situation remains fragile and there are still potential downward risks in many regions:

– The Brazilian crisis may deepen further with serious additional spill-over effects for the South American economy in general.

– Economic conditions in Russia could worsen significantly, in which case its immediate neighbours might be pulled down further as well.

– The slowdown in the Chinese economy could be longer than anticipated, prompting a depreciation of the renmimbi with repercussions for exchange rates of other Asian economies, not least Hong Kong, China.

But even in the event of these risks materialising, the reduced exposure of financial institutions to emerging market economies implies that they may have only limited effects on the OECD area as a whole, although the effects would not be negligible for some individual countries. If financial tensions can be avoided, the main crisis transmission mechanism would be through trade linkages. These are generally too small to have serious depressing effects on the OECD area (Table I.8). For example, simulations of the OECD's INTERLINK model indicate that a 20 per cent depreciation of the currencies of China and Hong Kong, China would have only limited effects on growth in the OECD area as a whole and that the effects would still be relatively small even if it were to be accompanied by depreciations of the currencies of other emerging market economies in Asia (see Box I.4).

Box I.3. The regional economic impact of the Kosovo crisis

The Kosovo crisis has become a humanitarian disaster with spillover effects that radiate outward from the conflict zone. The disruptions of war are likely to impose substantial economic hardships on the people living in the Federal Republic (FR) of Yugoslavia; for up to a million displaced Kosovars the situation is already catastrophic. In Albania and the Former Yugoslav Republic (FYR) of Macedonia, the need to absorb the influx of refugees is putting the political, economic and social fabric under enormous strain. The fragile post-Dayton structure in Bosnia-Herzegovina is holding for the moment, but the risks of destabilisation are clear. For the other transition countries in the Balkans (Bulgaria, Romania and Croatia), the direct cost has been less, but indirect costs are becoming significant and risk to undermine stabilisation and economic reform programmes. Further afield, the costs of the crisis appear small at present: some negative spillovers have been identified for Greece, Slovenia, Hungary, Turkey and Italy – though estimates of the overall growth impact for 1999 are well below a quarter of a percentage point of GDP in all cases.

The immediate priority for the international community is humanitarian support for refugees. In early May the number of refugees from Kosovo was estimated by the United Nations High Commission for Refugees (UNHCR) to be around 716 000, of which more than half were in Albania and close to a third were in the FYR of Macedonia. The number of refugees outside Kosovo continues to increase and could under plausible scenarios reach close to one million within few months. Neither Albania nor FYR Macedonia has adequate resources to meet the basic needs of the refugees, but various relief organisations and government agencies are now engaged, and flows of food and other forms of direct aid are coming into these countries. Unless the crisis is resolved much more rapidly than now seems likely, substantial additional assistance will be needed, not only to meet the needs of the refugees but also to cushion the impact of the crisis on the budgets and external accounts of these countries, and to forestall the risks of a breakdown of governance structures. The challenge will be to deliver this assistance in an effective and efficient way, avoiding co-ordination failures in the decentralised environment of aid delivery. One risk of such failures is that excessive supply of some types of goods sent for relief would find their way into local markets, drive down local prices and thus undermine incentives for domestic production.

Aside from the direct impact of the huge refugee flows, the countries of the region are economically affected, to differing degrees, by impacts on trade, tourism, transport costs and foreign investment.

Intra-regional trade links imply that export markets will be lost. The FR of Yugoslavia is an important destination of exports from Bosnia-Herzegovina and FYR of Macedonia. Even if Croatia does not have strong trade links with the FR of Yugoslavia, its exports could be affected through strong trade links with Bosnia-Herzegovina. However, neither the FR of Yugoslavia nor its immediate neighbours are important export markets for Bulgaria and Romania.

- Tourist traffic may be hit in some of the countries of the region, most strongly Croatia. Half of all holiday bookings in Croatia have reportedly been cancelled since the outbreak of hostilities. Tourism in parts of Greece, Bulgaria and even Italy could suffer if the conflict becomes drawn out.
- The FR of Yugoslavia was a major transit zone for shipments between western and southeast Europe. About 60 per cent of Bulgarian exports, for instance, transited through FR of Yugoslavia. Higher transport costs will reduce external competitiveness. Even if re-routing via Romania remains a possibility, the blocking of the Danube and difficulties with ground transportation have added significantly to shipping costs for Bulgaria, and – to a much lesser extent –

Table I.8. Share of selected emerging markets in total exports of mature economies, 1997

Per cent of total exports

	Mexico	Brazil	Other Latin America [a]	Russia	China	Korea and dynamic Asia [b]
United States	10.4	2.3	6.8	0.5	1.9	15.7
Japan	0.9	0.7	3.1	0.2	5.2	35.4
Germany	0.6	1.0	1.0	1.8	1.2	5.4
France	0.4	0.5	1.3	0.9	1.2	5.3
Italy	0.5	1.5	2.4	1.6	1.1	5.3
United Kingdom	0.2	0.6	1.2	0.7	0.5	6.2
Canada	0.4	0.5	1.0	0.1	0.7	2.9
European Union	0.4	0.8	1.4	1.3	0.9	4.8
OECD total	2.2	1.0	2.6	1.1	1.9	11.0

a) IMF classification of Western Hemisphere, excluding Brazil and Mexico.
b) Chinese Taipei; Hong Kong, China; Indonesia; Malaysia; the Philippines; Singapore and Thailand.
Source: Direction of Trade Statistics Yearbook, IMF, 1998.

Box I.3. The regional economic impact of the Kosovo crisis *(cont.)*

Turkey and Greece. In Bulgaria, added transportation costs are officially estimated at $ 1¼ million per day (close to 5 per cent of the daily average of the sum of exports and imports of goods).

– Foreign investors' confidence may be adversely affected, raising borrowing costs and, perhaps more critically, delaying any pick-up in much needed direct investment. In Bulgaria, it appears that the crisis has already complicated a few scheduled sales to foreign investors. The rise in risk premia on outstanding Bulgarian and Croatian bonds since the outbreak of crisis is another indication of flagging foreign investors' confidence. A rise has also been seen in the risk premium for Hungary, though the magnitude is too small to have any significant economic effect.

Any quantification of the impact on growth in the more seriously affected countries is at the moment extremely difficult.[1] The core of the problem is that incremental costs will interact with pre-existing conditions that were in some cases already economically unsustainable or close to it. Romania, for example, is substantially less hit than Bulgaria by identified spillover effects, but may nonetheless face a serious setback in its efforts to pursue essential economic reforms. In the face of very small margins for manoeuver, possible difficulties in revenue collection and crisis-related spending put public budgets under pressure, and might result in an accelerating inflation if governments are forced to resort to inflationary financing. Loss of export revenues and lower capital inflows will tighten the external financing constraint and lead the affected countries to reduce demand to stay within their means to import. If the macroeconomic balance becomes unsettled, the process of structural reforms may be undermined. Additional official assistance is clearly important to limit these risks. The indications are that such funding will be provided, both by the international financial institutions and by bilateral country donors.

While it is no doubt pre-mature to define precisely a longer-term reconstruction strategy for the region, including Kosovo and the rest of FR Yugoslavia, it is clearly not too soon for the international community to begin thinking in these terms. At least three elements need to be taken into account in such a strategy: the rebuilding of physical infrastructures; the construction of a new social infrastructure (rule of law, democratic institutions and effective governance mechanisms) conducive to the reconciliation of the different communities and the establishment of a civil society; and the putting in place of effective economic policies for growth. Such a programme will likely cost a lot, though estimates at this stage are hardly possible, and involve a number of players – the international financial institutions, the European communities, bilateral donors and – not least – the countries themselves. The key element will be to find effective mechanisms for co-ordination, to assure both that funding from a variety of sources is effectively channelled to priority uses and that the three elements of the strategy are implemented together, as failure in any one would likely undermine the results achieved under the other two.

1. A first estimate released by the World Bank and the International Money Fund is that, for the five countries most strongly affected by spillovers from the crisis (Albania, Bosnia and Herzegovina, FYR of Macedonia, Croatia, and Bulgaria) GDP this year might be down by as much as 5 per cent if the military campaign is prolonged. They also estimate that required additional funding in 1999 to close incremental balance of payments gaps for the six most affected countries (including Romania) may amount to $ 1.5 billion.

But emerging market countries within the OECD may be more affected

Although the OECD area as a whole may be sheltered from potential near-term crisis, emerging market economies within the OECD region that have macroeconomic imbalances and weak financial systems could face difficulties. A large budget deficit, a high – though declining – inflation rate and excessive risk exposure in the banking system make Turkey particularly vulnerable. Prudent macroeconomic policy in response to the drop in oil prices during 1998 has reduced the risk of contagion in Mexico, even if the financial system remains weak. Past macroeconomic stabilisation efforts in the Czech Republic, Hungary and Poland have also provided these countries with a cushion against external financial disturbances. However, high current account deficits in Hungary and Poland, and the weakness of the financial system, particularly in the Czech Republic, remain a cause of concern.

Over-capacity and weak demand in emerging markets are putting downward pressure on prices

Even in the absence of new crises, industrial over-capacity and weak demand in emerging markets will continue to put downward pressure on world prices. Indeed, this prospect is an important source of widely expressed, if somewhat unwarranted, concerns about global deflation. Together with large currency depreciations, this

Box I.4. Devaluation of the Chinese currency: impact on OECD countries

The weakening of the Chinese economy is often seen as a major risk for the global economy, principally because it is perceived to increase the likelihood of a depreciation of the renmimbi. Even if fundamentals in China would not seem to point to any need for a downward currency adjustment, a further unexpected reduction of economic growth might prompt the authorities to devalue the currency in an attempt to stimulate exports. However, a depreciation of the Chinese currency could lead to a depreciation of the currencies of neighbouring countries. The currency board system in Hong Kong, China would probably come under intense pressure, and other Asian economies might be tempted to neutralise the impact of a Chinese devaluation on their competitiveness. A significant reduction in open currency positions, and hence exposure to exchange rate movements, has made balance sheets in these countries less vulnerable to depreciation than at the start of the crisis in 1997. The resulting compression of demand and imports in these countries would accordingly be significantly less than in recent past. Nonetheless, a marked change in the international competitiveness of Asian emerging market economies would have effects on the OECD area.

A devaluation of the Chinese renmimbi and the Hong Kong dollar by themselves would have very limited effects on the OECD area. According to simulations of the OECD's INTERLINK model, a 20 per cent devaluation of the two currencies in mid-1999 would strengthen the Chinese current account by $ 12 billion in 2001 (see table below). The counterpart would be fully reflected in the current account of OECD countries. These very small trade linkages imply that the impact on growth in the OECD area as a whole and in most individual OECD countries would be hardly noticeable.

The adverse effects on the OECD area would be stronger, though still modest, if the devaluation of the renmimbi and the Hong Kong dollar in mid-1999 were to be accompanied by depreciations of other Asian currencies. If a 20 per cent fall in the international value of the renmimbi and the Hong Kong dollar were to trigger off a 10 per cent depreciation of the currencies of other emerging market economies in Asia (including Korea), the current account of the OECD area as a whole could deteriorate by around $ 29 billion. Given its strong direct and indirect trade links with the Asian emerging market economies, Japan would be the most seriously affected country in the OECD area, the level of its GDP falling by more than ¾ percentage point in 2001.

Impact of a hypothetical devaluation in China

	China and Hong Kong, China devalue by 20 per cent in mid-1999	With accompanying 10 per cent devaluations in other Dynamic Asian Economies[a] and Korea
Real GDP level in 2001		
United States	–0.2	–0.4
Japan	–0.3	–0.8
European Union	–0.1	–0.2
OECD	–0.1	–0.4
Current account balance in 2001 ($billion)		
United States	–3.9	–10.4
Japan	–4.8	–12.6
European Union	–2.8	–9.3
OECD	–14.2	–29.2
China	11.9	8.9
Dynamic Asian Economies[a]	2.2	21.4
Non-OECD	14.2	29.1

a) Chinese Taipei; Hong Kong, China; Indonesia; Malaysia; Philippines; Singapore and Thailand.

over-capacity has prompted producers to cut export prices, the dollar price of manufacturing exports in 1998 declining by almost 6 per cent in the non-OECD area as a whole and by close to 10 per cent in the Dynamic Asian Economies.[4] This has put

4. Chinese Taipei; Hong Kong, China; Indonesia; Malaysia; the Philippines; Singapore and Thailand.

pressure on producers in the OECD area to follow suit or lose market share. Indeed, together with lower import demand, competitive pressures from producers in the non-OECD area seem to have contributed to the comparatively depressed state of the manufacturing sector in much of the OECD area.

Since some of the non-OECD regions (notably in Asia) have been large buyers in commodity markets in recent years, the recession in emerging markets has played an important role in driving down the real price of commodities to levels that are historically very low. Indeed, by early 1999, non-oil commodity prices in real terms had fallen back to the lowest levels reached in the post-war period. The fall in commodity prices since 1996, which has also been strongly influenced by increased production, has directly reduced the inflation rate in the OECD area. It may also have moderated inflation indirectly through the lowering of inflation expectations and wage claims.

Though these price trends have been beneficial to the OECD area as a whole, they have adversely affected OECD countries with large commodity-producing sectors. The decline in oil prices has weakened the government budget and current account balances in Mexico and in Norway. Mexico has tightened macroeconomic policies in order to offset the impact of the oil price decline on the fiscal balance. In Norway, the oil price decline came on top of a tightening of macroeconomic policies to cool an overheated economy and has contributed to a marked weakening of activity. The decline in non-oil commodity prices and weakness in export volumes combined with continued strong growth in domestic demand have contributed to a current-account deficit of 5 per cent in Australia. In New Zealand, the current-account deficit has not widened further, partly because of weaker internal demand, but it remains large. To maintain financial market confidence in the face of such large external disequilibria, it will be essential to guard against any reduction in the fiscal surplus in Australia and to strengthen the fiscal balance in New Zealand. In Canada, adverse terms-of-trade effects have been largely offset by other developments, notably strong growth in the United States, and the current-account deficit has remained modest. This would not seem to require immediate policy reaction.

The United States: how solid is the expansion?

Continuing strong US performance has been a surprise

The continued strong peformance of the US economy has surprised most analysts and forecasters. The central issue that this raises is how these developments in the economy should be interpreted and what this means for policy as the economy evolves. In particular:

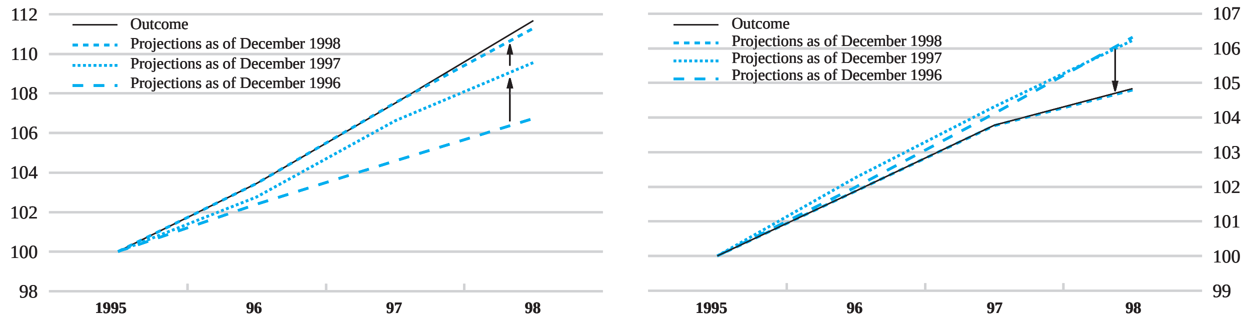
– Can positive surprises continue, reflecting structural improvements which are having favourable long-term effects and, if so, for how long?

– Or have they masked accumulating imbalances, underlying financial fragility and suppressed inflation pressure, making the economy vulnerable to a steady upward drift in inflation and/or a sharp slowdown in activity?

The past few years have seen an apparent breakdown of at least some important empirical regularities on which most analysis of the US economy has relied. Most importantly, strong growth has persisted longer than most analytical work based on past performance has suggested was possible without igniting inflation. On the

Figure I.2. **Projections and outcomes for the United States**

Growth rates (cumulative effect on level of real GDP)[1] **Inflation rates (cumulative effect on level of GDP deflator)[1]**



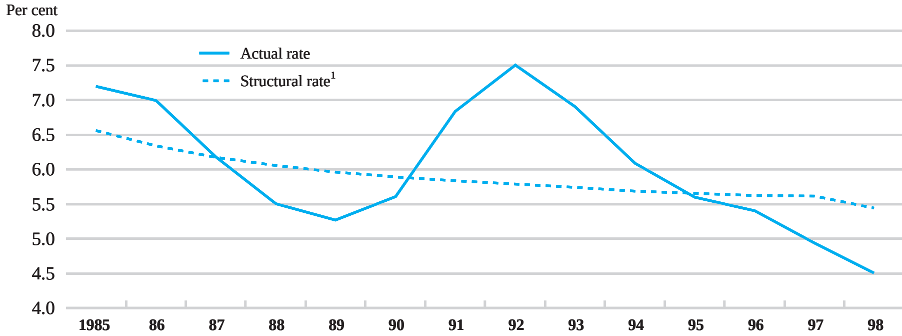
1. 1995 = 100.
Source: OECD Economic Outlook (various issues).

contrary, inflation has come out below forecasts even as output growth has typically been underpredicted, suggesting that more is involved than simple underestimates of aggregate demand (Figure I.2).

Surprises have mainly come from the supply side

Indeed, the surprises that have led to the widespread errors in forecasting macroeconomic performance have mainly come from the supply side. Some of these surprises, such as declining non-wage labour costs and falling import prices due to low commodity prices, the Asia crisis, the slack in other OECD economies and the firmness of the dollar, may be temporary. But some of the forces at work may be more permanent. Most importantly, the unemployment rate has been below consensus estimates of the structural rate since 1995 (Figure I.3) without generating any signs of a rise in unit labour costs or inflation, even if real wages have increased strongly. While empirical studies suggest that the favourable temporary developments noted above are mainly to thank for this achievement, there are also reasons to believe that labour market performance has improved over the past decade and that the structural rate of unemployment may have declined in response to changes in the economy. These include:

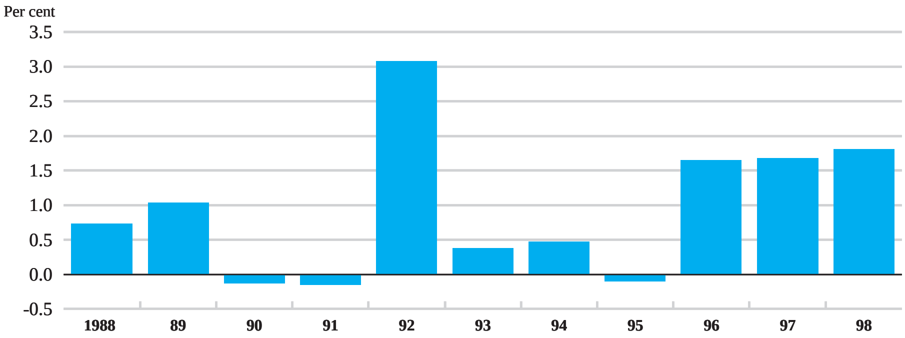
Figure I.3. **Actual and structural unemployment rates in the United States**



1. OECD estimates.

Figure I.4. **Labour productivity[1] growth in the US business sector**

Year-on-year percentage changes



1. GDP per employed person.

– stronger competition in product markets, which has strengthened the resistance of employers to give into wage demands and has also forced employees to moderate their claims; and

– social assistance reforms in the mid-1990s and the expanded use of tax measures to encourage work at low wages, both of which may have reduced reservation wages, intensified job search, and increased participation in the labour force.

It is still too early to judge whether the strong increase in labour productivity since 1996 (Figure I.4 and Box I.5) reflects a cyclical increase or whether it signals a more permanent increase in the underlying growth rates of potential. The increase is integrally linked to very strong business investment which in turn appears to reflect:

– a strong profit position which has provided businesses with ample internal funds;

– exceptionally rapid technical progress in the computer industry, which may have directly added ¼ percentage point annually to productivity growth; and

– the resulting dramatic fall in the price of high technology capital equipment[5] that has encouraged the diffusion of such products throughout the economy (Figure I.5).

At least some of these developments will probably persist. There is little evidence to suggest that price declines on advanced technology equipment will come to an end over the foreseeable future, and this factor is likely to operate to maintain existing investment trends over the medium term. However, business capital spending could weaken when corporate profits start falling. And the extent to which total factor productivity growth in the future will increase as a result of wider diffusion and more effective use of modern technology is uncertain.

Important changes in the structure of the US economy[6] are likely to influence its behaviour both over the cycle and longer term, in ways that are not yet fully understood and may therefore lead to surprises:

5. Prices on computer investment equipment fell by around 25 per cent per year on average in 1997 and 1998.
6. Given a host of serious measurement problems, it is difficult to gauge the importance of individual sectors in the economy. For example, the same firm may operate in several sectors, whereas all its activities are accounted for in the sector of its dominant activity. Moreover, outsourcing can mask the importance of sectors in the economy.

Box I.5. What is happening in the US economy: measurement issues

Structural changes in the US economy may have affected the statistical information base on which economic policy formulation depends. Partly this is because financially stretched statistical agencies may not have fully adapted to these changes (in particular, agriculture and manufacturing remain covered considerably more comprehensively than services) and partly it relates to conceptual problems, notably those relating to quality changes and price-volume splits, whose importance increases as the share of output which cannot be measured in physical terms rises. Where regulatory arrangements provide collection points for data, liberalisation may also have had an effect.

The recent behaviour of labour productivity is a case in point, since there have been important discrepancies between the various measures of both output and employment growth. The income measure of GDP has been showing a significantly stronger rise in output than has the most widely accepted measure based on expenditures. At the same time, the establishment-based payroll measure of employment has risen more than employment gains recorded in the household survey. As a consequence, the average productivity growth rate over the 1993-1998 period is almost one percentage point higher if derived from the income measure of output and the household measure of employment than if it is derived from the expenditure measure of output and the payroll measure of employment (see table). Cumulatively over the period, this differential amounts to nearly 5 per cent, a figure that is large relative to most plausible estimates of slack in the economy. Unfortunately, it is not possible to state categorically what productivity measure is the most reliable until, and unless, the next census provides more accurate information about employment and the next comprehensive benchmark revision of the national accounts better reconciles the different output measures.

Average growth in GDP per employed person 1993-98

Per cent

	Employment measure	
	Household survey	**Payroll data**
GDP expenditure measure	1.6	1.0
GDP income measure	1.9	1.4

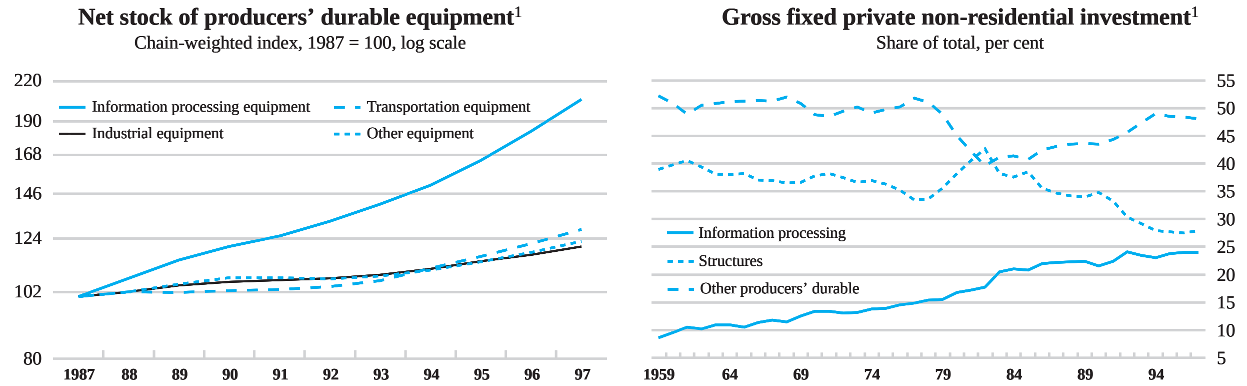
Note: The expenditure-based GDP price deflator is used to convert the income-based GDP series into a constant price series.

Questions about the quality of data or how to interpret them are not confined to output and employment data.[1] The publication of the Boskin Report[2] called attention to the complexities of measuring inflation, national accounts and flow-of-funds data show different pictures for household saving behaviour, and external financial accounts probably have large errors and omissions. Questions also extend beyond the United States, whose economic and financial statistics are generally thought to compare favourably in international terms. The elimination of customs points within the European Union as part of the single market programme, for example, has affected the accuracy of European trade statistics and the growth of electronic commerce will pose challenges to collection of statistics not only for external transactions but more widely. The importance of economic and financial statistics has been emphasised by both G-7 countries[3] and the IMF, which has established a Special Data Dissemination Standard to encourage more comprehensive provision and timely reporting of information. Concern to improve economic and financial information internationally has largely been motivated by a desire to encourage better reporting by emerging market countries. But, as the size of revisions being made to national accounts in EU countries suggests (see Box I.2), adapting information systems to a changing world will be a challenge even for those countries where statistical systems are most advanced.

1. A further elaboration on these and other statistical issues is contained in *OECD Economic Surveys*, United States, 1999.
2. Report of the United States Senate Advisory Commission to Study the Consumer Price Index, Washington, 1977.
3. See, for example, the G-7 leaders' Statement on the World Economy and the accompanying Declaration of G-7 Finance Ministers an Central Bank Governors, 30 October 1998, in which G-7 countries committed themselves "to deliver greater transparency … in disclosure of economic statistics and key indicators".

– The weight of manufacturing has been declining steadily and now directly accounts for around 15 per cent of employment and only slightly more for output (Table I.9). The weakness of this sector during 1998 was not important enough in macroeconomic terms to slow the overall economy.

Figure I.5. **The increasing diffusion of information processing equipment in the United States**



1. In private non-residential sector.
Sources: US Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business,* September 1998; *Economic Report of the President,* February 1999.

Table I.9. **Manufacturing in the US economy**

Share in total

	Employment	GDP	Corporate profits
1960	31.0	27.0	46.7
1970	27.3	24.1	37.7
1980	22.4	21.0	38.2
1990	17.4	18.0	31.4
1997	15.2	17.0	28.9

Source: Economic Report of the President, February 1999.

– The diffusion of high technology equipment noted above may be affecting the cyclical behaviour of the economy through its influence on inventory management and its impact on the rate of scrapping of capital equipment and the timing of replacement spending.

– The openness of the economy and exposure to global influences has increased significantly even during the 1990s, as reflected in the rising share of trade in GDP and high level of cross-border investment activity (Table I.10).

Table I.10. **The openness of the US economy**

Per cent of GDP

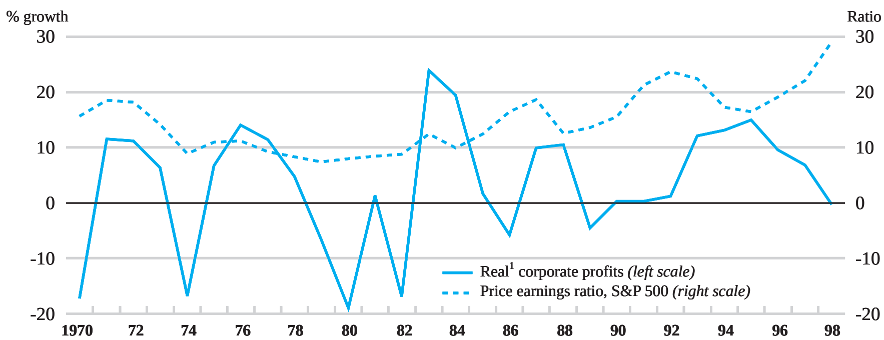
	1989	1997
Exports of goods and services	9.4	11.9
Imports of goods and services	10.8	13.1
Stock of outward direct investment by US business, market value	15.3	22.1
Stock of inward direct investment by foreign business, market value	9.8	20.0

Source: Economic Report of the President, February 1999.

The stock market is still vulnerable to a correction…

Better productivity performance and subdued cost increases have been reflected in strong growth of corporate earnings in the 1990s. Growth in profits has in turn been critical to sustaining both the strength of business investment and the stock market boom. However, even if there has been a significant improvement on the supply side, it does not look possible for corporate earnings in real terms to continue to rise indefinitely at an annual rate of close to 10 per cent as they have done on average during the 1990s; indeed, they slowed appreciably during 1998 (Figure I.6). With price-earnings ratios unusually high in historical terms, investors appear to be anticipating significantly higher earnings growth than has been the norm in the past or the corporate sector can plausibly deliver in the future.[7] Even if the risk premium has durably fallen from the high levels observed over the decades prior to the 1990s, the earnings growth rates required to validate the current level of equity prices seem high for reasonable values of the premium. Unless real interest rates fall or the dividend payout ratio increases significantly, investors may eventually have to adjust their expectations in light of actual and prospective slowing of earnings growth, thus making the stock market vulnerable to a correction.

Figure I.6. **Corporate profits and price earnings ratio in the United States**



1. Adjusted with the GDP deflator in the business sector.
Sources: Economic Report of the President, February 1999 and Bloomberg.

… which would tend to depress demand

Continued slowing of profit growth and a possible correction of the stock market would have important implications for the economy and near-term macroeconomic management. As noted above, the increase in profits in the past has provided corporations with ample internal funds for investment, and the levelling off of earnings would most likely be accompanied by a deceleration in the growth of capital spending. The boom in equity prices has also strengthened household balance sheets (Table I.11) and thus played a key role in driving down the household saving rate to around zero. A fall in stock prices would weaken the forces supporting private spending, but longer-term profit growth trends will not be clear for some time. How investors will respond to short-term profit fluctuations and adjust their expectations is highly uncertain.

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7. See Chapter V "Recent equity market developments and implications" in *OECD Economic Outlook* 64, December 1998, and M. Kennedy *et al.* (1998), Asset Prices and Monetary Policy, *OECD Economics Department Working Paper* No. 188.

Table I.11. **Household balance sheets[a] in the United States**

Per cent of disposable income

	1960	1990	1994	1998
Assets	569.3	582.7	588.4	714.0
of which:				
Tangible assets	199.1	223.5	205.5	214.3
Financial assets	370.2	359.2	382.8	499.7
Liabilities	59.5	88.8	92.4	103.7
Net worth	509.8	493.9	495.9	610.3
Net financial assets	310.7	270.4	290.4	396.0

a) Includes non-profit organisations.
Source: Federal Reserve, *Flow of Funds Accounts of the United States* (various issues).

In this uncertain environment and in the absence of concrete inflationary pressures, the monetary authorities have chosen to maintain a relatively neutral policy stance. Looking forward, the appropriate policy response will depend on how the uncertainties considered above evolve. If temporary factors have masked underlying inflation pressures since 1996, the risk is rising inflation pressure. If the level of potential output has risen because labour market performance has improved but no underlying increase in productivity performance has occurred, inflationary pressures will eventually build up if domestic demand continues to expand at robust rates. These circumstances would warrant monetary tightening to slow the economy. On the other hand, to the extent that underlying productivity performance and hence potential growth have improved, there may be more spare capacity than measures of labour market tightness would suggest. In this case, there would be less need for monetary authorities to respond to buoyant demand. Furthermore, if profit growth were to slow further under pressure from rising levels of spare capacity, even if underlying productivity performance has not improved, this could hasten a correction in equity prices and would encourage a slowdown in business investment. The risk in this case is that the economy could slow more abruptly than now appears likely and that monetary easing would be appropriate.

A cautious policy stance is appropriate

Overall, the monetary authorities should continue to respond cautiously to developments until they can be interpreted with greater confidence. At the same time, fiscal policy should remain oriented towards medium and long-term objectives, preserving the budget surpluses that are now in prospect in order to prepare for the ageing of the population.

Japan: structural reform needs to be stepped up

Activity in Japan is stabilising, but prospects remain poor

While economic activity in Japan appears to be stabilising, the prospects for sustained expansion remain poor. Bank recapitalisation and restructuring are now under way, but it may be some time before the financial sector is fully restored to health. At the same time, poor profitability has put much of the corporate sector under pressure to restructure and reduce employment. Fiscal and monetary policies are already very easy, leaving little scope for further stimulus, and at some stage, fiscal support will have to be withdrawn. The policy challenge facing Japan is to develop sources of dynamism which allow it to adapt constructively to the pressures it is facing. Ways must be found to sustain enough domestic demand to permit fiscal retrenchment to proceed and, at the same time, to create new enterprises and generate enough jobs to absorb the labour market adjustments that will be necessary.

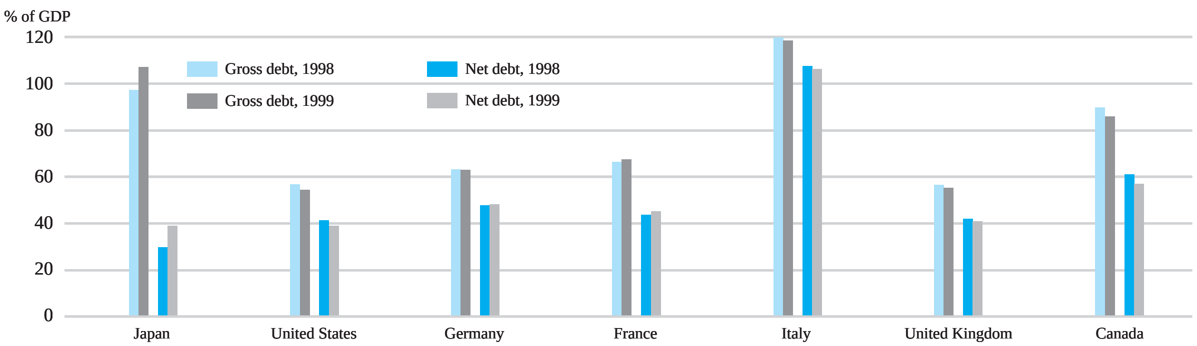
Box I.6. Spiralling general government debt in Japan

Successive fiscal packages to stimulate aggregate demand in Japan have resulted in a rapid build-up of public debt in the 1990s. With general government gross financial liabilities relative to GDP increasing by 40 percentage points since 1991, gross debt is already well above the level in most OECD countries (see figure below). Since the government holds large amounts of financial assets, net government debt is still relatively low compared to other countries. Until recently, the increasing financing needs of the government could be satisfied without putting pressure on interest rates.

The Trust Fund Bureau of the Ministry of Finance, which is charged with investing funds raised in the postal saving system as well as other government revenues such as pension contributions, has significantly increased its holding of government bonds since the early 1990s. Since mid-1997, the flight to quality in response to mounting concerns about the state of the global financial system in general and the Japanese financial system in particular permitted a lowering of government bond yields despite the increasing funding needs of the government.

General government gross and net debt, 1998 and 1999

End of period



The rise in long-term interest rates since late 1998 has, however, put into sharper focus the large financing needs of the government over the coming years. The general government budget deficit over this and the next year is set to rise relative to GDP. Should the Trust Fund Bureau reduce its purchases of government bonds, the increase in bond holdings in the private sector (excluding semi-public agencies) would be much more rapid. The Bureau announced in December that it would not buy government bonds in 1999, but later reversed that decision. In addition to financing the deficit, bonds may have to be issued to finance the costs related to the resolution of the problems in the financial system and the eventual costs of increased government guarantees for loans contracted by small and medium-sized enterprises. To place all this debt in private portfolios might require a significant increase in bond yields, especially since there is no end in sight to the build up of government debt.

Indeed, a major fiscal consolidation in the medium term is unavoidable to contain an explosive growth in the general government net debt to GDP ratio. The general government deficit in 2000 is projected to be 9 per cent of GDP: 5¼ per cent structural primary deficit, 1½ per cent net interest payments and 2¼ per cent cyclical deficit. Even if the cyclical component were to be eliminated by the year 2004, the net-debt ratio could rise to 75 per cent compared to 30 per cent in 1998. If the structural primary deficit relative to GDP is kept constant at its 2000 value and GDP grows at its estimated potential rate of 1 per cent, the net debt-to-GDP

Macroeconomic policy cannot provide increased stimulus

The economic situation does not warrant an immediate withdrawal of fiscal stimulus, but rising public debt levels (see Box I.6) and the likelihood of market reactions to them make a major consolidation effort over the medium term unavoidable. The only question is when it must begin. The November 1998 fiscal package – the tenth and most ambitious package since March 1992 – was soon followed by a sharp increase in bond yields,[8] which was unhelpful in the context

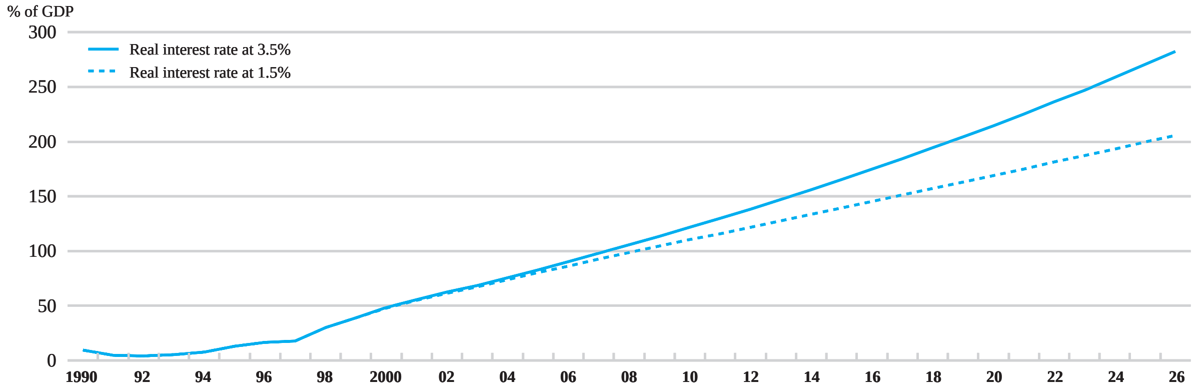
8. This rise was in part prompted by the scale of government bond issuance in 1999 and in part by the announcement that the Trust Fund Bureau in the Ministry of Finance would stop buying bonds in view of the likely liquidation of postal saving accounts in the near future. Even if bond yields have fallen back since February, partly in response to news that the Trust Fund Bureau would resume bond purchases, the yield on 10-year bonds was nevertheless nearly half a percentage point higher in early May than at the October trough.

Box I.6. **Spiralling general government debt in Japan** *(cont.)*

ratio would rise without bound under all plausible values for the real interest rate on government debt (see figure below).[1] However, the required tightening of fiscal policy to stabilise the ratio depends critically on the real interest rate. If the average implicit real rate falls gradually from its current value of 3½ per cent to 1½ per cent, a small structural primary surplus, involving a tightening of around 5¾ per cent of GDP, will suffice to stabilise the ratio as from 2004. However, if the implicit rate remains at 3½ per cent, which is more in line with real rates in other major OECD areas in the past, a tightening of more than 7 percentage points of GDP will be required.

These estimates of the required tightening understate the pressures on fiscal policy in the medium and long term. The ageing of the population in Japan is already increasing public pension outlays, and OECD estimates suggest that they could rise from around 6½ per cent of GDP in 1995 to 14¼ per cent in 2020.[2] Under these circumstances, it will already be a challenge to keep the structural primary budget deficit constant at 5¼ per cent of GDP. Moreover, public finances will come under additional pressure if corporate restructuring results in further large increases in joblessness. Even if short maximum duration of benefits should limit increased outlays on insurance benefits, a large increase in unemployment and a lengthening of unemployment spells would most likely put the government under strong pressure to increase the duration of insurance benefits with adverse consequences for public finances.

Scenarios for general government net debt with unchanged fiscal policy[1] in Japan



1. Assuming that the structural primary deficit is held constant at its 2000 level of 5.3% of GDP thereafter.

1. The scenarios shown in the figure are based on a simple debt-dynamics model: $d_t = p_t + [(1 + r_t) / (1 + g_t)] * d_{t-1}$, where *d* is the net-debt-to-GDP ratio, *p* is the ratio of the primary budget deficit to GDP, *r* is the real implicit interest rate on government debt, and *g* is the growth rate of the output. In the scenario with 1.5 per cent real interest rates, the implicit rate is assumed to decline steadily from 3.5 per cent in 2000 to 1.5 per cent in 2010.
2. See Table 40 in *OECD Economic Surveys*, Japan, Paris, 1997.

of very low inflation, bank restructuring and efforts to stimulate private spending. To counter the rise in bond yields due to the widening of the fiscal deficit, monetary policy was eased further in February. This helped to reverse the increase in interest rates on longer dated instruments and it may also have contributed to a modest decline in the value of the yen *vis-à-vis* the US dollar. But the overnight rate has now been driven down to virtually zero, and further easing via operations in the money market is clearly no longer possible.

These developments have given rise to a debate about whether the budget deficit should be partially monetised. With the central bank buying a significant part of new government bonds, yields would not have to rise to entice private investors to hold more public debt and the money supply would expand. This could translate into higher domestic demand, higher inflation expectations (notwithstanding the large slack in the economy), and a fall in the exchange rate. However, the increase in the monetary base will probably have only a limited effect on the broad money supply so long as banks continue to be reluctant to expand their balance sheets or if there is little demand for credit in the private sector. Too much depreciation of the yen could also trigger off significant protectionist reactions abroad. In addition, monetisation could remove an incentive for fiscal discipline in the medium term, as the authorities might be tempted to shy away from difficult consolidation measures if they could rely on the central bank underwriting deficits. But even if there are risks associated with monetisation, more forceful intervention to support the bond market may have to be taken if renewed increases in bond yields seriously hamper the recovery.

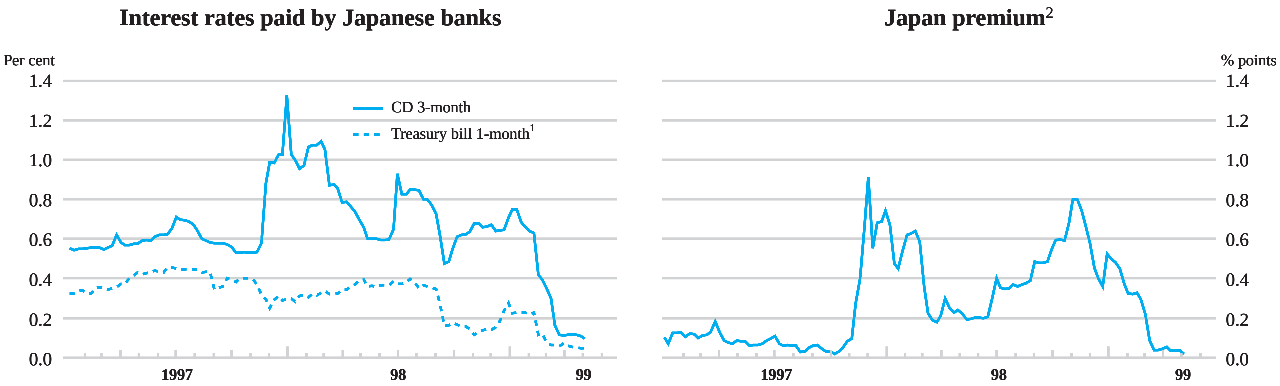
Continued progress resolving banking sector problems is essential

It is unlikely that there would have been any need for such a debate had the monetary transmission mechanism been working properly. Thus, as emphasised in previous editions of *OECD Economic Outlook*, further progress in dealing with problems in the banking system is essential. After long delays the authorities have recently taken several effective steps. The newly created Financial Reconstruction Committee and the Financial Supervisory Agency have enforced better disclosure about asset quality and imposed minimum levels of loan-loss reserves for problem credits. Two major private banks have been declared insolvent, with the hope that such forceful actions would encourage other major banks to apply for capital injections of public funds in exchange for concrete restructuring plans. The authorities have injected about ¥ 7½ trillion (1½ per cent of GDP) into 15 major banks in exchange for debt write-offs of around ¥ 9 trillion and restructuring measures. A sign of renewed confidence in the financial system is the decline in the risk premia Japanese banks must pay in the domestic money markets and the virtual disappearance of the Japan premium – the premium Japanese banks have had to pay on loans raised in the international inter-bank market – for those banks that have continued to raise funds internationally (Figure I.7).

It is, however, uncertain if the measures carried out so far will suffice to bring the banking system back to health. Capital injections of ¥ 7½ trillion look small compared to the officially estimated size of problem loans of ¥ 51 trillion (around 10 per cent of GDP) in 19 major banks as of end-September 1998: ¥ 6 trillion of non-recoverable loans and ¥ 45 trillion of doubtful loans,[9] some of which are already, or will probably become, non-performing. Moreover, the size of problem loans has most likely increased since property prices have continued to fall during the recession, and private estimates of problem loans in the banking system as a whole have ranged as high as ¥ 150 trillion.[10] Furthermore, it is not yet clear whether the restructuring measures will suffice to cut costs and restore profitability, as they are intended to do, even if balance sheets are adequately capitalised. Moreover, the success of these measures in the long term will depend on whether they induce greater emphasis on commercial criteria in banks' lending decisions. In view of the critical importance of restoring confidence in the banking system for the economy as a whole, the best strategy for the authorities

9. Credit exposures for which an adequate specific risk management is needed (so-called Category II loans). A loan loss requirement of 15 per cent now applies to some of these loans.
10. *OECD Economic Surveys*, Japan, Paris, 1998, p. 4.

Figure I.7. **Risk premia in Japan**



1. Repurchase rate (Gensaki).
2. Percentage point margin of the average three-month borrowing rates for US dollars of the two major Japanese banks over LIBOR.
Source: Bloomberg.

might be to err on the side of caution and insist on larger public capital injections and more forceful restructuring than currently envisaged.

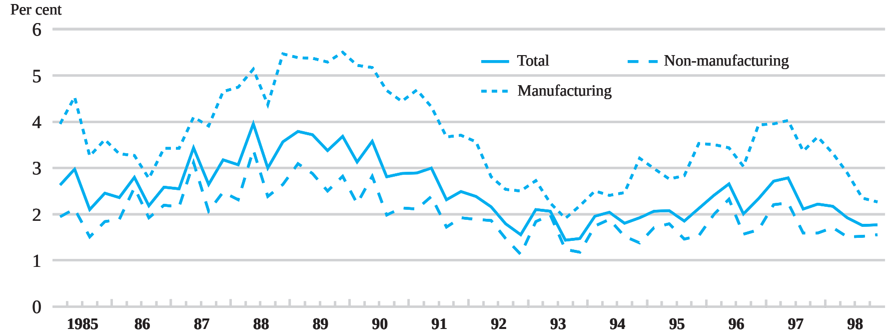
Sustained recovery will require structural adjustment

Even if bank recapitalisation restores the normal monetary transmission mechanism, a sustained recovery while fiscal consolidation proceeds will require considerable structural adjustment. Over-manning in Japanese companies appears to have reached record levels, judging by company surveys and the recent decline in labour productivity levels. Indeed, companies could have reduced their 1998 employment levels by 2½ per cent in 1998 if they had merely kept their productivity levels (measured as output per employee) unchanged from the previous year. Moreover, secular efficiency gains suggest that the scope for labour retrenchment could have been substantially greater. Apart from the general commitment to the traditional system of lifetime employment, this over-manning has also been encouraged by government subsidies to companies carrying under-utilised labour on their payrolls, and by *de facto* high firing costs.

The lifetime employment system is likely to come under increasing strain as companies seek to improve profitability…

The system of lifetime employment is coming under increasing strains. The recession has reduced profits in the business sector in general and in manufacturing in particular, through both lower sales and lower profit margins (Figure I.8). As a result, the capital income share in the business sector has continued its downward trend, reaching levels not seen since the early 1980s. Japanese businesses need to restore profitability, and they may have no alternative to reducing surplus labour towards that end. Indeed, rationalisation has already started, and a number of corporations have announced big cuts in their staffing levels. These will be phased in gradually to respect the implicit commitment to lifetime employment, where that exists, but the impact will fall on new entrants to the labour force and those displaced as fiscal retrenchment proceeds. If the weakness of the economy continues, companies might be forced to adopt more prompt employment adjustments.

Figure I.8. **Profit margins[1] in the Japanese non-financial corporate sector**

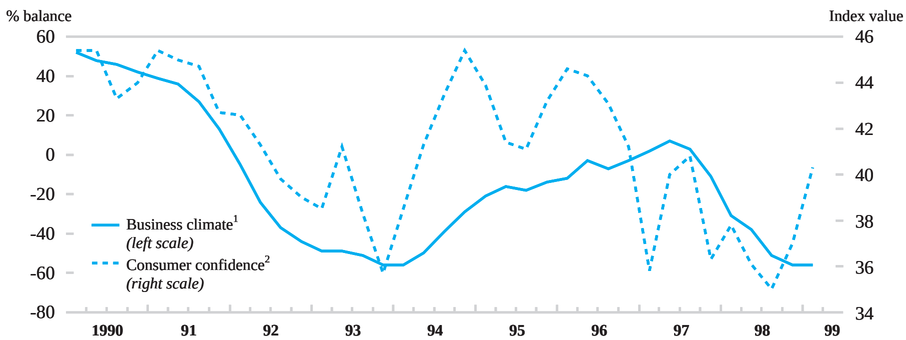


1. Current profits as a percentage of total sales.
Source: Bank of Japan, *Economic Statistics Annual*, various issues.

… and a labour shake-out could further undermine consumer confidence

If corporate restructuring and, eventually, fiscal retrenchment are accompanied by further increases in open unemployment, they would work against the revival of consumer confidence which now appears to be under way (Figure I.9). The low level of consumer confidence that has prevailed until recently can be attributed, at least in part, to concerns about job security in a society that has put a high value on life-time employment. As there is evidence from the past that flagging consumer confidence is associated with increased saving, the needed restoration of profitability might put a brake on a recovery and might even trigger a renewed downturn.

Figure I.9. **Business climate and consumer confidence indicators in Japan**



1. Balance of positive and negative answers (“favourable” minus “unfavourable”) as a percentage of total replies.
2. An index which can take a value from 0 (“will deteriorate”) to 100 (“will improve”).
Source: OECD, *Main Economic Indicators.*

Policy makers must facilitate adjustment

The critical challenge for policy makers at present is to facilitate the inevitable restructuring of the economy. Adjustment in the existing corporate sector appears to require financial restructuring to reduce indebtedness, which could be facilitated by debt-equity swaps. It might also be encouraged by a more generous safety net for the unemployed. But it is essential that enough jobs be generated elsewhere to absorb the release of surplus labour from existing enterprises and any cuts in employment that will result from the fiscal consolidation. This would minimise the short-term costs of restructuring, and speed up the realisation of the long-term gains to the economy due to more efficient resource allocation.

The key to a rapid deployment of labour will be to remove obstacles to enterprise creation in order to reverse the trend decline in the birth rate of firms. Regulatory reforms are needed to restore business dynamism, and the Japanese authorities have indeed taken important steps in this area with beneficial results. However, regulatory reforms to date have typically been of an incremental nature and with a long delay in actual implementation. A recent OECD report[11] has documented a detailed list of areas where reform needs to be vigorously pursued, including telecommunications, the electricity market, labour and financial markets, general competition legislation and market access for foreign firms. To harness the capacity of the private sector to create new enterprises and generate jobs, the authorities need to take decisive measures in these areas.

Europe: coping with cyclical divergence

Activity has slowed across Europe and cyclical divergence has emerged

There has been a general slowing of activity in the mature economies of western Europe, and considerable divergence in cyclical conditions has emerged throughout the region, both within the euro area and among countries not participating in monetary union. A number of countries have continued to enjoy robust non-inflationary growth while others have slowed to below potential rates (notably Germany and Italy) or nearly stopped growing altogether (the United Kingdom). Questions this divergence raises for policy include why it has occurred, whether it will persist if no measures are taken to deal with it, and, if so, whether countries where economies are weak will rebound or whether their weakness will spread more widely.

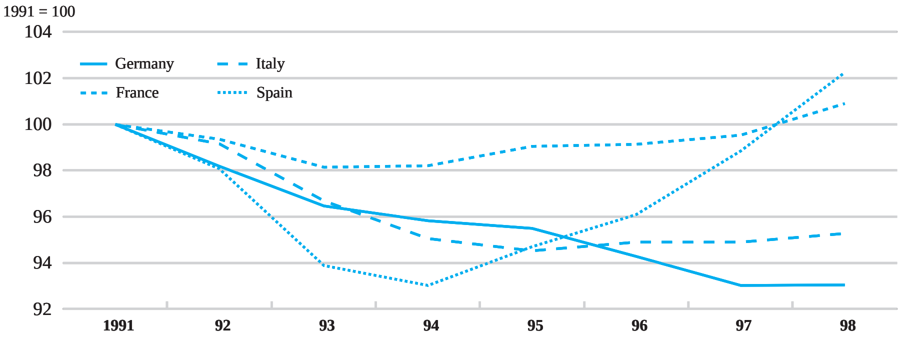
The issue mainly concerns the detachment of Germany and Italy from the rest of the euro area, particularly France. A number of forces appear to have contributed. First, relatively high direct trade exposures and their export product mixes made Germany and Italy more vulnerable to the emerging markets crisis than many other countries. Second, the deterioration in business confidence has been more marked in Germany than elsewhere since last summer. Third, while long-standing regional problems in eastern Germany and southern Italy are structural rather than cyclical, they operate to reduce the ability of these economies to adapt to changing conditions. Indeed, in some respects the detachment of Germany and Italy is not a recent phenomenon; their relative employment performance has been persistently poorer than elsewhere, even during periods such as the upswing after the 1993 recession when demand and activity were comparatively buoyant (Figure I.10).

Growth will rebound but divergences will persist

As the international situation stabilises, some, although not all, of these forces will dissipate. Furthermore, household confidence in the area remains high, in contrast to business confidence (Figure I.11). Private consumption should remain buoyant,

11. OECD, *The OECD Review of Regulatory Reform in Japan*, Paris, 1999.

Figure I.10. **Employment in selected euro area countries**

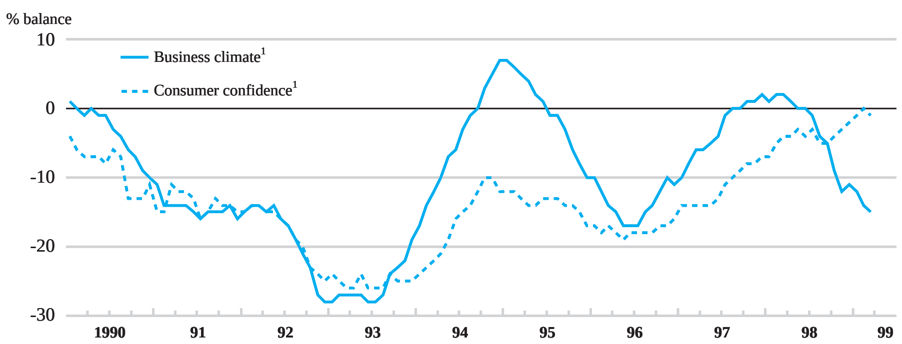


supported by rising disposable incomes as the pace of fiscal consolidation has slowed. Germany and Italy should benefit from this buoyancy as their exports to the rest of the area pick up, and activity in the area as a whole is projected to strengthen again later this year and in 2000 (Table I.12). While weakness in Germany and Italy seems unlikely to prevent the rest of the area from performing well, growth in these two countries is projected to remain modest and output gaps to remain large. Indeed, the output gap for the euro area as a whole will largely reflect cyclical slack in Germany and Italy.

Monetary policy in the euro area cannot respond to conditions in individual countries

Monetary policy in the euro area is now directed at ensuring price stability in the area as a whole, and cannot respond to economic slack in individual countries except to the degree that this affects the overall inflation picture. The low level of underlying inflation (Figure I.12) and rising slack in the area allowed the European Central Bank (ECB) to reduce interest rates in April. This decision should work to reassure the public that it is taking a symmetric approach to policy, *i.e.* that avoiding deflation is as important as avoiding excessive inflation. However, there are limits to the scope for further easing. Even before the recent cut by the ECB, average policy rates in the euro area had already been lowered significantly during the past year, as interest rates

Figure I.11. **Business climate and consumer confidence indicators in the European Union**



1. Balance of positive and negative answers as a percentage of total replies.
Source: Eurostat, *European Economy, Supplement B.*

Table I.12. **Macroeconomic indicators in the euro area, 1996-2000**

Per cent change, volumes

	1996	1997	1998	1999	2000
Private consumption	1.7	1.5	2.9	2.7	2.6
Government consumption	2.0	0.1	1.2	1.3	1.2
Gross fixed capital formation	0.6	2.0	4.0	3.1	4.0
Final domestic demand	1.6	1.3	2.8	2.5	2.6
Stockbuilding [a]	–0.4	0.6	0.6	–0.2	0.0
Total domestic demand	1.1	1.9	3.4	2.3	2.6
Exports of goods and services [b]	7.6	11.1	4.4	3.0	5.3
Imports of goods and services [b]	4.7	8.7	7.7	4.2	5.7
Net exports [a]	0.5	0.6	–0.3	–0.1	0.1
GDP at market prices	1.6	2.5	2.9	2.1	2.6
GDP deflator	2.0	1.4	1.5	1.4	1.5
Memorandum items:					
Private consumption deflator	2.5	1.9	1.3	1.2	1.4
Industrial production	–0.1	4.1	3.9	1.8	3.3
Unemployment rate	12.3	12.4	11.7	11.2	10.6
Output gap	–2.0	–1.7	–1.0	–1.2	–1.0
General government financial balance	–4.1	–2.5	–2.1	–2.0	–1.7
Current account balance ($ billion)	80.2	105.0	89.5	81.9	91.8
Current account balance (% GDP)	1.1	1.6	1.4	1.2	1.4

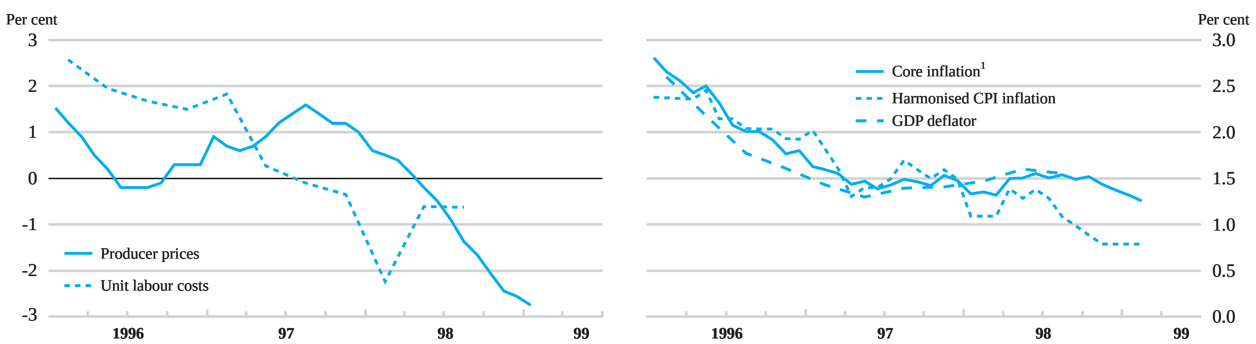
a) Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
b) Excluding intra-euro area trade.

converged to the lowest rates within the area. The full effects of this may not yet have been felt. The depreciation of the euro since the beginning of the year is also acting as a stimulus to demand. Furthermore, real interest rates in the euro area are at their lowest level for a long time (Figure I.13) and the growth of monetary aggregates has exceeded the indicator rate set by the ECB (Figure I.14).

Most other EU countries, as well as Norway and Switzerland, have some scope for adapting monetary conditions to their cyclical situations. In the United Kingdom, weak activity implies room for further easing and in Sweden this could involve bringing interest rates close to comparable euro rates. Commitments within the European

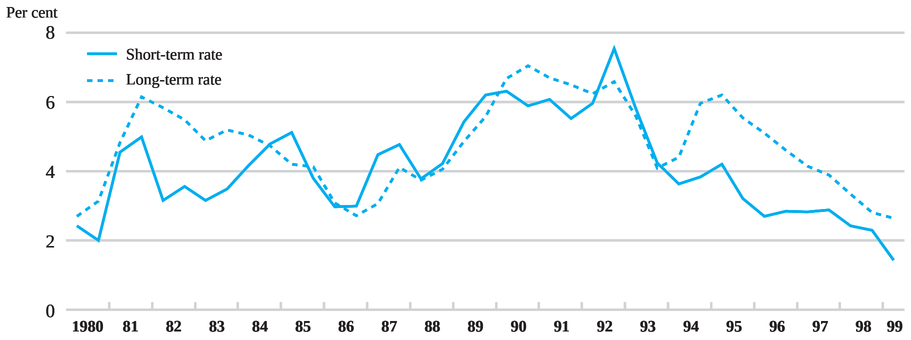
Figure I.12. **Inflation trends in the euro area**

Year-on-year percentage changes



1. Excluding unprocessed food and energy.
Source: European Central Bank.

Figure I.13. **Real interest rates in the euro area**



Note: Interest rates for the euro area are moving GDP-weighted averages of national interest rates.
Real short-term interest rates are measured by deducting the annual percentage change in the GDP deflator from nominal rates and real long-term rates by substracting the low frequency component of the annual change of the GDP deflator using the Hodrick-Prescott filter.

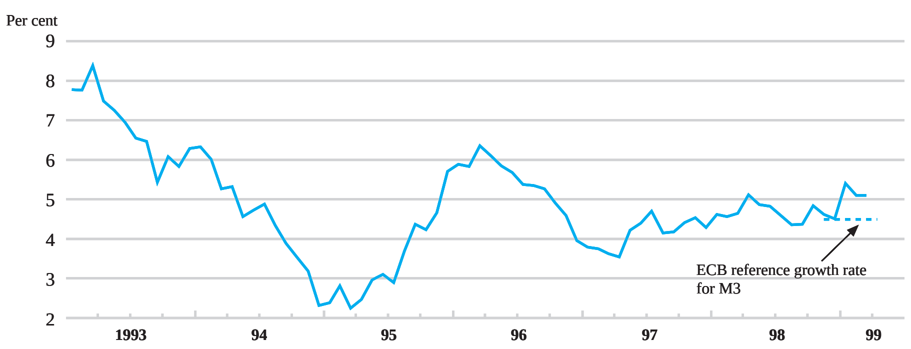
Exchange Rate Mechanism will act as limiting factors in Denmark and Greece, but in the latter country the approaching prospect of joining the euro area should lead to lower risk premia in interest rates.

Limits to the scope for counter-cyclical fiscal policies…

While countries currently suffering from deficient demand could, in principle, use fiscal policy as a counter-cyclical device, actual deficits and, for EU countries, the constraints of the Stability and Growth Pact preclude this in practice. Although underlying structural balances appear set to improve somewhat, neither Germany nor Italy has scope for providing fiscal support for activity if commitments to bring budgets "close to balance" by 2002 are to be met. Countries experiencing excess demand could usefully tighten fiscal policy, thus reducing inflationary pressures. However, it is notable that in two countries where output gaps have already been eliminated, Finland and Ireland, budget positions are already in substantial surplus. Experience suggests that fiscal tightening can be politically difficult in such circumstances.

Figure I.14. **Growth of M3 in the euro area**

Year-on-year percentage change

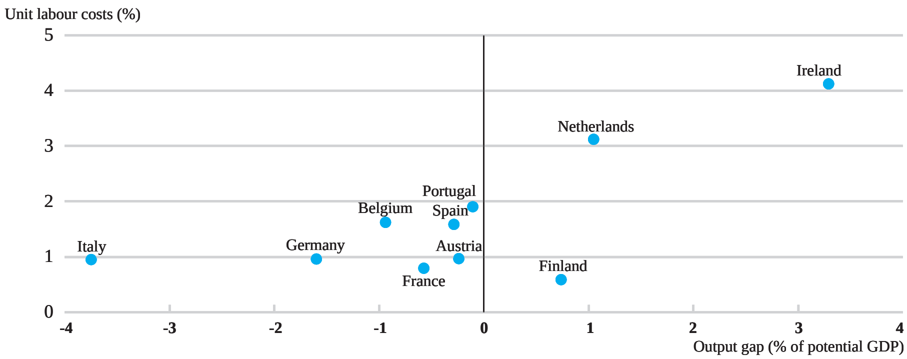


Source: European Central Bank.

… increase the importance of flexible market mechanisms

As has often been emphasised in OECD analyses,[12] flexible adjustments in labour and product markets are necessary if European economies are to enjoy satisfactory employment performance. They are especially indispensable to deal with asymmetric cyclical conditions in a monetary union when the use of fiscal policy is constrained. The divergent changes in unit labour costs in the slow-growing and fast-growing members of the monetary union show that these adjustment mechanisms are broadly operating (Figure I.15). The fast-growing and slow-growing members are faced with a decline and an improvement in their competitiveness, respectively, within the union, which will ultimately tend to harmonise performance. However, the strength and speed of the response of labour costs to changes in labour market conditions is held back by regulations and institutional arrangements in the labour market. Reforms in this area would speed up the convergence process, and make countries participating in the monetary union less vulnerable to possible future asymmetric shocks.

Figure I.15. **Projected output gaps and unit labour costs[1] in euro area countries,[2] 1999**



1. In the business sector, year-on-year percentage changes.
2. Excluding Luxembourg.

A significant reduction in unemployment requires labour-market reforms…

Structural reforms are also critical to achieving significant reductions in unemployment and higher output growth in the European economy in the medium and longer term. As a few European countries have demonstrated, wide-ranging reforms in labour and product markets that durably reduce the structural unemployment rate increase the productive capacity of the economy and allow growth to be higher in the medium term. Though the specific content of the reform strategy has differed across these countries, they have been broadly in line with recommendations of the *OECD Jobs Strategy* to increase societies' adaptability to change. With evidence accumulating that the *OECD Jobs Strategy* delivers higher employment and lower unemployment, countries can embark on reforms along these lines with greater certainty than before.[13] Indeed, further delays in implementing the strategy will continue to cramp growth prospects for individual countries and the euro region as a whole.

12. See OECD, *EMU, Facts, Challenges and Policies*, Paris, 1999, for an extensive discussion of the issues. Previous issues of the *OECD Economic Outlook* and various publications setting out the *OECD Jobs Strategy* have regularly treated these issues.
13. See OECD, *The OECD Jobs Strategy: Assessing Performance and Policy*, Paris (forthcoming).

... and stronger competition in product markets

More competitive product markets are also required to strengthen economy-wide dynamism and efficiency in the medium and long term. The adoption of the single currency can be expected to strengthen market discipline in euro area countries over time, and the deeper integration of the single market is already spurring companies to merge in order to take advantage of economies of scale and scope. However, to permit businesses to take the maximum advantage of shifting technological opportunities, it is important to eliminate barriers to entry and to reduce barriers to exit. The abolition of statutory monopolies in areas such as telecommunications and the energy market for intensive users is encouraging greater efficiency and stimulating innovations, but care must be taken to create a genuine level playing field for all competitors. Barriers to exit need to be reduced to allow production factors to be released to activities with higher benefits to society. There is much that remains to be done in European countries to reduce subsidies to particular sectors.

Appendix: The OECD medium-term reference scenario

The medium-term reference scenario extends the projections to 2004

The OECD medium-term reference scenario extends the short-term projections on a consistent basis to the end of 2004. The current version features a continuation of the short-term area-wide expansion, with medium-term growth of 2½ to 2¾ per cent, consistent with steadily closing output gaps, and growth in world trade recovering to an average 7½ per cent per annum. Excluding certain high inflation countries, area-wide inflation remains stable at around 1¾ per cent per annum; the average unemployment rate falls by a ½ percentage point over the period but remains stubbornly high in a number of European countries. The current phase of fiscal consolidation towards overall balance is projected to continue over the medium term, but the distribution of government net lending positions across countries and regions is quite uneven, with substantial surpluses in a number of countries offset by large but declining deficits in others. As a consequence, government debt stabilises for the area as a whole, but remains high in a number of countries and continues to rise in Japan. In spite of the closure of output gaps, the present levels of current account imbalances between the major OECD countries and regions persist over the medium term, mostly reflecting underlying structural factors.

Scope and key assumptions

Its main purpose is to provide a basis for scenarios and simulations

The medium-term reference scenario is highly conditional on specific assumptions about policies and economic developments in OECD and non-OECD countries and regions. Its main purpose is to provide a basis for comparisons with simulations and scenarios based on alternative assumptions. It is also intended to provide insights on the possible build-up or unwinding of specific imbalances and tensions in the world economy over the medium term and the scope for policies to assist the adjustment process.

The reference scenario does not embody a view about the timing of future cyclical events, but instead assumes a pattern of growth such that the gap between actual and potential output is broadly eliminated in all OECD countries over the medium term. Commodity prices and key exchange rates are assumed to be unchanged in real terms beyond the short-term horizon (with certain exceptions). Monetary policies are assumed to be directed towards keeping inflation low or in line with medium-term objectives. Fiscal policies are assumed to be consistent with current policy settings and, for the most part, continued fiscal consolidation, achieved at fixed tax-to-GDP ratios, through trend reductions in public consumption and social spending.

Consistent with short-term projections, the reference scenario assumes a progressive recovery of economies in the non-OECD regions, with import growth adjusting steadily back towards historic trend rates of growth over the period. In level terms, however, imports in the Asian crisis economies only revert to some 80 to 90 per cent of pre-crisis trend levels (depending on the region).

Broad features of the reference scenario

The scenario projects OECD area output and world trade to accelerate in 2001

After growing at an annual rate of just over 2 per cent in the short term, output in the OECD area as a whole is projected to accelerate somewhat in 2001 and grow thereafter at an average 2¾ per cent per annum, consistent with the closing of estimated output gaps by 2004 (Table I.13). Over the same period world trade growth recovers from current rates of 4 to 4½ per cent to a stable 7½ per cent per annum in 2001 and thereafter. Given very different short-term cyclical positions, the pattern and timing of growth differs significantly between the main OECD regions (see Figure I.16).

With GDP in the United States continuing to grow strongly in the short term, some slowing towards potential is expected in 2000 and 2001, mostly reflecting a slowdown in domestic demand as the adjustment to higher levels of stock market wealth dissipates. Thereafter, activity expands at around 2½ per cent per annum, converging to potential (which grows at about 2¾ per cent). In Europe, output gaps are still substantial in some countries (most notably Italy) and the recovery of output growth is assumed to strengthen further in the short term, rising to an average 2½ to 2¾ per cent over the medium term following robust growth in consumption and investment. Given continuing and substantial near-term weakness, the process of medium-term adjustment is more drawn out in the Japanese economy. In spite of some slowing of potential output growth in recent years (to around 1 per cent), the short-term GDP projections imply a further considerable widening of the output gap (to around 5 per cent in 2000), which is likely to close only gradually over the medium term. After stabilising in 2000, GDP is projected to recover steadily thereafter, supported by stronger consumption demand and exports benefiting from the recovery in Asia, before slowing gradually towards the end of the period.

Labour productivity is assumed to accelerate slightly but the fall in unemployment will be modest

Labour productivity in the OECD is assumed to accelerate slightly from a recent rate of 1¼ per cent to grow at about 1½ to 1¾ per cent – broadly consistent with average growth over the past decade. Area-wide employment growth is expected to remain at around an average 1 per cent *per annum* and, with the labour force also growing at a little below 1 per cent, the resulting reduction in unemployment for the OECD area is relatively modest, with an unemployment rate of around 6½ per cent by 2004. For OECD Europe, the reduction in unemployment is somewhat larger, from around 9¼ per cent this year to around 8½ per cent by 2004, close to its 1990 trough. Within the euro area, the unemployment rate falls by similar amounts but remains high at an average 9¾ per cent in 2004, 10 per cent or higher in France, Italy, Belgium and Spain.

Table I.13. Medium-term reference scenario summary

Per cent

	Real GDP growth	Inflation rate [a]		Unemployment rate [b]		Current balance [c]		Long-term interest rate	
	2001-2004	2000	2004	2000	2004	2000	2004	2000	2004
United States	2.3	1.5	2.3	4.4	5.4	–3.5	–3.4	5.2	5.7
Japan	2.3	–0.6	–0.6	5.3	4.0	3.5	3.5	1.8	2.8
Germany	2.5	1.3	1.4	10.0	9.2	0.2	0.6	4.2	5.0
France	2.3	1.1	1.5	10.8	10.1	2.6	3.4	4.2	5.0
Italy	2.8	1.5	1.5	11.9	10.1	2.2	2.6	4.4	5.0
United Kingdom	2.0	2.5	2.4	7.3	7.5	–0.1	–0.5	4.6	5.0
Canada	2.7	1.9	2.3	7.7	7.6	–1.9	–1.7	5.2	5.7
Total of major countries	2.3	1.2	1.6	6.6	6.5	–0.6	–0.5	4.3	4.9
Australia	3.2	2.8	2.1	7.4	7.0	–4.7	–3.6	5.5	6.3
Austria	2.5	1.4	1.3	6.1	5.6	–2.1	–2.0	4.2	5.0
Belgium	2.0	1.5	1.8	10.9	10.5	4.3	4.5	4.3	5.1
Czech Republic	3.2	6.1	4.7	8.5	7.0	–2.2	–0.8	8.2 [d]	9.3 [d]
Denmark	2.3	2.8	2.7	5.8	6.0	–1.0	–0.5	4.6	5.6
Finland	3.6	1.8	2.2	10.0	8.3	6.1	7.1	4.4	5.2
Greece	3.6	2.6	2.0	10.1	8.2	–2.9	–2.1	6.5 [d]	3.9 [d]
Hungary	4.4	7.0	4.2	7.0	5.5	–6.2	–4.3	12.9 [d]	9.4 [d]
Iceland	2.4	4.2	5.3	2.0	3.7	–6.3	–4.2	9.6 [d]	10.4 [d]
Ireland	5.5	3.7	3.1	5.9	6.5	0.0	–1.2	4.3	5.1
Korea	5.1	2.3	1.8	7.5	5.0	3.5	–1.6	8.0	7.2
Mexico	4.7	10.5	7.2	3.2	3.2	–4.1	–4.5	17.0	11.8
Netherlands	2.9	2.1	1.9	4.1	4.4	5.9	6.5	4.2	4.8
New Zealand	3.1	1.9	1.8	6.8	5.7	–5.9	–3.5	5.6	6.2
Norway	2.6	2.4	1.8	4.0	4.0	6.3	7.5	4.6	4.8
Poland	5.2	5.5	3.6	10.7	8.6	–5.6	–5.8	13.9	9.0
Portugal	3.0	2.5	2.4	5.0	5.0	–4.7	–5.1	4.4	5.2
Spain	3.2	2.6	2.0	16.2	14.5	–1.9	–2.3	4.3	5.0
Sweden	2.5	1.2	1.5	5.3	5.3	1.8	2.2	4.5	5.2
Switzerland	1.9	1.2	1.3	2.7	2.4	7.6	8.1	2.4	4.0
Turkey	5.0	31.0	21.2	6.4	5.5	–0.7	–0.9	57.0	38.0
Total of above European countries	2.7	2.0 [e]	1.9 [e]	9.3	8.4	1.1	1.3	4.7 [e]	5.2 [e]
Total of above OECD countries	2.6	1.7 [e]	1.8 [e]	7.0	6.5	–0.5	–0.4	4.9 [e]	5.3 [e]
Euro area	2.6	1.5	1.6	10.6	9.7	1.4	1.7	4.2	5.0

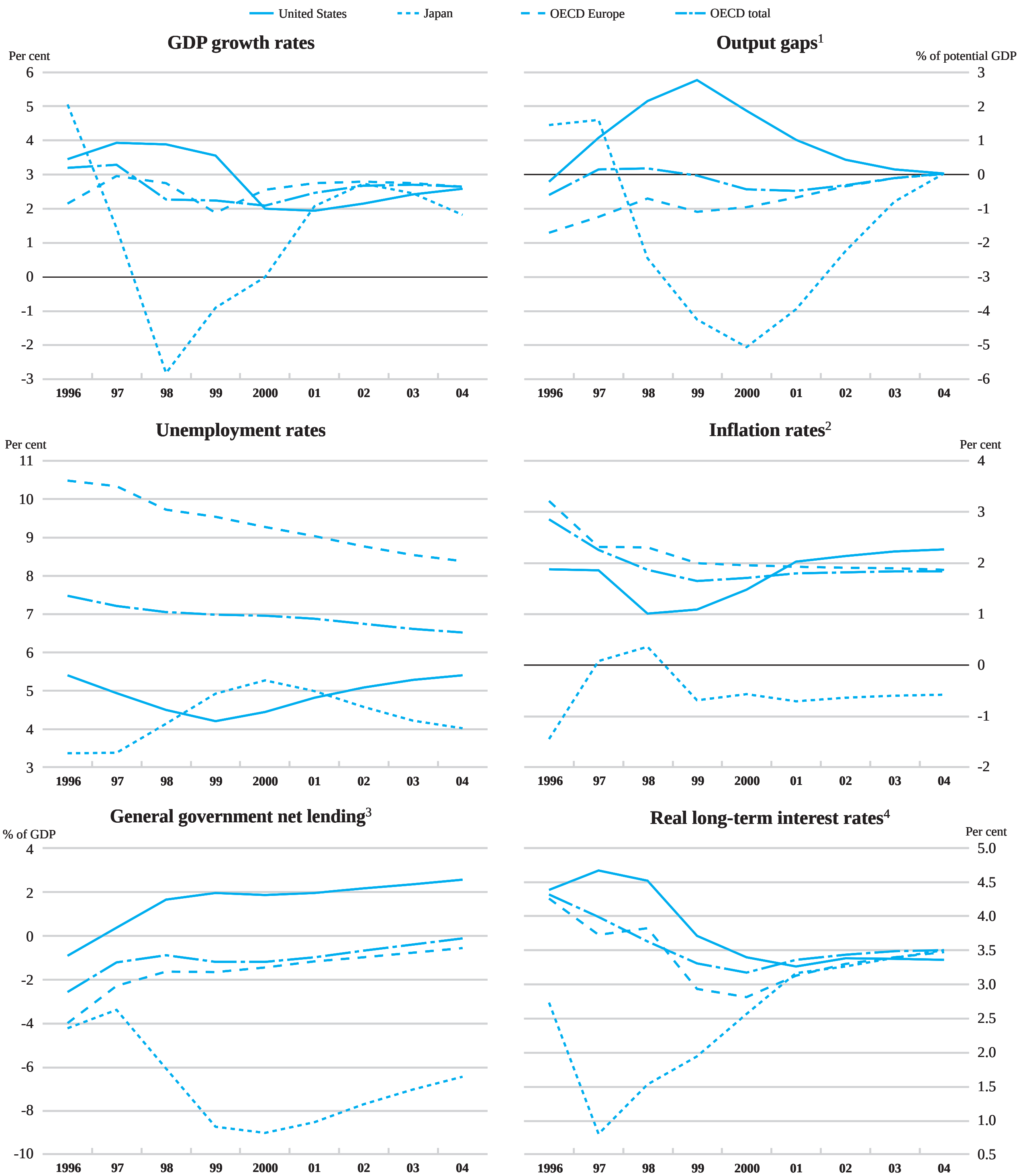
Note: For further details see ''Sources and Methods''.
a) Percentage change from the previous period in the GDP deflator.
b) Per cent of labour force.
c) Per cent of nominal GDP.
d) Short-term interest rate.
e) Excluding Turkey.

The scenario shows further progress in reducing budget deficits

Given the current fiscal assumptions and sustained medium-term growth, the scenario shows some further progress being made in reducing actual and structural deficit levels as shares of GDP. For the OECD area as a whole, government deficits fall gradually from around 1¼ per cent of GDP this year and next to near balance by the year 2004 (Table I.14). Overall, the pace of fiscal consolidation is sufficient to stabilise the ratio of gross general government financial liabilities to GDP for the total OECD area at recent levels, at around 70 per cent by 2000, with some improvements thereafter. Nonetheless, there are significant differences between regions.

For the United States, government net lending remains in significant and growing surplus over the period, rising to around 2½ per cent of GDP by 2004. As a result

Figure I.16. **Medium-term reference scenario**



1. Per cent difference between the level of real GDP and its estimated potential.
2. GDP deflators. Totals for OECD and OECD Europe exclude Turkey.
3. Totals for OECD and OECD Europe government net lending exclude the Czech Republic, Hungary, Luxembourg, Mexico, Poland, Switzerland and Turkey.
4. The OECD Europe aggregate is replaced by the euro area, defined as the average for the 11 members as from 1999; before 1999, the German rate is reported. OECD total excludes Turkey.

Table I.14. Fiscal trends in the medium-term reference scenario

As a percentage of nominal GDP

	Financial balances[a]		Gross financial liabilities[b]			Gross public debt (Maastricht definition)[c]	
	2000	2004	2000	2004	Change between 2000 and 2004	2000	2004
United States	1.8	2.5	51.7	42.0	–9.7		
Japan[d]	–9.0	–6.4	117.6	148.3	30.7		
Germany[e]	–1.9	–1.1	63.0	61.6	–1.4	61.0	59.6
France	–2.0	–1.0	67.7	65.8	–1.9	59.4	57.5
Italy	–2.1	–0.7	116.8	105.4	–11.4	115.6	104.2
United Kingdom	–0.4	–0.1	54.0	48.5	–5.6	46.2	40.6
Canada	1.7	1.8	81.6	66.0	–15.6		
Total of above countries	–1.3	–0.2	72.3	71.3	–1.0	69.8	65.1
Australia	0.7	1.2	25.5	14.5	–10.9		
Austria	–2.1	–1.8	62.9	63.8	0.9	62.9	63.8
Belgium	–0.8	0.0	109.9	96.8	–13.2	109.9	96.8
Czech Republic	–4.0	–3.5					
Denmark	1.9	2.4	52.0	38.7	–13.3	48.0	34.8
Finland	2.7	4.3	45.4	33.5	–11.9	44.7	32.8
Greece	–2.1	0.0	103.5	88.9	–14.6	103.5	88.9
Hungary	–4.8	–2.9					
Iceland	0.3	–0.8	41.5	36.6	–4.9		
Ireland[f]	2.1	2.1	43.0	22.5	–20.4	40.1	21.0
Korea	–1.0	1.0	19.5	30.5	11.0		
Netherlands	–1.7	–0.6	66.1	59.5	–6.6	66.1	59.5
New Zealand	–0.3	1.3					
Norway	3.9	4.9	35.4	35.7	0.3		
Poland	–3.0	–2.4					
Portugal	–1.8	–1.1	56.0	49.8	–6.2	56.0	49.8
Spain	–1.4	–0.7	71.2	64.8	–6.5	65.3	58.8
Sweden	2.0	3.7	61.8	40.2	–21.6	61.6	40.0
Total of above european countries	–1.4	–0.6	73.4	67.0	–5.9	69.5	63.5
Total of above OECD countries	–1.2	–0.1	69.8	68.1	–1.7		
Euro area	–1.7	–0.8	75.7	70.5	–5.2	72.4	67.3

Note: For further details see ''Sources and Methods''.

a) General government fiscal surplus (+) or deficit (–) as a percentage of GDP. For Germany (starting 1993), France (starting 1991) and Sweden (starting 1995), financial balances measured according to Maastricht definitions.

b) Includes all financial liabilities, as defined by the System of National Accounts (where data availability permits) and covers the general government sector, which is a consolidation of central government, state and local government and the social security sector.

c) The Maastricht definition of gross public debt is based on data provided by the Commission of European Communities up to 1998 and projected forward in line with the OECD projection for GDP and general government financial liabilities.

d) The 1998 outlays would have risen by 5.4 percentage points of GDP if account were taken of the assumption by the cental government of the debt of the Japan Railway Settlement Corporation and the National Forest Special Account. This debt is included in the gross financial liabilities.

e) Includes the debt of German Railways Fund from 1994 onwards and the Inherited Debt Fund from 1995 onwards.

f) The debt ratio calculated for the purposes of monitoring progress towards the Maastricht debt criteria is lower than which is obtained using national measure of GDP, due to the use of EU measure of GDP which excludes royalty payments.

public sector debt is expected to fall significantly. Within Europe, most countries continue to make further progress in reducing deficits or maintaining surpluses but in a number of cases the "close to balance" objective is not really achieved. Indeed, the average deficit for the euro area (around 2 per cent of GDP in 1998) falls but is not eliminated (it remains around ¾ per cent of GDP) in 2004. This does, however produce improvements in public sector debt-to-GDP ratios. By contrast, for Japan the combination of economic recession and fiscal stimulus has resulted in large actual and underlying structural deficits in the short term. With economic recovery proceeding only slowly over the medium term, progress with fiscal consolidation is extremely limited and projected deficit reductions (to around 6½ per cent of GDP by 2004) are achieved only through a substantial slowing of government consumption and reductions in investment expenditures. As a result, the projected levels of general government debt rise quite substantially over the period (an increase of over 30 per cent of GDP by 2004).

Monetary policy ensures that inflation remains low

Monetary policy in the scenario is keyed to ensuring that inflation remains low, at or below 2 per cent for the area as a whole, although developments vary across countries and regions. For the United States, inflation rises moderately over the period to around 2¼ per cent. For Japan, where the negative output gap is large and closes slowly over the period, the underlying rate of inflation remains stable at around –½ per cent. For Europe (excluding Turkey), the rate of inflation remains stable, at around 1¾ per cent, with a slightly lower rate of around 1½ per cent within the euro area.

Little current account adjustment takes place

With regard to sectoral balances, the main counterpart to the general improvement in budget deficits is a decline in private sector saving and investment balances (most notably for the United States business sector) associated with continued robust growth. For the OECD area, the external sector remains in small deficit (½ per cent of GDP) over most of the period, and, in the absence of significant exchange rate movements, there is little overall adjustment in the current external imbalances between regions.

With unchanged real exchange rates, for OECD Europe, there is some modest increase in the current external surplus to around 1¼ per cent of GDP in 2004. For the United States, the external deficit stays at around 3½ per cent of GDP and private sector savings remain low. For Japan, the external surplus also stays at around 3½ per cent of GDP; private sector saving declines moderately but remains at a relatively high level. Although the output gap for Japan is currently much larger than for most other OECD countries, its potential growth rate is also estimated to be much lower (reflecting mostly demographic factors affecting labour supply) and the closure of the gap over the medium-term implies little difference in the growth rates of GDP or imports relative to those of other countries. Without major changes in potential growth rates or trade openness, associated for example with structural reforms, and at current real exchange rates, the projection implies little scope for further significant adjustment in current account imbalances from current high levels.

II. DEVELOPMENTS IN INDIVIDUAL OECD COUNTRIES

United States

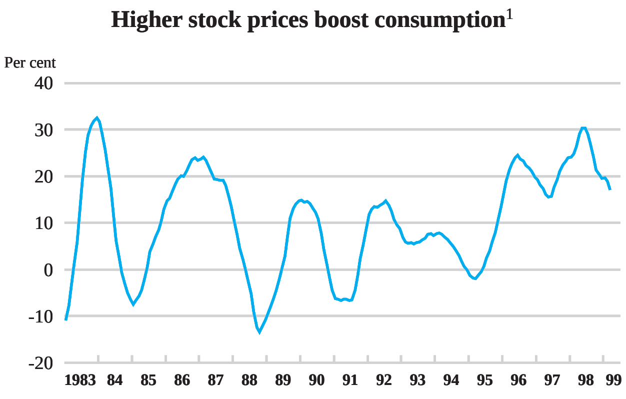
In 1998 strong productivity growth and terms-of-trade gains underpinned another year of rapid growth with low inflation. The buoyancy of aggregate demand, notably business investment and household consumption, was supported in part by high and rising share prices. As the wealth effect from the stock market starts to wane and falling capacity utilisation in manufacturing damps investment, output growth may ease in 1999 and drop to around 2 per cent next year. As a result, unemployment, after remaining remarkably stable recently, may rise somewhat. Falling inflation expectations and a slowing economy should help to limit the increase in prices.

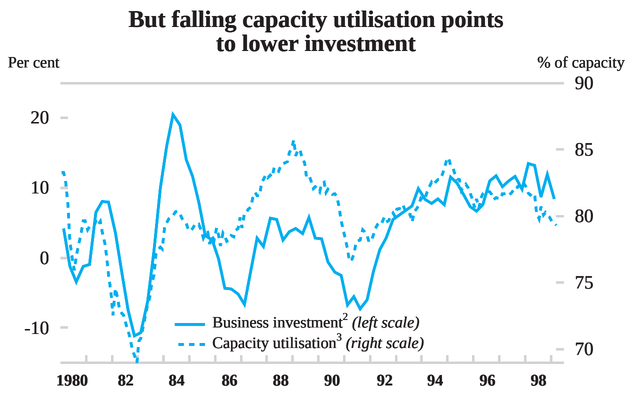
Growth at recent rates will give rise to overheating if it persists. But with inflation still low and the economy expected to slow, there are no immediate pressures to change the present stance of monetary policies. Fiscal policy should guard against a breach of the legislated spending caps in order to preserve the expected significant federal budget surpluses and reduce net public sector debt, thereby protecting future Social Security benefits.

Continued strong growth…

The US economy grew strongly in the fourth quarter of 1998 and its buoyancy continued into the first quarter of 1999, with growth outpacing, the 3¾ per cent rate seen in the previous three years. Substantial gains in both labour and capital productivity, not all of which appears to have been cyclical, have supported this good performance. In addition, rapid growth in the capital stock has boosted the potential growth of the economy to close to 3 per cent. Consequently, although the unemployment rate dropped by a further quarter of a percentage point over the past year, to reach 4.3 per cent in the first quarter of 1999, signs of overheating have not yet appeared. Employee compensation has even decelerated slightly, apparently reflecting an

United States





1. Twelve-month moving average of the monthly Wilshire 5000 stock price index deflated by the consumer price index, year-on-year percentage changes.
2. Year-on-year percentage changes.
3. In manufacturing.

Employment, income and inflation

Percentage changes from previous period

	1996	1997	1998	1999	2000
Employment[a]	1.9	2.4	2.2	1.8	1.5
Unemployment rate[b]	5.4	4.9	4.5	4.2	4.4
Employment cost index	2.8	3.1	3.5	3.0	3.7
Compensation per employee[c]	2.7	3.9	3.9	4.1	4.2
Labour productivity[c]	1.7	1.7	1.8	2.0	0.6
Unit labour cost[c]	1.0	2.2	2.1	2.1	3.6
GDP deflator	1.9	1.9	1.0	1.1	1.5
Private consumption deflator	2.0	1.9	0.8	1.3	1.8
Real household disposable income	2.5	2.4	3.1	3.2	2.4

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

easing in inflation expectations. This has helped the annual inflation rate to drift lower – to 1 per cent according to many price indicators – despite the fact that the speed at which import prices have been falling has slackened somewhat in recent months.

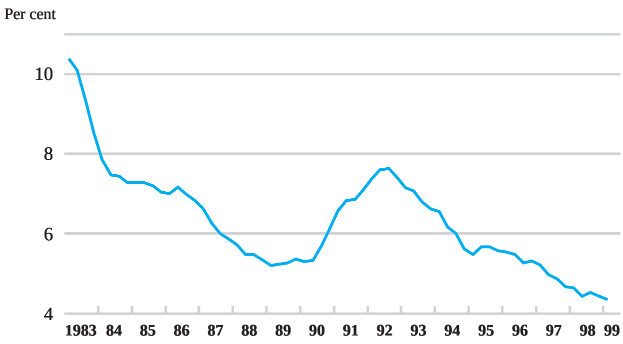
… owes much to higher wealth and investment…

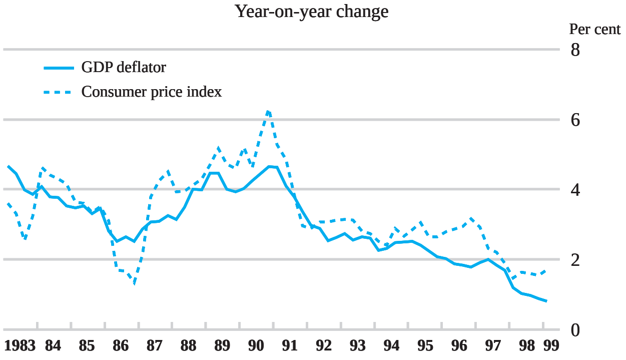
Domestic demand appears to have been boosted by pronounced wealth effects, as continued improvement in corporate profitability in many sectors of the economy has underpinned equity prices. After quickly recovering from their third quarter falls (aided by three cuts in official interest rates from 5.5 per cent to 4.75 per cent by November 1998), equity prices rose to a new all-time high at the end of April, 12 per cent above their peak in the summer of 1998. With their balance sheet positions thus strengthening, households continued to reduce their saving rate and, by the first quarter of 1999, were consuming more than their disposable income.

… financed by accelerating credit growth

A key element in sustaining the recent performance of the economy has been surging outlays on plant and equipment that has boosted the demand for credit. This development, encouraged by a continued fall in the price of investment goods and lower interest rates, has led to a rapid growth of the capital stock, exceeding that of employment to a much greater extent, during an upswing, than seen since the

United States





Financial indicators

	1996	1997	1998	1999	2000
Household saving ratio [a]	3.1	2.2	0.5	–0.8	–1.0
Private sector financial balance	–0.8	–2.0	–3.9	–4.7	–4.6
General government financial balance [b]	–0.9	0.4	1.7	1.9	1.8
Current account balance [b]	–1.8	–1.9	–2.7	–3.4	–3.5
Short-term interest rate [c]	5.0	5.1	4.8	4.5	4.5
Long-term interest rate [d]	6.4	6.4	5.3	5.2	5.2

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

early 1980s. With housing investment also strong, total borrowing by the domestic non-financial private sector has accelerated, with bank lending leading to faster growth in the broad money stock. By the beginning of the second quarter of 1999, the continued strength in the economy had raised yields on both corporate and ten-year government notes some 25 basis points above their levels of the second half of 1998.

But these factors may wane…

Despite such developments, a number of factors may contribute to some slowing in growth. First, in the absence of future substantial increases in equity prices, a reduction in the pace at which the saving rate has been falling is likely. Second, mortgage rate are unlikely to decline further, while housing construction appears to have moved above a level that can be sustained by replacement demand and the pace of new household formation. Third, capacity utilisation in manufacturing is falling and this, with the possible impact of tight labour markets on corporate profitability, suggests that some slackening in the growth of investment may occur. Fourth, fiscal policy seems set to remain restrictive, with current budget plans only allowing moderate increases in discretionary government spending in 1999 and cuts in 2000. As a result,

Demand and output

Percentage changes, volume (1992 prices)

	1995 current prices billion $	1996	1997	1998	1999	2000
Private consumption	4 953.9	3.2	3.4	4.9	4.5	2.6
Government consumption	1 138.1	0.7	1.3	1.1	1.8	0.3
Gross fixed investment	1 230.9	7.9	7.3	9.7	6.1	1.0
Public	218.4	3.4	1.2	0.1	4.3	1.6
Residential	284.8	7.4	2.5	10.4	5.3	–5.3
Non-residential	727.7	9.3	10.7	11.8	6.8	3.0
Final domestic demand	7 322.9	3.6	3.8	5.2	4.5	2.0
Stockbuilding [a]	30.6	0.0	0.5	–0.1	–0.3	–0.1
Total domestic demand	7 353.5	3.6	4.2	5.1	4.2	1.9
Exports of goods and services	819.5	8.5	12.8	1.5	2.7	5.7
Imports of goods and services	903.4	9.2	13.9	10.6	7.6	4.3
Net exports [a]	–83.9	–0.2	–0.4	–1.4	–0.9	0.0
GDP at market prices	7 269.6	3.4	3.9	3.9	3.6	2.0
Industrial production	–	4.5	6.0	3.7	1.4	1.8

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

External indicators

	1996	1997	1998	1999	2000
	$ billion				
Merchandise exports	612.0	679.3	671.1	678	707
Merchandise imports	803.3	877.3	919.0	983	1 020
Trade balance	–191.3	–198.0	–248.0	–305	–313
Invisibles, net	56.4	42.7	14.5	2	–7
Current account balance	–134.9	–155.2	–233.4	–303	–320
	Percentage changes				
Merchandise export volumes[a]	9.7	15.4	2.2	3.1	6.0
Merchandise import volumes[a]	10.0	14.7	11.5	8.2	4.3
Export performance[b]	3.6	5.6	–0.1	–0.2	–0.4
Terms of trade	–0.6	0.7	2.8	–0.9	–1.0

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

the federal government net lending (on a national accounts basis) could rise to $110 billion (1¼ per cent of GDP) both this year and next, even after extra military spending. With, in addition, the state and local government surplus likely to remain at about ¾ per cent of GDP, net general government debt should fall from 41 per cent of GDP in 1998 to 37 per cent in 2000.

… slowing the economy and containing inflation

All in all, economic growth is projected to slip from 3½ per cent in 1999 to 2 per cent next year. While strong consumption is likely to be the main force behind this year's continued expansion, some weakening in personal spending could be evident, by the end of the year. The slowdown should be accentuated in 2000 by the assumed tighter fiscal stance, as slow spending growth boosts the structural budget surplus, and by the feedback of lower demand growth on private investment. With output growth slackening, the unemployment rate should start to rise and may move back to around 4½ per cent by the end of 2000. Such an increase, together with a moderation in inflation expectations, may help to lessen the increase in domestic prices that might otherwise be associated with such a low level of unemployment. Import growth may slacken in the projection period as domestic demand weakens and as foreign suppliers may have greater difficulty increasing their penetration of domestic markets given the stabilisation in the dollar exchange rate. Exports may progressively improve as foreign markets strengthen. Nonetheless, the current account may widen to 3½ per cent of GDP in 1999 and 2000, given the extent to which imports exceed exports.

The risks to the projection are evenly spread. One source of downside risks to the projections remains a drop in equity prices. Several factors could trigger a reversal of expectations about corporate profits leading to a sell-off in the market. Negative international developments might lead to weaker export growth and financial instability, or alternatively a rebound in domestic inflation coming from a reversal of terms-of-trade gains, might generate upward pressure on interest rates. An alternative upside scenario would be that the recent improvement in the domestic supply-side of the economy proved to be permanent, with continued corporate profit growth bringing another boost to the stock market. This would add to personal consumption, and raise output. It might also, though, prolong the period of stable inflation, obviating the need for any change in interest rates.

Japan

The economic situation remains serious, even if the prospects for a stabilisation in activity have improved. Output has fallen by more than 5 per cent since the recession began in 1997, and the unemployment rate has jumped to record levels. All components of private spending shrank in the second half of 1998. Deflationary pressures are still considerable in line with the widening output gap. A limited recovery in export volumes combined with a build-up in policy support through the middle of the year could be enough to end the fall in output. But assuming no further fiscal policy action, output is likely to do no more than stabilise.

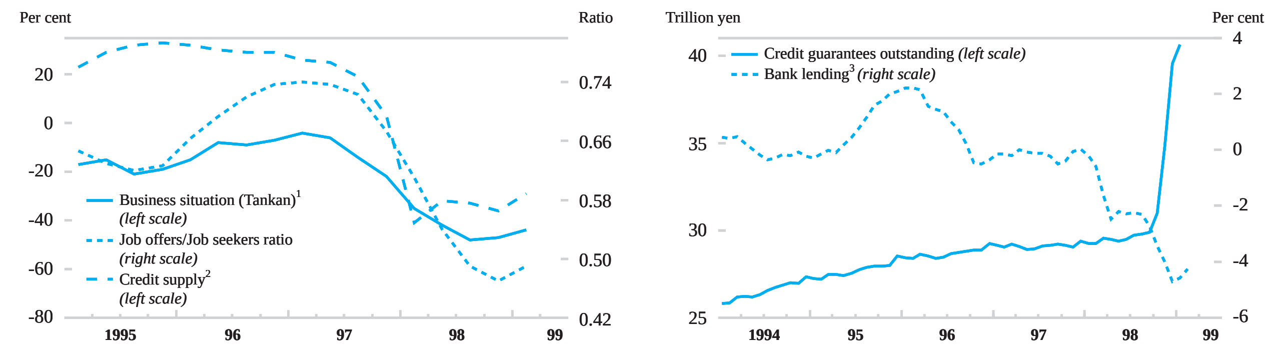
The possibilities for further macroeconomic support are now severely restricted. Indeed, even the existing level of the structural budget deficit is not sustainable for much longer in view of the extremely rapid build-up in government debt. The authorities, therefore, face a limited menu of choices to improve performance. Stepping up the pace of structural reforms, especially those freeing up business activity and mitigating income uncertainty, would enhance medium-term economic prospects, even if it may not go far in relieving short-term demand deficiency. Substantial progress in recapitalising the banking system has been made and, if this allows normal lending operations to be resumed, the easy stance of monetary policy may suffice to head off the spectre of deflation.

The recession deepened in the second half of 1998

There have been few signs of any immediate end to the recession. The effect of last year's first stimulus package became perceptible during the autumn, as exemplified by a rapid increase in public investment spending. The housing sector also seems to have touched bottom late last year, and housing starts have risen in recent months. Export developments have been erratic, but the underlying trend seems to have improved since around the turn of the year. But on most other counts shrinkage has continued into 1999. There has been no let-up in the pace of decline in business investment, as firms continue to recognise the extent of their existing excess capacity and re-appraise their future capital needs. Available surveys and orders data all suggest that this phase of adjustment will continue for some time to come, despite the recent limited recovery in business confidence. Business inventories began their correction more than a year ago, but further progress in clearing the backlog is required. Meanwhile consumers seem to have preferred to wait for bargain sales before purchasing. Saving propensities reached a record high in the first quarter of this year,

Japan

A deep recession is still underway | **Countering the credit crunch**



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

Employment, income and inflation

Percentage changes from previous period

	1996	1997	1998	1999	2000
Employment	0.4	1.1	–0.6	–1.0	–0.5
Unemployment rate [a]	3.4	3.4	4.1	4.9	5.3
Compensation of employees	2.0	2.4	–0.7	–1.5	–1.1
Unit labour cost	–2.9	1.0	2.2	–0.6	–1.1
Household disposable income	2.6	1.4	0.5	–0.7	–0.3
GDP deflator	–1.4	0.1	0.4	–0.7	–0.6
Private consumption deflator	0.1	1.4	0.4	–0.3	–0.6

a) As a percentage of labour force.

and household incomes have continued to be squeezed by the dual effects of wage and employment cutbacks. Despite a stabilisation of the labour force over the past year unemployment has surged to over 3¼ million, 4.8 per cent of the labour force, as overall employment has fallen by nearly 2 per cent since the January 1998 peak. Overtime has also continued to fall, bringing down hours worked per employee as well as average wages and salaries.

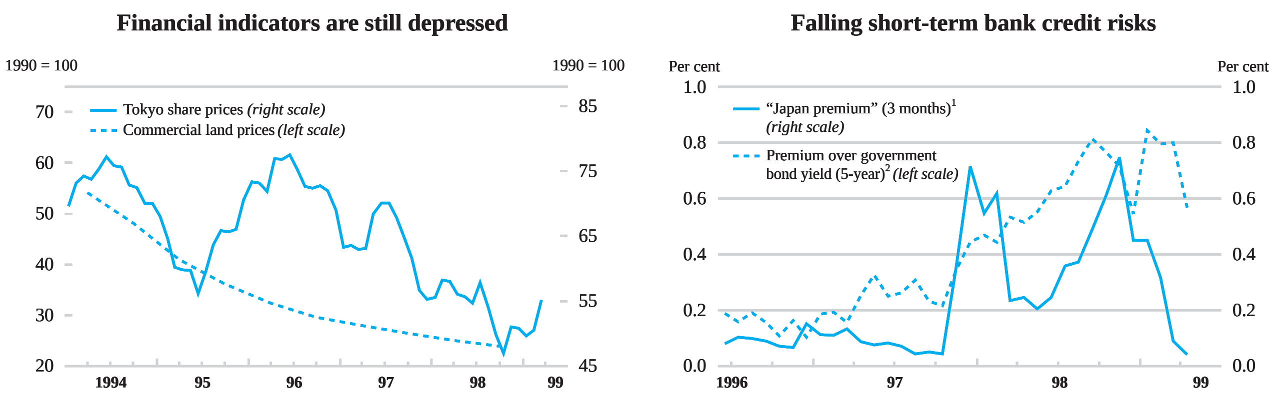
The extra slack has maintained deflationary tendencies

As slack in the economy has risen, incentives for price-cutting have increased. Excluding perishable food items, consumer prices have been edging down since last summer. Other measures of prices show more substantial declines. Domestic wholesale and corporate service prices have been falling at a fairly steady rate of around 2 and 1 per cent per year, respectively, while the broad-based GDP deflator has been essentially unchanged, in part thanks to persistent improvements in the terms of trade. These, when combined with sharp income-related falls in import volumes and higher net investment income, led to a jump in the current account surplus to about $ 125 billion at an annual rate (3.3 per cent of GDP) in the second half of 1998.

Fiscal policy has become increasingly expansionary

The authorities have struggled to implement macroeconomic policies that are appropriate to the steadily worsening economic conditions. They have implemented

Japan



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

Financial indicators

	1996	1997	1998	1999	2000
Household saving ratio[a]	13.4	12.6	13.6	13.3	13.1
General government financial balance[b, e]	–4.2	–3.4	–6.0	–8.7	–9.0
Current account balance[b]	1.4	2.3	3.2	3.0	3.5
Short-term interest rate[c]	0.6	0.6	0.7	0.3	0.4
Long-term interest rate[d]	3.1	2.4	1.5	1.7	1.8

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

the two major fiscal packages of 1998, with the effects of the first visible as from the autumn. The second, announced in November, included over 8 trillion yen (1.6 per cent of GDP) in public works and other measures, including vouchers. That was followed up with an initial budget for fiscal year (FY) 1999 that was also expansionary. It included new corporate and housing tax cuts, continued personal income tax reductions and higher public works outlays, again heavily front-loaded to the first half of the fiscal year. Spending financed by the Fiscal Investment and Loan Programme (often called the "second budget") is also growing, especially in the area of housing. However, local governments have not been sharing in this stimulus drive because of their severe financial situation, although they are implementing local income and corporate tax reductions. Overall, the general government deficit, also boosted by the initial effects of the banking-sector rescue scheme, is believed to have surged to 6 per cent of GDP last year and looks set to jump further to over 8¾ per cent this year and next, even without any further supplementary fiscal measures. Cyclically adjusted, the deficit is projected to rise from 5 to about 6¾ per cent of GDP in both 1999 and 2000, and gross debt could increase to 118 per cent of GDP, the highest in the OECD and double the level at the outset of the 1990s downturn.* Assuming no further fiscal action, policy stimulus in the form of public investment spending is likely to peak around the middle of this year, and then would steadily peter out over the course of next year.

The monetary authorities tried to fend off recessionary pressures, at first with little success

The Bank of Japan has been striving with increasing urgency to head off further downward pressure on prices; it has resisted upward pressure on interest rates and has tried to ensure that creditworthy borrowers are provided with adequate financing. Late in 1998 it took a series of actions designed to ease market conditions. First, it set up a temporary lending facility to finance up to half of banks' increase in corporate loans at an interest rate of only 0.5 per cent. This has led to around 1 trillion yen in additional liquidity. Second, it began to lend to financial institutions with corporate bonds and loans on deeds as collateral. Third, it expanded commercial paper repurchase operations by extending the maturity limit for such paper from three months to one year. But even these aggressive actions were overwhelmed by deteriorating market sentiment. Interest rates were already rising, especially at longer maturities, following the record low levels achieved in October – around 0.7 per cent on 10-year government bonds – partly in response to increased recognition of the seriousness of

* Even though the net debt ratio is much lower, its rise has been virtually as rapid.

Demand and output

Percentage changes, volume (1990 prices)

	1995 current prices trillion yen	1996	1997	1998	1999	2000
Private consumption	290.5	2.9	1.0	–1.1	–0.1	0.5
Government consumption	47.4	1.9	1.5	0.7	0.6	0.7
Gross fixed investment	137.6	11.1	–1.9	–8.8	–3.3	–2.4
Public [a]	41.3	9.2	–10.4	–0.3	14.2	–4.5
Residential	24.1	13.6	–16.3	–13.7	–1.1	1.8
Non-residential	72.1	11.3	7.1	–11.4	–12.6	–2.2
Final domestic demand	475.6	5.3	0.1	–3.3	–0.9	–0.3
Stockbuilding [b]	0.5	0.4	–0.1	–0.1	–0.2	0.0
Total domestic demand	476.1	5.7	0.1	–3.5	–1.2	–0.3
Exports of goods and services	45.4	6.3	11.6	–2.3	1.5	3.9
Imports of goods and services	38.3	11.9	0.5	–7.7	–0.5	2.1
Net exports [b]	7.1	–0.5	1.4	0.6	0.3	0.3
GDP at market prices	483.2	5.1	1.4	–2.8	–0.9	0.0
Industrial production [c]	–	2.3	3.6	–6.9	–1.6	0.4

a) Including public corporations.
b) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
c) Mining and manufacturing.

the public finance outlook. Following the announcement of debt-management plans that called for much less financing by public financial institutions than had been expected, long-term rates surged, with the 10-year rate reaching nearly 2½ per cent in early February 1999. Corporate rates rose even more sharply. The exchange market responded by driving the yen back up through the key level of 110 to the dollar.*

More recent initiatives have been more effective…

The authorities reacted on a number of fronts. Early in the year they expressed their displeasure with excessive yen appreciation when the dollar fell below 110 yen, and since then the currency has fluctuated in a fairly narrow range around 120 to the dollar. Later, they announced modifications to their deficit financing plans to rely less on bond issuance to the public, to shift the share of funding to two- and six-year maturities and to launch a 30-year bond. Then they decided to hold down the Housing Loan Corporation's mortgage rate by around 0.4 percentage point relative to normal procedures. Finally, in mid-February the central bank drove the principal target rate – the rate on uncollateralised overnight funds – down from ¼ per cent to nearly zero. The results have been dramatic. The equities market has jumped back to above year-earlier levels, and long-term rates have reversed about a half of their earlier run-up. Also, the "Japan premium" (the higher cost of funds confronting Japanese banks in global financial markets) has been largely eliminated since the middle of January.

… but the debate has turned to more radical monetary policy options

A lively debate has nevertheless ensued as to whether monetary policy should do more to ensure faster growth in money and liquidity, now that overnight rates are practically at zero. Alternatives proposed include: explicitly targeting interest rates further along the maturity spectrum; monetising the government debt by buying more

* It should be recalled that the yen had been appreciating since the summer, in part because commercial banks were seeking to shrink their foreign assets and acquire dollars to meet year-end requirements.

External indicators

	1996	1997	1998	1999	2000
			$ billion		
Merchandise exports	400.4	409.3	373.3	386	398
Merchandise imports	316.8	307.5	251.2	258	260
Trade balance	83.6	101.7	122.1	129	138
Invisibles, net	–17.8	–7.2	–1.5	–4	4
Current account balance	65.8	94.5	120.7	125	142
			Percentage changes		
Merchandise export volumes [a]	0.7	11.8	–1.2	0.9	4.3
Merchandise import volumes [a]	5.0	1.7	–5.3	1.1	2.1
Export performance [b]	–7.3	0.3	–2.6	–5.1	–1.8
Terms of trade	–6.8	–3.9	6.5	2.1	0.2

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

bonds, either at issue or in the open market; setting a target growth rate for a money aggregate (most often base money or M2 plus CDs) or targeting a positive inflation rate more directly. Thus far, the Bank has refused to adopt any of these strategies, given the legal, institutional and economic difficulties involved.

The central projection is for a stabilisation of activity at recent low levels…

Although the worst of the recession is thought to be over, no pickup to speak of is expected. Corporate restructuring will be a major drag for the foreseeable future. With expectations of future growth rates marked down, the need for the business capital stock, as officially estimated, to grow at the near 4 per cent rate implied by the current investment levels is dubious. Higher long-term interest rates, impaired credit supply and squeezed profits will also restrain capital spending. Similar factors will also encourage firms to continue to gradually dishoard their labour inputs, pushing productivity towards trend levels and unemployment through the 5 per cent level later this year. Adjustment is also likely on the wages front, with accelerating declines in compensation, mainly in the form of reduced bonuses. The result is that household incomes will stagnate, limiting gains in consumption expenditures. Housing investment could fluctuate, in response to expectations of a future rise in mortgage rates and the end-2000 expiry of a temporary housing-related tax cut. Inventories are projected to continue their adjustment process for the rest of this year, in line with their still-excessive levels in relation to shipments. A recovery in export markets, especially in Asia, and a near-stabilisation in domestic demand, could help bring about a rebound in trade volumes, albeit with only a moderate net external contribution. Overall, real GDP may fall nearly 1 per cent in 1999 before stabilising next year. This would imply some modest reduction in the current fiscal year. Prices may edge down this year, although higher oil prices will limit consumer price declines. By next year, however, price declines could become more entrenched. Persistently large losses in export market share could bring a pause in the recent uptrend in the current account surplus in 1999, but it may resume in 2000, owing mainly to a widening investment income surplus.

… but even a stabilisation may be difficult to achieve

Despite the more upbeat mood in the financial markets and the recent recovery in consumer confidence, there seem to be few upside risks to these projections. Rather, the investment and employment cutbacks associated with corporate restructuring could be even more severe, especially if lenders become more concerned with business profitability. Deepening fears over job security and the underfunding of both the public and private pension systems could lead households to boost desired saving, leading to additional retrenchment. Concerns over the public finances might flare up anew, boosting long-term interest rates and curtailing interest-sensitive spending. Finally, notwithstanding the recent recapitalisation of the banking sector and the resulting alleviation of the credit crunch, there remain medium-term concerns regarding the financial system. Although recent increases in share prices have helped to strengthen financial institutions' balance sheets, continuing declines in land prices may raise the share of loans that are non-performing. And the massive provision of public funds and a significant increase in the public sector's assumption of credit risk[*] have been made without, thus far, any market test of whether banks' lending practices are now appropriate.

* While major commercial banks, life-insurance companies and foreign banks have continued to shrink their business lending operations, government financial institutions boosted their lending to business by 4.6 trillion yen (6½ per cent) over the course of 1998. In late 1998 the government decided to provide an extra 20 trillion yen (over 4 per cent of GDP) in credit guarantees to small and medium sized enterprises through the mixed public-private corporations which at that point had some 30 trillion yen under guarantee. By end-February two-thirds of that additional availability had been used up, and preparations were underway for a further 10 trillion yen allocation. The Bank of Japan has also absorbed greater risk: for example, by end-1998 it held 42 per cent of all commercial paper outstanding, having purchased 85 per cent of net issuance in the final quarter of the year.

Germany

Growth slowed sharply during the second half of 1998, due to weaker exports and investment activity. Business confidence deteriorated markedly and incoming orders slowed, pointing to weak activity in the first half of 1999. Private consumption, by contrast, should continue to support activity and exports should gradually recover in line with the projected revival of world trade. While growth for the year is likely to be around 1¾ per cent, it should accelerate to some 2¼ per cent in 2000. Employment growth will remain sluggish and the level of unemployment high.

While the fiscal deficit should continue to fall over the next two years, the decline will be marginal and recent decisions on pensions and other entitlements mean that further efforts will be required to achieve longer-run fiscal sustainability. A priority will be to continue the tax reform process so as to widen the tax base and lower statutory tax rates on business activity. With respect to structural reform, many of the significant flexibility-enhancing labour market reforms of recent years have been reversed

Activity weakened markedly in the course of the second half of 1998

GDP growth slowed throughout the second half of 1998 and in the fourth quarter it is estimated to have fallen by some 1½ per cent (at an annual rate).* Exports fell in the last quarter, with significant declines in exports to Asia and Russia. Imports also declined, but the external sector became an increasing drag on growth. Investment in plant and machinery, which had been strong during the first nine months of the year, decelerated rapidly and construction continued to contract. With public consumption falling, second-half activity was underpinned by private consumption, which expanded by 3 per cent, and by inventory accumulation.

The business climate has deteriorated markedly…

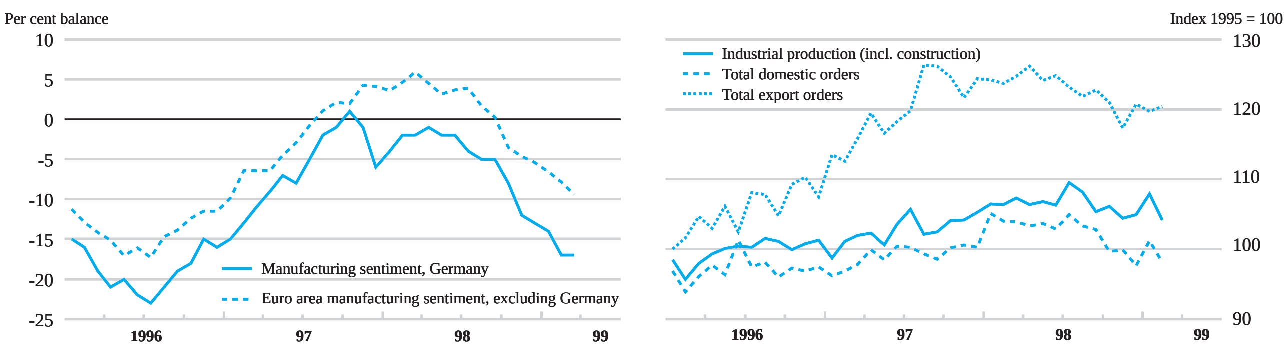
Surveys indicate that enterprises expect manufacturing orders to stabilise slowly, but business sentiment has deteriorated markedly since September 1998, and the trend has continued into 1999. The deterioration has been more pronounced than in other European countries, and the stock-market has also been less buoyant.

… but consumer confidence has improved

By contrast, consumer confidence has strengthened markedly. Rising employment has probably contributed to this improvement, as has decelerating consumer

Germany

Business sentiment has deteriorated[1] **And industrial orders have declined**



1. Industrial confidence indicator in manufacturing. Euro area aggregate is weighted by GDP shares in the euro area total, excluding Germany.
Sources: European Commission; Deutsche Bundesbank; OECD.

* Based on national accounts at 1991 prices. Germany began to introduce the European System of Accounts and 1995 prices in May 1999 onwards (See Box I.2 in Chapter I).

Employment, income and inflation

Percentage changes from previous period

	1996	1997	1998	1999	2000
Employment	–1.3	–1.3	0.0	0.3	0.4
Unemployment rate [a]	10.3	11.4	11.2	10.7	10.0
Compensation of employees	1.0	0.2	1.4	2.9	2.8
Unit labour cost	–0.3	–1.9	–1.3	1.1	0.5
Household disposable income	3.7	1.8	2.8	3.5	3.6
GDP deflator	1.0	0.6	0.9	0.9	1.3
Private consumption deflator	2.0	1.9	0.9	0.7	1.2

a) As a percentage of labour force.

price inflation; the annual rate of inflation was down to some ¼ per cent at the start of the year. Real wage increases due to lower household taxes are also reinforcing consumer confidence and should establish a base for continued solid growth in consumer expenditure.

Despite high wage growth, competitiveness remains unaffected

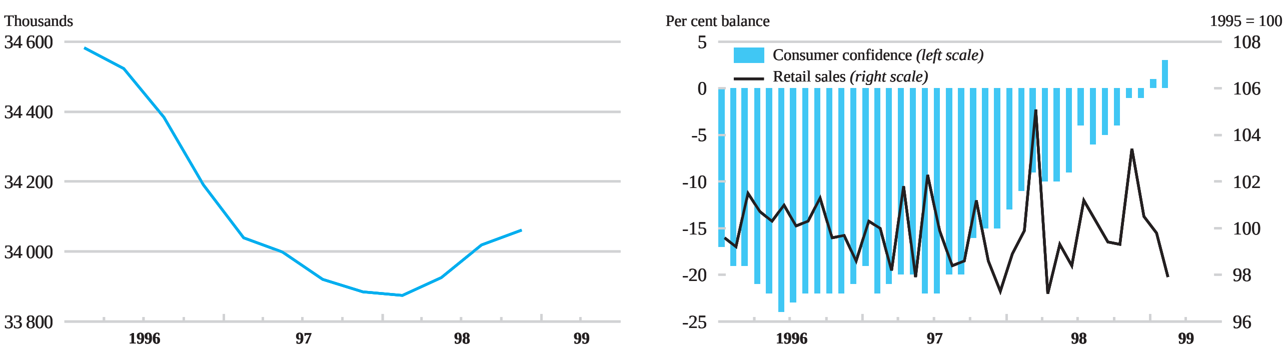
The 15-month wage settlement in the metal industry agreed at the start of 1999 implies a 4.1 per cent rise for the year. Wage rates for the economy as a whole are set to rise by some 3 per cent. Overall wage costs will, however, rise somewhat less, due to a reduction of the employer's pension contribution rate by some 40 basis points in April. Despite the pick-up in wage growth, international competitiveness will be roughly maintained. The weakening of the euro at the start of 1999 has partly offset the effects of the appreciation of the Deutschemark against the dollar in 1998, and productivity growth has been high so that the real effective exchange rate measured in relative unit labour costs remains at the level reached at the end of 1997. Enterprises are projected to respond to wage rises by raising productivity through lower employment growth and by a greater emphasis on investment for rationalisation.

Financial conditions should remain supportive

Nominal long-term interest rates remain low by recent historical experience, with yields of 4 per cent on ten-year government bonds. The cost of corporate

Germany

Employment has increased | **And consumer confidence has improved**



Sources: Deutsche Bundesbank; OECD.

Financial indicators

	1996	1997	1998	1999	2000
Household saving ratio [a]	11.5	11.0	11.0	11.2	11.2
General government financial balance [b, c]	–3.4	–2.6	–2.0	–1.9	–1.9
Current account balance [b]	–0.6	–0.2	–0.2	0.0	0.2
Short-term interest rate [d]	3.3	3.3	3.5	2.7	2.6
Long-term interest rate [e]	6.2	5.7	4.6	4.1	4.2

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

borrowing from banks has declined and business lending by the German banking sector has continued to grow at a brisk pace, implying no financial constraints on growth.

Fiscal consolidation has slowed but is subject to significant uncertainty

After several years of rapid fiscal consolidation, the general government deficit is projected to improve only marginally this year, and next. A large number of fiscal measures have been introduced this year as part of the government's tax reform package which is programmed to bring a net relief of some DM 20 billion (€ 10 billion) by 2002. Households will benefit, while the tax burden on business activity will rise as business tax allowances are restricted. There are also new commitments for social spending on pensions and entitlements. Under currently legislated policies the general government deficit is projected to decline from 2.0 per cent of GDP in 1998 to 1.9 per cent this year (Maastricht basis) and should remain broadly unchanged

Demand and output

Percentage changes, volume (1991 prices)

	1995 current prices billion DM	1996	1997	1998	1999	2000
Private consumption	1 975.3	1.6	0.5	1.9	2.5	2.5
Government consumption	686.6	2.7	–0.7	0.6	1.1	1.0
Gross fixed investment	735.6	–1.2	0.1	1.6	1.2	3.1
Public	82.5	–6.4	–8.6	–1.9	3.6	1.3
Residential	251.8	–0.5	–0.7	–3.8	–0.9	1.7
Non-residential	401.3	–0.5	2.1	5.2	2.0	4.0
Final domestic demand	3 397.5	1.2	0.1	1.6	1.9	2.3
Stockbuilding [a]	18.3	–0.5	1.2	1.5	–0.1	0.0
Total domestic demand	3 415.7	0.7	1.4	3.1	1.7	2.2
Exports of goods and services	821.2	5.1	11.1	5.4	3.0	5.3
Imports of goods and services	794.2	2.9	8.1	6.6	3.0	5.0
Net exports [a]	27.1	0.6	0.8	–0.3	0.0	0.1
GDP at market prices	3 442.8	1.3	2.2	2.8	1.7	2.3
GDP at market prices in billion euros	1 760.3					
Industrial production	–	0.4	3.6	4.5	1.4	3.5
Memorandum items						
Investment in machinery and equipment	262.3	1.9	3.9	10.1	2.5	4.7
Construction investment	473.3	–3.1	–2.5	–4.3	0.2	1.7

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

External indicators

	1996	1997	1998	1999	2000
			$ billion		
Merchandise exports	522.7	511.2	538.0	536	563
Merchandise imports	451.4	439.3	459.7	459	482
Trade balance	71.3	71.9	78.3	77	81
Invisibles, net	–85.1	–76.0	–81.9	–76	–76
Current account balance	–13.8	–4.0	–3.5	1	5
			Percentage changes		
Merchandise export volumes[a]	7.1	10.7	4.8	2.6	5.3
Merchandise import volumes[a]	5.5	6.1	8.3	2.9	5.0
Export performance[b]	0.0	0.6	–2.8	–1.2	–0.3
Terms of trade	–0.3	–1.6	1.9	0.1	–0.2

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

in 2000. A number of commitments are not yet legislated and are therefore not included in the projections, including a constitutionally-mandated increase in family allowances and further reform of business taxation.

A new approach to labour-market reform is being implemented

A number of recently-introduced labour-market reforms were reversed at the beginning of the year and greater emphasis is now being placed on active labour-market measures and job creation programmes. Local government can now launch job-creation measures in a wider range of areas and special measures have been introduced to provide work experience for 100 000 youths. New forms of early retirement have also been advocated. The government has initiated joint discussions with all the social partners to reach a consensus on how to raise employment.

GDP growth is projected to slow in 1999 but to pick up later in the year

GDP growth will remain slow in the first half of 1999, with strong private and public consumption partially offset by weak exports, stagnant investment and de-stocking. Exports should recover in the course of the year as world trade growth picks up. Investment activity has been adversely affected by uncertainty about tax reform and structural policy more generally, but as the policy environment becomes clearer it is projected to improve slowly. GDP growth should be around 1¾ per cent in 1999 and near potential in 2000 (2¼ per cent). With growth slowing and some labour-shedding arising from the wage pick-up, employment is likely to begin to stagnate this year, following strong employment growth in the last half of 1998. Unemployment should decline gradually, depending on the scale and direction of active labour market programmes. Despite an increase in energy taxes in April, and higher world energy prices, inflation should remain subdued at under 1 per cent.

Domestic developments add to the generally risky atmosphere

The projection is contingent upon a pick-up in world trade growth. Domestic risks are also important. Insofar as the rapid deterioration of the business environment and in investment activity is related to uncertainty about tax policy and the direction of structural reforms, and these uncertainties are not resolved quickly, the upturn in investment could be slower than projected. With respect to upside risks, expansionary monetary conditions in the euro area could lead to a more rapid recovery in European activity than projected and this would improve growth prospects in Germany.

France

GDP growth was vigorous in 1998. Household spending was buoyant and investment picked up strongly from the previous year. The financial crises in some emerging markets had a small impact on exports due to France's limited direct exposure to those markets. Output growth, however, weakened in the second half as business confidence deteriorated markedly. Real GDP is likely to grow moderately in 1999, but continued strong consumer spending and revived exports should help restore more rapid economic growth in 2000. Employment should increase further, partly with the help of subsidies associated with the shortening of working hours, but not fast enough to reduce the unemployment rate decisively.

Keeping the French economy on a robust growth path will call for policies consistent with dynamic and flexible labour and product markets, and strong commitment to fiscal discipline. The second law on the 35-hour working week scheduled for discussion in second half of 1999 should be designed so as to avoid an increase in unit labour costs. It would be prudent to reduce the government's structural deficit in 2000 and build additional safety margins in the budget. This would accommodate possible unforeseen developments in the coming years, such as lower than expected growth, as well as prepare for a probable rise in future pension outlays.

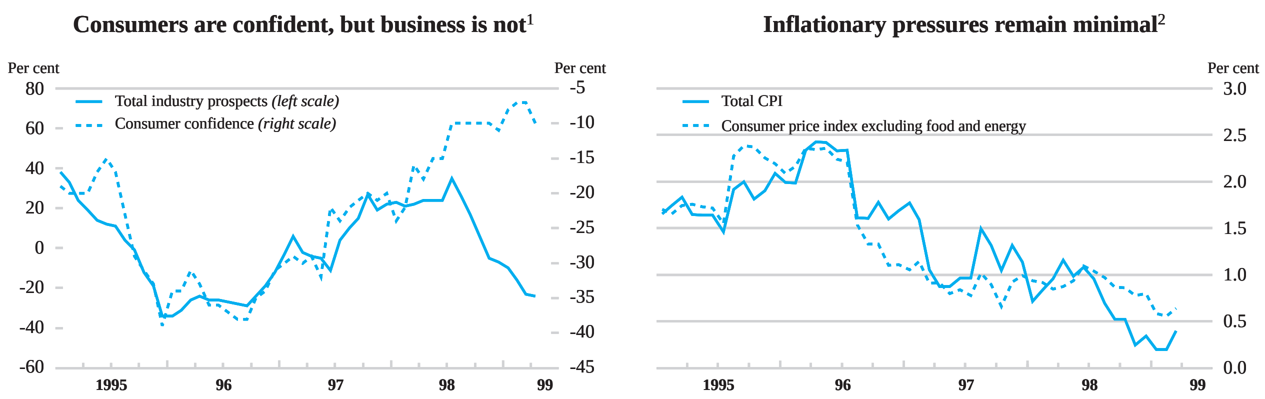
Strong domestic demand kept the economy buoyant...

The recovery of output witnessed since mid-1997 was sustained in 1998 with real GDP rising by 3.2 per cent, the strongest growth rate in ten years.* Stable prices, rapid job creation, real wage gains, low interest rates and rising consumer confidence bolstered private consumption. Purchases of electronic goods, such as microcomputers and mobile phones, and telecommunications and transport services were particularly buoyant reflecting in part the intensified competition in the network sectors. Favourable prospects for demand and the easing of monetary and financial conditions brought about a rebound in investment.

but business confidence has weakened

Since last autumn, however, industrial production has declined, and business confidence has weakened considerably. The contribution of stockbuilding to output growth slowed down throughout the year. In addition, the foreign balance contribu-

France



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

* In May 1999, France introduced the new European System of Accounts and rebased its national accounts on 1995 prices. This resulted in slightly different past GDP growth rates, a higher level of nominal GDP, and a somewhat smaller public deficit in 1998 (see Box I.2 in Chapter I). The present *OECD Economic Outlook* was prepared before ther release of these new data and therefore remains based on national accounts at 1980 prices.

Employment, income and inflation

Percentage changes from previous period

	1996	1997	1998	1999	2000
Employment	0.1	0.4	1.4	1.2	1.3
Unemployment rate[a]	12.3	12.4	11.8	11.3	10.8
Compensation of employees	3.4	2.7	3.8	3.7	3.8
Unit labour cost	1.8	0.4	0.6	1.3	1.2
Household disposable income	2.4	3.5	3.5	3.5	3.6
GDP deflator	1.2	0.9	0.7	0.9	1.1
Private consumption deflator	1.8	1.1	0.3	0.7	1.1

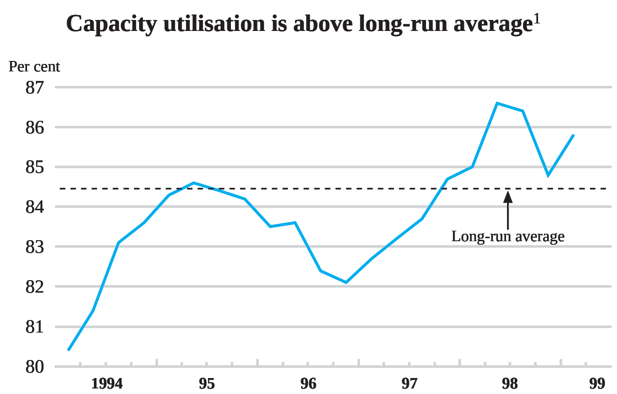
a) As a percentage of labour force.

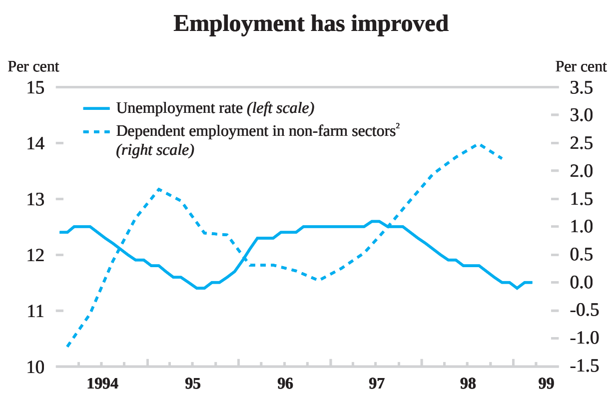
tion turned negative during 1998, reflecting the weakness of other European economies. Among the countries in the euro area, France appears to have been less affected by the crises in emerging economies. The share of exports to East Asia in total trade is smaller than that in Germany and Italy, and the share of exports to Russia is marginal. The relatively high share of services also contributed to limiting the direct exposure of the French economy to the crises in emerging economies. Accordingly, the current account was hardly affected in 1998, still showing a large surplus of 2.8 per cent of GDP.

Job creation has strengthened, but unemployment has remained high

Growth has become richer in jobs. The greater flexibility due to the rise of temporary contracts, part-time work, and cuts in social contributions targetted towards low wage earners has contributed to the development of service jobs. Private sector employment grew by 2.2 per cent in the year to December 1998. Public employment growth was also dynamic, partly as a result of a large-scale youth-employment programme which generated 100 000 hires in 1998. In March 1999, the unemployment rate was 11.5 per cent compared to 12.0 per cent a year earlier. Recent developments on the 35-hour workweek reflect the decision of the government to provide financial support to working time reduction in public enterprises. By early April 1999, 3 300 enterprise agreements had been reached covering about 5½ per cent of total

France





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

Financial indicators

	1996	1997	1998	1999	2000
Household saving ratio[a]	13.3	14.6	14.1	14.1	14.1
General government financial balance[b, c]	–4.1	–3.0	–2.9	–2.5	–2.0
Current account balance[b]	1.3	2.7	2.8	2.6	2.6
Short-term interest rate[d]	3.9	3.5	3.6	2.7	2.6
Long-term interest rate[e]	6.5	5.7	4.8	4.1	4.2

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

business sector employment. The number of agreements is expected to pick up after parliamentary adoption of a second law, which will specify the modalities of working-time reduction. The impact on employment will depend on the extent to which the law limits any significant increase in unit labour costs. Such features as setting the overtime premium at a reasonable level, annualising working hours and using flat-rate remunerations for managers would contribute to this end.

The pace of fiscal adjustment has slowed, and several fiscal challenges still lie ahead

Despite some slippage on health care outlays, the general government deficit declined to 2.9 per cent of GDP in 1998. The state budget law for 1999 projects bringing the deficit down to 2.3 per cent of GDP. Pressure, however, may arise once more from the social security account. Controls on health care spending remain insufficient, so that, in the absence of corrective measures, the social security deficit may slightly exceed the official target in 1999. Initial parameters announced for the 2000 budget suggest a general governement deficit target of 1.7 to 2 per cent of GDP. This would require a freeze on state expenditure in real terms. Such a freeze may be difficult to achieve in view of the social spending priorities of the government: 350 000 youth jobs

Demand and output

Percentage changes, volume (1980 prices)

	1995 current prices billion FF	1996	1997	1998	1999	2000
Private consumption	4 586.6	2.0	0.9	3.8	2.8	2.5
Government consumption	1 495.6	2.6	1.2	1.1	1.5	1.6
Gross fixed investment	1 374.8	–0.5	0.3	4.1	4.0	4.2
General government	242.1	–7.5	0.2	2.1	2.9	2.6
Household	351.1	–1.0	–0.6	1.3	4.3	4.4
Other	781.6	2.0	0.7	5.8	4.2	4.5
Final domestic demand	7 457.1	1.6	0.8	3.3	2.8	2.6
Stockbuilding[a]	23.7	–0.7	0.1	0.4	–0.2	0.0
Total domestic demand	7 480.9	0.9	0.9	3.7	2.6	2.7
Exports of goods and services	1 803.0	5.2	12.6	6.3	3.7	4.9
Imports of goods and services	1 621.5	3.0	8.0	8.0	4.7	5.0
Net exports[a]	181.5	0.6	1.4	–0.4	–0.3	0.0
GDP at market prices	7 662.4	1.6	2.3	3.2	2.3	2.6
GDP at market prices in billion euros	1 168.1					
Industrial production[b]	–	0.2	3.9	4.5	2.1	3.0

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) Quarterly index.

External indicators

	1996	1997	1998	1999	2000
			$ billion		
Merchandise exports	281.8	284.1	298.0	301	315
Merchandise imports	266.9	255.9	270.2	278	290
Trade balance	15.0	28.1	27.9	23	25
Invisibles, net	5.6	9.4	11.9	13	14
Current account balance	20.5	37.6	39.8	37	39
			Percentage changes		
Merchandise export volumes [a]	5.1	13.0	6.7	3.9	5.2
Merchandise import volumes [a]	2.5	8.1	8.7	5.0	5.0
Export performance [b]	–0.8	3.9	0.0	–0.1	–0.4
Terms of trade	–1.2	–0.3	0.5	–0.7	–0.2

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

are to be remunerated in the public sector; reduced social security contributions are to be made more generous for low wage earners; and public aid is planned in support of working-time reduction to 35 hours per week. Despite these constraints, a significant reduction in the structural budget deficit in 2000 is essential. This would help build additional safety margins in the budget to deal with unforeseen developments, such as lower than expected growth, and prepare for a probable rise in future pension outlays.

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

Output growth is estimated to have slowed down somewhat during the first half of 1999. GDP growth should however remain above that in major neighbouring countries in 1999 and 2000 and slightly exceed the estimated potential rate. Domestic demand will continue to drive the expansion, boosted by low interest rates. Private consumption will benefit from high consumer confidence, gains in real income and a reduction in precautionary saving. Business surveys point to slower industrial investment but other indicators still suggest that investment activity will remain strong in the service sector. Reflecting partly a calendar effect in anticipation of the end of fiscal incentives, the recovery in residential construction investment should continue in 1999. Export growth is projected to pick up somewhat during 1999, driven by market expansion and the lower value of the euro. The current account surplus should remain around 2.5 per cent of GDP in 1999. In the coming months, the continuing slowdown of industrial activity is likely to reduce employment creation and raise the unemployment rate slightly. The negative effect of slower growth on total employment, however, could be attenuated somewhat by the continued implementation of the 35-hour working week and the extension of the youth-employment scheme. The unemployment rate may fall to 10.5 per cent by the end of 2000. Wage and price inflation is projected to pick up only marginally, reflecting a stabilisation of oil and commodity prices and a narrowing output gap.

The risks to the projections are on both sides

There are downside and upside risks to the projection. The major risk on the down side could come from unforeseen adverse shocks, such as a sharp drop in global equity markets or a spill-over of the war in Kosovo to other countries. Such shocks would adversely affect consumer confidence, reducing it from the current high level, and would prevent a recovery in business confidence. On the upside, private consumption could be more buoyant than expected. Recent data suggest that private consumption was strong during the first quarter of 1999. Consumer spending could therefore exceed the projected growth rate for 1999, especially as the support given by the 50 basis point cut in European Central Bank interest rates in April may contribute to stronger domestic demand than expected.

Italy

GDP growth remained weak in 1998, principally reflecting the poor performance of net exports. Despite an easier macro-economic policy stance, activity is projected to remain slow in 1999, with the basis for growth broadening only slowly. Some decline in the trade surplus is projected to occur, reflecting the adverse effect on international competitiveness of rising unit labour costs, less favourable terms of trade and slow export-market growth. Though edging down over the coming two years, the unemployment rate is projected to remain high.

The present fiscal policy stance leaves little margin for slippage relative to the terms of the Stability and Growth Pact, while further social security reform remains a critical issue for medium-term fiscal sustainability. There is an even greater need for structural reforms to strengthen competitiveness and flexibility in the labour market – particularly as it affects the south.

Economic activity has not accelerated as expected…

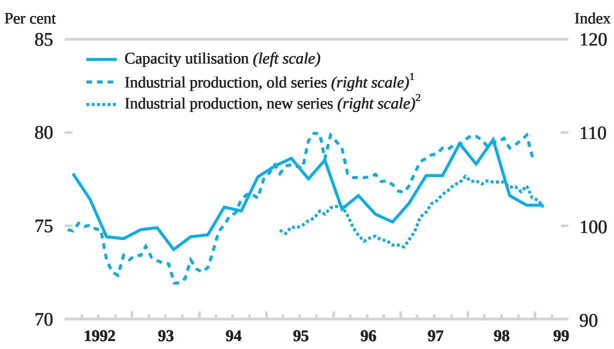
Real GDP grew by only 1.4 per cent in 1998.* Private consumption lost strength over the year, reflecting the expiration of car incentives and the still-slow increase in households' incomes. Weaker foreign-market growth translated into poor exports, while low commodity prices caused buoyant imports until mid-year. For the second year in succession, the external sector provided a strongly negative contribution to output growth. As industrial production lost momentum, capacity utilisation in manufacturing remained some five percentage points below the level seen in the last 1990 cyclical peak. Growth was helped by stronger spending on machinery and equipment, but the response of investment to the decline of interest rates and good corporate profits is still relatively muted.

… and unemployment remains high

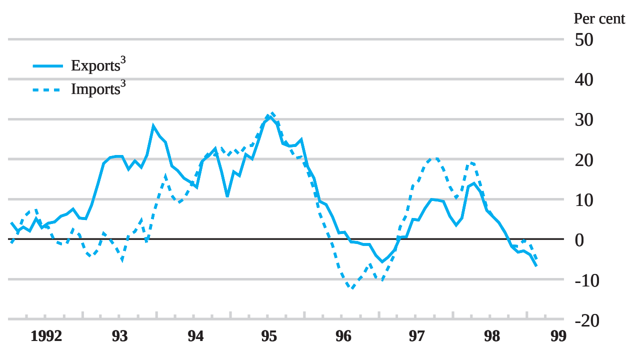
Despite slow growth, the unemployment rate fell slightly in early 1999, helped by the rise of atypical service contracts. However, at 12.4 per cent it was almost 2½ points higher than in October 1993 when the economy began to come out of recession. Regional labour market trends remained divergent, the unemployment rate falling to 7.1 per cent in the centre-north and rising to 23.6 per cent in the south.

Italy

Activity is no longer strengthening



The performance of the external sector has slowed



1. 1990 = 100, three-month moving averages.
2. 1995 = 100, three-month moving averages.
3. Year-on-year percentage changes using three-month moving averages.

* National accounts figures referred to in this note and the associated tables are ISTAT estimates of March 1999. ISTAT subsequently released figures consistent with the new European System of Accounts (ESA 95). Such figures show Italy's real GDP to have grown by 1.3 per cent in 1998 (See Box I.2 in Chapter I).

Employment, income and inflation

Percentage changes from previous period

	1996	1997	1998	1999	2000
Employment	0.4	0.0	0.4	0.4	0.5
Unemployment rate [a]	12.1	12.3	12.2	12.1	11.9
Compensation of employees	6.0	4.7	0.8	2.7	2.9
Unit labour cost [b]	5.1	3.2	–0.6	1.3	0.6
Household disposable income	4.6	3.2	3.3	3.1	3.3
GDP deflator	5.2	2.6	2.9	2.3	1.5
Private consumption deflator	4.5	2.5	2.4	1.7	1.5

a) As a percentage of labour force.
b) The estimate for 1998 takes into account the introduction of the regional tax (IRAP) which was accompanied by the partial abolition of the employers' compulsory contributions to the health care system. Excluding the one-off effects of IRAP, the unit labour cost is estimated to have risen by 0.6 per cent in 1998.

Employment continued to increase in the north, while the expansion of the labour force remained concentrated in the south, as a tightening in the benefit regime brought more job-seekers onto the market. Against a backdrop of decelerating export demand, labour shedding in larger industries continued, the number of jobs in this sector being almost 4 per cent lower in January 1999 than a year earlier.

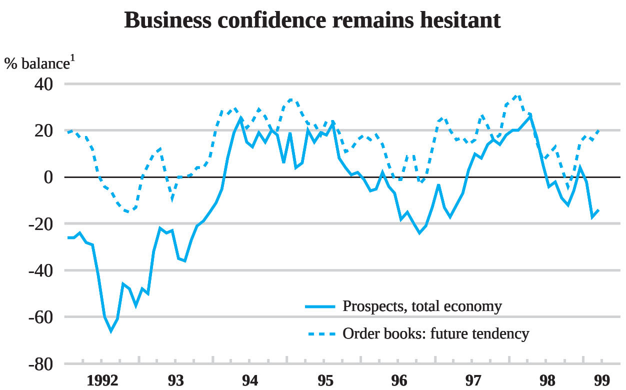
Weak productivity translates into higher unit labour costs

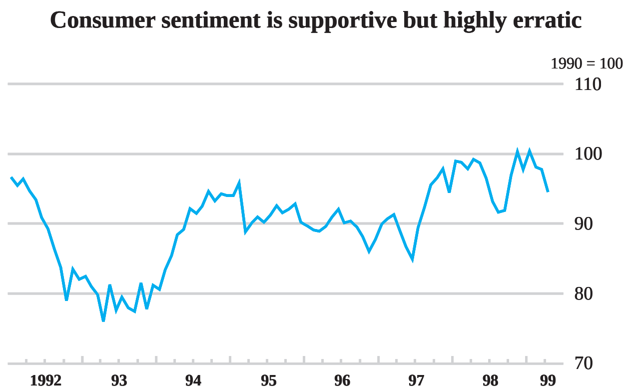
Notwithstanding moderate wage growth, weak productivity gains meant that unit labour costs rose by 0.6 per cent in 1998 (excluding the one-off effects of tax reform, which reduced social insurance charges). After a pause, the rate of inflation moved down again, ending the year at 1.7 per cent, broadly consistent with the official projections and falling further to 1.5 per cent by April 1999. Nevertheless, the differential between Italian and German inflation had widened to 1.2 percentage points at the end of 1998, compared with 0.6 point a year earlier.

Exports to Europe have weakened

On the external side, the positive terms of trade helped to limit the fall in the trade surplus, partly offsetting the impact on export volumes of lower demand and greater competition in the emerging markets. Since 1997, a sizeable amount of exports has been redirected towards the European Union, but from the second quarter weakening European demand was reflected in a fall in Italy's trade balance with the

Italy





1. Per cent balance of positive and negative answers.

Financial indicators

	1996	1997	1998	1999	2000
Household saving ratio [a]	13.8	12.4	11.5	11.1	10.7
General government financial balance [b]	–6.6	–2.7	–2.7	–2.5	–2.1
Current account balance [b]	3.3	2.9	2.0	1.9	2.2
Short-term interest rate [c]	8.8	6.9	5.0	2.7	2.6
Long-term interest rate [d]	9.4	6.9	4.9	4.2	4.4

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

area. Trade with Germany, which is Italy's major trading partner, has been most affected, swinging into deficit in 1998 and continuing to deteriorate in early 1999.

The monetary policy framework is supportive…

Real short-term interest rates have declined to lows unprecedented since the early 1980s and are thus supportive of growth. The long-term differential with Germany, at about 25 basis points, is somewhat lower than at the end of 1998. The present yield curve seems to suggest an environment of continued low inflation expectations. Producer prices point in a similar direction, as a number of corporations have recently cut prices to preserve market shares.

… with fiscal consolidation slowing

The 1999 budget law aimed to achieve a general government deficit of 2 per cent of GDP, but the government recently revised the objective to 2.4 per cent, signalling an intention not to offset the impact of slower growth by a further contraction in the cyclically-adjusted balance. Indeed, due to falling tax pressure – linked to the partial refund of the Tax for Europe – as well as to tax breaks and spending in the south, the cyclically-adjusted primary surplus is tending to decrease. Nevertheless,

Demand and output

Percentage changes, volume (1995 prices)

	1995 current prices trillion L	1996	1997	1998	1999	2000
Private consumption [a]	1 083.3	0.8	2.6	1.9	1.9	2.2
Government consumption	291.6	0.3	–0.8	1.4	0.6	0.4
Gross fixed investment	317.0	1.9	0.8	3.5	2.6	3.4
Machinery and equipment [b]	157.6	–0.3	2.6	4.4	1.8	2.6
Construction [b]	159.4	4.1	–0.8	2.7	3.5	4.2
Residential	84.6	–3.4	–4.4	4.6	5.0	5.0
Non-residential	74.8	12.5	2.6	0.9	2.1	3.5
Final domestic demand	1 691.9	0.9	1.7	2.1	1.8	2.2
Stockbuilding [c]	15.2	–0.6	0.7	0.5	–0.5	0.0
Total domestic demand	1 707.1	0.2	2.4	2.6	1.3	2.1
Exports of goods and services	440.8	1.6	5.0	1.3	2.0	5.0
Imports of goods and services	390.4	–1.1	9.9	6.1	1.7	4.8
Net exports [c]	50.4	0.6	–0.9	–1.1	0.1	0.1
GDP at market prices	1 757.5	0.9	1.5	1.4	1.4	2.2
GDP at market prices in trillion euros	0.908					
Industrial production	–	–2.9	2.7	0.8	0.8	2.5

a) Final consumption in the domestic market by households.
b) OECD estimates for the breakdown of gross fixed investment, from 1995 to 1998.
c) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

External indicators

	1996	1997	1998	1999	2000
			$ billion		
Merchandise exports	250.8	238.4	241.9	239	251
Merchandise imports	190.1	191.3	199.7	199	208
Trade balance	60.7	47.1	42.2	40	42
Invisibles, net	–20.2	–13.5	–19.0	–17	–15
Current account balance	40.5	33.5	23.2	23	27
			Percentage changes		
Merchandise export volumes [a]	4.5	4.6	2.4	2.2	4.8
Merchandise import volumes [a]	0.1	9.9	8.0	1.8	4.8
Export performance [b]	–2.1	–4.2	–4.1	–1.4	–0.7
Terms of trade	2.4	–0.7	4.2	0.0	0.1

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

given falling interest payments, and on the assumption of unchanged policies, the overall deficit is projected to fall further, to 2.1 per cent of GDP by 2000.

Output prospects remain weak, slowing the improvement of the labour market

Recent export orders and consumer and business surveys suggest that weak activity could continue until the end of the first semester. Given the underlying trend in relative unit labour costs, and slowly expanding export markets, a strong pick-up in exports remains unlikely, although accelerating world trade should help to spur export volumes in 2000. The recovery will thus be slow, with real GDP growth accelerating from close to 1½ per cent in 1999 to 2¼ per cent in 2000. This will be led mainly by private consumption, which is being supported by rising disposable incomes. Gross fixed investment should also be stimulated to some extent by gradually improving world output prospects, public investment and tax incentives to residential construction. With rising participation rates in the south partly offsetting projected small employment gains, the rate of unemployment is expected to ease only slightly, to 11.9 per cent in 2000. It will thus remain well above the estimated structural rate, while the economy at large will continue to operate at a level below potential. The inflation rate, measured using the private consumption deflator, is thus likely to continue to fall, to about 1.7 per cent in 1999. For the country as a whole, the effects of the Kosovo conflict on tourism are expected to be modest. But the disappearance of the strongly positive terms-of-trade effect enjoyed in 1998, combined with gradually recovering import volumes, are likely to result in a further small erosion of the trade balance and the current account.

There remain significant uncertainties, especially as to the recovery of investment and exports

The main uncertainties attach to the recovery of investment, for reasons arising both from domestic developments and the external environment, where the Kosovo factor could reinforce the negative effect of cyclical weakness on business confidence. Although the economy has lower interest rates than it has enjoyed for decades, business investors do not seem to be exploiting the full range of opportunities opened up by a lower cost of capital. For 1998 one symptom of their reluctance to invest was the upsurge of the "errors and omissions" item of the balance of payments, suggesting that a sizeable amount of the current account surplus was reinvested abroad directly without a financial account counterpart. Italian direct investment abroad is considerably higher than would be expected for a country with as marked regional income and employment disparities as Italy. On the external side, uncertainties arise from possibly slower export growth. Italian firms are directing sizeable amounts of intermediate inputs and consumer goods to the European market in particular, possibly implying lower export growth if this market grows less rapidly than projected.

United Kingdom

The United Kingdom is experiencing a sharp slowdown, following a six-year expansion which saw employment grow strongly and unemployment decline to the lowest level in two decades. Inflation has been close to target, and is projected to remain so. Faced with slowing activity, monetary policy was eased considerably, and fiscal policy has become neutral, after a prolonged spell of tightening. The lagged effects of the earlier tight policy stance combined with a strong pound nonetheless foreshadow a soft first half in 1999 before activity accelerates anew.

Currently, monetary policy should continue to use the available room for manoeuvre. To finance priority spending areas, fiscal policy should focus on restructuring expenditures rather than raising taxes. The ongoing efforts to boost labour supply and reduce other obstacles to growth should be vigorously pursued so as to improve prospects and to raise living standards over the longer term.

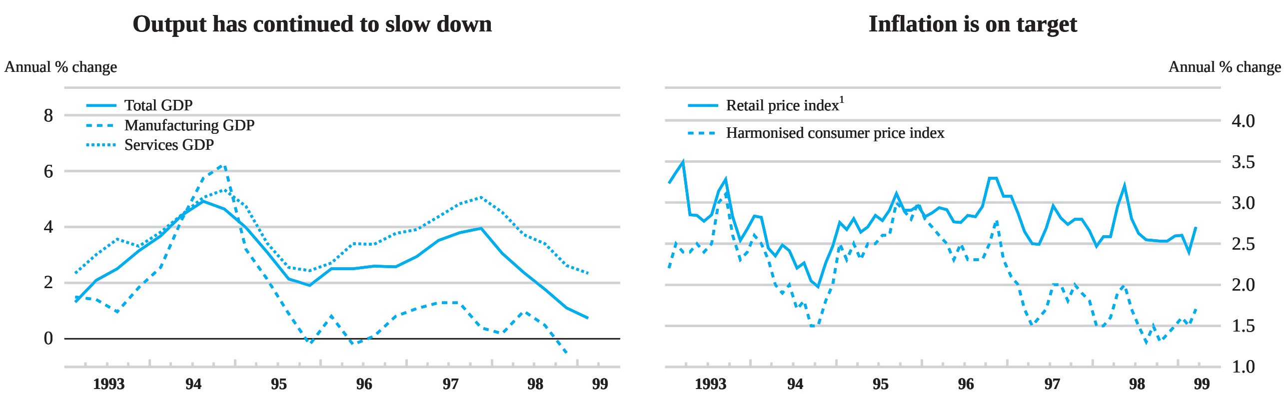
Economic growth has continued to weaken, falling well below potential

The pace of annual real GDP growth slackened to 1.1 per cent in the last quarter of 1998. This is well below potential. Early 1999 data show activity remaining weak, mainly due to the deceleration of exports caused by the pound's sizeable appreciation through mid-1998 and the contraction in demand in a number of Asian economies. At the same time, the trade deficit widened to 2.5 per cent of GDP in 1998. Domestic demand has held up relatively well so far, with business investment still robust. Private consumption has slowed, however, partly as a result of the introduction of self-assessment for the personal income tax and other tax changes, which led to a surge in tax payments and pulled down disposable incomes. The effect on private consumption was cushioned by a steep fall in the household saving ratio.

Unemployment has started to rise and inflation is close to target

Employment continued to expand strongly through early 1999, with participation rates on the rise. A large number of jobs have been created in the service sector, while employment in manufacturing has shrunk. In the course of 1998, the unemployment rate declined to 6.2 per cent but it edged up in the first quarter of 1999. Meanwhile, earnings growth has slowed, falling to around the 4.5 per cent rate that the Bank of England deems compatible with the inflation target in the medium term. The recent evolution of vacancies, recruitment intentions and reported skill shortages also suggests that labour market tightening has ceased. Against this background, the

United Kingdom



1. All items excluding mortgage interest payments (RPIX).
Source: Office for National Statistics.

Employment, income and inflation

Percentage changes from previous period

	1996	1997	1998	1999	2000
Employment	1.1	1.6	1.4	–0.1	–0.2
Unemployment rate[a]	8.0	6.9	6.2	6.7	7.3
Compensation of employees	5.1	7.2	7.8	4.5	4.1
Unit labour cost	2.4	3.5	5.6	3.8	2.5
Household disposable income	5.4	6.8	2.5	4.1	4.6
GDP deflator	3.3	2.5	2.5	2.7	2.5
Private consumption deflator	3.1	2.4	2.1	2.4	2.4

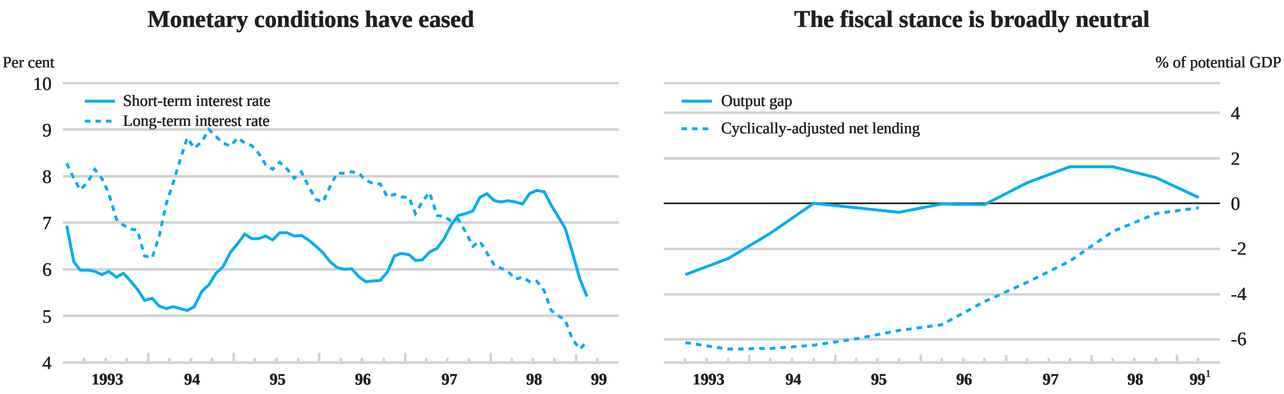
a) As a percentage of labour force.

rate of inflation has been remarkably stable, barely deviating since mid-1998 from the medium-term, symmetric target of 2.5 per cent a year for the retail price index excluding mortgage interest payments.* The upward pressures stemming from relatively tight labour market conditions have been offset by sustained declines in energy and commodity prices as well as the strength of the pound. Producers' output prices in manufacturing (excluding excise duties) have even declined, pulled down by falling import prices.

In the face of a softening economy and subdued inflationary pressures, the stance of monetary policy has been eased…

As signs of a sharp slowdown accumulated and expected inflation abated, the Bank of England cut its repo rate in steps between October 1998 and April 1999, from 7.5 to 5.25 per cent. Market rates dropped steeply as well, including at the long end, with 10-year government bond yields down to around 4.5 per cent by March 1999. The differential *vis-à-vis* euro area rates, however, remains significant, especially at the short end. Forward rates indicate that market participants expect further interest rate cuts this year. The Secretariat's interest rate projection is essentially

United Kingdom



1. Projection.

* Measured by the harmonised consumer price index developed under the auspices of Eurostat, inflation has recently been about one percentage point lower.

Financial indicators

	1996	1997	1998	1999	2000
Household saving ratio[a]	9.7	10.0	7.8	8.1	8.4
General government financial balance[b]	–4.4	–2.0	0.4	–0.2	–0.4
Current account balance[b]	–0.1	0.8	0.1	0.1	–0.1
Short-term interest rate[c]	6.0	6.8	7.3	5.4	4.5
Long-term interest rate[d]	7.8	7.0	5.5	4.4	4.6

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

in line with those expectations. Notwithstanding declining interest rates, the effective exchange rate of the pound has strengthened since last autumn.

… and the fiscal stance has become neutral

Following several years of vigorous fiscal consolidation efforts the 1999/2000 budget projects a small deficit, against a small surplus in the previous financial year. Adjusted for cyclical developments, this implies a broadly neutral fiscal stance. Some of the measures announced in previous budgets but implemented gradually – such as the abolition of advance corporation tax and introduction of quarterly corporation tax payments, or the increase in road-fuel duties – tend to tighten the fiscal stance. However, a series of new measures should support aggregate demand, including the introduction of a new lower 10 per cent personal income tax bracket, more generous investment tax credits, and additional public spending, particularly in the education and health sectors. The impact of recent interest rate drops on public debt service partly offsets the budgetary cost of these initiatives. Other important fiscal

Demand and output

Percentage changes, volume (1995 prices)

	1995 current prices billion £	1996	1997	1998	1999	2000
Private consumption	454.2	3.6	4.0	2.7	1.2	1.6
Government consumption	140.4	1.7	0.0	1.5	2.0	2.2
Gross fixed investment	108.7	4.9	6.9	8.3	2.1	1.5
Public[a]	15.9	–21.4	–8.5	2.8	10.7	7.2
Private residential	24.0	9.7	4.7	–0.3	–1.7	3.0
Private non-residential	68.8	8.8	10.0	11.5	2.1	0.4
Final domestic demand	703.3	3.5	3.7	3.4	1.5	1.7
Stockbuilding[b]	4.4	–0.4	0.3	0.0	0.0	0.0
Total domestic demand	707.7	3.0	3.9	3.5	1.5	1.7
Exports of goods and services	202.4	7.5	8.6	3.1	2.4	3.9
Imports of goods and services	205.2	9.1	9.4	8.4	4.1	4.1
Net exports[b]	–2.8	–0.5	–0.3	–1.8	–0.6	–0.2
GDP at market prices[c]	704.9	2.6	3.5	2.1	0.7	1.6
Manufacturing production	–	0.4	1.1	0.1	0.1	1.4

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

External indicators

	1996	1997	1998	1999	2000
	$ billion				
Merchandise exports	261.2	281.4	269.7	267	281
Merchandise imports	281.7	300.9	303.8	303	318
Trade balance	–20.4	–19.5	–34.0	–35	–37
Invisibles, net	19.5	29.6	35.2	37	35
Current account balance	–0.9	10.1	1.1	2	–2
	Percentage changes				
Merchandise export volumes[a]	8.2	7.6	0.0	1.3	4.3
Merchandise import volumes[a]	9.8	8.7	8.1	3.9	4.5
Export performance[b]	2.0	–1.8	–6.8	–3.6	–1.5
Terms of trade	1.1	1.5	2.2	1.7	0.4

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

measures comprise corporate income tax rate cuts, reductions in national insurance contributions on low wage earners, increased targeting of some social benefits, the abolition of mortgage-interest relief, the creation of a Research and Development tax credit, and the introduction of a climate change levy (some of these measures will become effective only in 2000 or 2001). On a national accounts and calendar year basis, the Secretariat projects marginally lower revenues and higher outlays than the authorities, reflecting weaker projected activity. Even so, the deficit should remain smaller than net government investment over the cycle, and debt should continue to decline as a share of GDP, in accordance with the rules governing fiscal policy. The public debt and deficit ratios as defined in the Maastricht Treaty should also remain well below the euro area average.

The cyclical slowdown is projected to be more benign than earlier ones…

Both domestic and foreign demand are projected to decelerate in 1999, bringing the economy close to recession, and pushing up unemployment towards its estimated structural rate. As the effects of monetary policy easing feed through, however, growth should pick up from around the second half of this year. Consistent with survey evidence, business investment is projected to decelerate considerably in 1999, contrasting with a continued public investment boost. The growth contribution of the external sector should remain negative, despite the projected import slowdown, largely reflecting earlier losses in competitiveness. Inflation should remain in the neighbourhood of the authorities’ target, with the effects of the introduction of the minimum wage and recent higher public sector pay settlements offset by lower private sector pay increases and a profit squeeze due to slowing activity.

… although downside risks remain

On the external side, there remains a downside risk posed by the possibility of a sharper than projected slowdown in the United States or in the euro area, or a worsening of conditions in Japan or the emerging markets. On the domestic side, the risks are more balanced. There is still a limited but genuine risk that real earnings will run too far ahead of productivity, prompting labour shedding and monetary policy tightening. The associated rise in unemployment would encourage precautionary saving and depress household consumption. On the other hand, consumer confidence remains strong and could underpin a more robust recovery.

Canada

The Canadian economy has regained considerable momentum in the wake of prolonged labour conflicts as buoyant US demand outweighed adverse effects of the Asia crisis and household confidence got a boost from an improving job market. Although activity is likely to be dampened by slower US growth in the period ahead, there are a number of mitigating factors. Exchange-rate depreciation last year has significantly enhanced Canada's competitive position; with the achievement of a budget surplus, fiscal policy is no longer acting as a drag on growth; and low inflation has allowed a decline in short-term interest rates.

Although a closing of the output gap during the course of next year cannot be excluded, given the uncertainties surrounding this measure monetary authorities should probe to see whether the economy could reach higher levels of output without inflation pressures. Such a flexible course of monetary policy would be facilitated by a continued focus on public debt reduction combined with reforms to the tax system.

Growth has rebounded, entailing an improvement in labour market conditions…

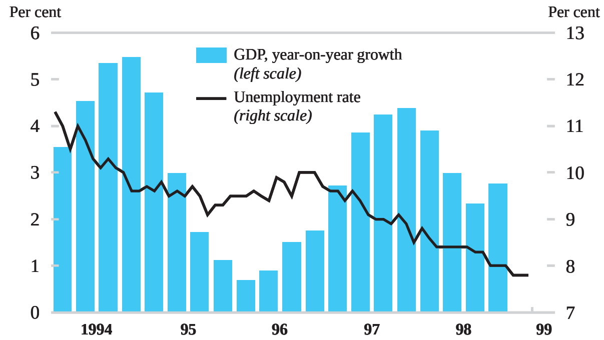
After slowing to below 2 per cent in the middle of 1998, real GDP growth accelerated to 4½ per cent (at an annual rate) in the fourth quarter, boosted by strong export demand and stock-building. To a considerable extent, this reflected the "gearing up" of the North American auto industry following strike-related shutdowns. However, both exports and domestic sales of machinery and equipment also grew at a healthy pace, given buoyant US demand and sharply rising spending on computers in Canada. By contrast, household expenditure remained relatively weak before strengthening more recently as consumer confidence rebounded in response to improving labour market conditions. Since the fourth quarter of 1998, the twelve-month rate of employment growth has exceeded 3 per cent, with young people benefiting disproportionately. The surge in job creation has been accompanied by substantial labour force re-entry of discouraged workers, as evidenced by a marked rise in the participation rate for the first time in the decade. Nevertheless, the unemployment rate has continued to decline, running below 8 per cent since the beginning of the year.

… while wage and price pressures have remained subdued

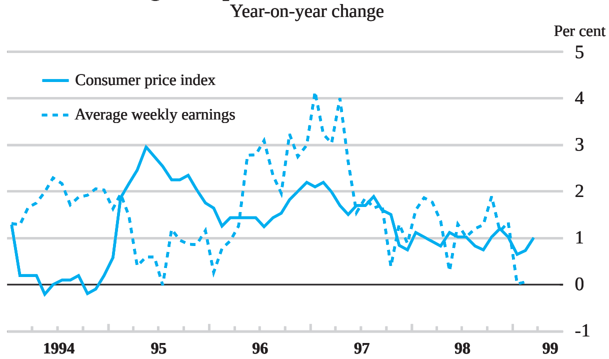
So far, improving labour market conditions have not led to significant wage pressures. Over the past eighteen months or so, both settlements and effective earnings have grown only slightly more than consumer prices. The latter have continued to increase at rates near the lower end of the official 1 to 3 per cent official target

Canada

Stronger growth has lowered unemployment



But wage and price inflation remain subdued
Year-on-year change



Employment, income and inflation

Percentage changes from previous period

	1996	1997	1998	1999	2000
Employment	1.2	1.9	2.8	2.3	1.7
Unemployment rate [a]	9.7	9.2	8.3	7.8	7.7
Compensation of employees	2.4	4.7	3.8	4.4	4.9
Unit labour cost	1.2	0.9	0.8	1.5	2.1
Household disposable income	1.7	2.3	3.0	4.1	4.9
GDP deflator	1.5	0.7	–0.4	1.0	1.9
Private consumption deflator	1.5	1.7	1.2	1.7	2.0

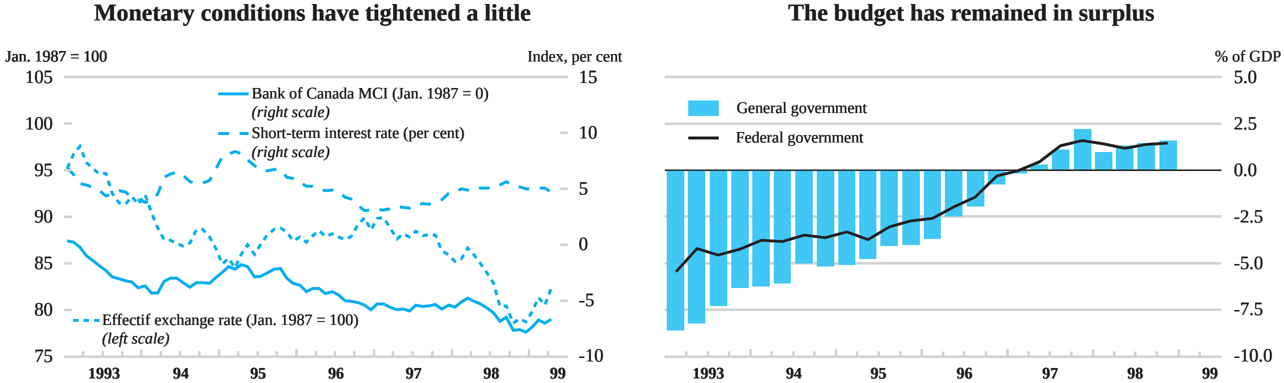
a) As a percentage of labour force.

band, even though exchange rate depreciation during 1998 has entailed a significant rise in import prices. This reflects the downward pressure on inflation from the persisting output gap and increased competition in retail trade. The overall price level – as measured by the GDP deflator – even declined through 1998 as Canada's terms of trade deteriorated substantially, although the lower exchange rate has allowed exporters to raise their prices somewhat in Canadian dollar terms. For 1998 as a whole, the adverse terms-of-trade effect on the external current account was largely offset by an improvement in the real foreign balance, owing in part to lower import volume growth as a result of the mid-year weakness in domestic demand and the more favourable competitive position of Canadian businesses.

Monetary conditions have tightened somewhat due to the recent firming of the exchange rate

Overall monetary conditions – as measured by the Bank of Canada's Index (MCI), which captures the combined effect of movements in short-term interest rates and the exchange rate – have tightened somewhat since late 1998. This largely reflects the recent appreciation of the Canadian dollar against both its US counterpart and most major currencies, against a background of stabilising commodity prices. Improved financial market conditions, coupled with the general firmness of recent domestic economic data, appear to have contributed to this. Short-term interest rates, which had been lowered in parallel with those in the United States in the autumn of 1998, remained broadly stable thereafter, but were cut again at the end of March.

Canada



Financial indicators

	1996	1997	1998	1999	2000
Household saving ratio [a]	5.5	2.2	1.2	1.4	1.9
General government financial balance [b]	–2.2	0.9	1.3	1.6	1.7
Current account balance [b]	0.5	–1.5	–2.1	–1.9	–1.9
Short-term interest rate [c]	4.4	3.5	5.0	4.8	4.7
Long-term interest rate [d]	7.5	6.5	5.5	5.2	5.2

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

Longer-term Canada/US interest-rate spreads narrowed gradually, turning negative in February. In the period following the Russian crisis, the emergence of such spreads had led the authorities to raise short-term interest rates markedly in order to counter financial turbulence, although this was not warranted by macroeconomic conditions. The Bank has indicated that the normalisation of financial conditions makes it now possible to re-focus attention on the medium-term policy objective of keeping the trend of inflation inside the target range. Both short- and long-term rates are assumed to move in line with those in the US markets, implying little change over the projection period.

The rise in the budget surplus has slowed as fiscal tightening comes to an end

The general government financial surplus (national accounts definition) increased to over 1¼ per cent of GDP in 1998, up from just under 1 per cent in the year before. According to OECD estimates, this partly reflected a further tightening of the fiscal stance – albeit to a lesser extent than over the 1995-97 period when discretionary measures were withdrawing 2 per cent of GDP per annum from aggregate

Demand and output

Percentage changes, volume (1992 prices)

	1995 current prices billion C$	1996	1997	1998	1999	2000
Private consumption	463.0	2.3	4.1	2.7	2.2	2.3
Government consumption	173.3	–2.5	–0.8	0.7	1.2	1.5
Gross fixed investment	136.6	6.6	11.1	4.2	4.5	5.8
Public [a]	20.5	–2.8	–8.2	4.5	4.5	3.5
Residential	36.2	10.2	12.4	–1.6	1.2	4.4
Non-residential	79.9	7.4	15.0	6.7	5.9	6.7
Final domestic demand	772.8	2.0	4.3	2.6	2.4	2.8
Stockbuilding [b]	8.8	–0.8	0.8	–0.4	–0.3	0.0
Total domestic demand	781.7	1.1	5.2	2.2	2.1	2.8
Exports of goods and services	302.3	5.9	8.0	8.1	6.8	6.1
Imports of goods and services	277.1	5.4	13.3	6.4	4.9	6.5
Net exports [b]	25.1	0.3	–1.5	0.7	0.8	0.0
Error of estimate [b]	0.0	–0.2	0.3	0.1	0.0	0.0
GDP at market prices	806.8	1.2	3.8	3.0	2.9	2.8
Industrial production	–	1.3	5.2	2.4	3.0	3.5

a) Excluding nationalised industries and public corporations.
b) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

External indicators

	1996	1997	1998	1999	2000
			$ billion		
Merchandise exports	205.1	217.4	218.0	238	258
Merchandise imports	174.4	199.9	204.9	221	240
Trade balance	30.7	17.5	13.1	17	18
Invisibles, net	–27.4	–26.8	–25.5	–28	–31
Current account balance	3.3	–9.2	–12.4	–12	–13
			Percentage changes		
Merchandise export volumes [a]	5.7	9.0	8.6	7.2	6.2
Merchandise import volumes [a]	5.6	16.1	7.9	5.1	6.4
Export performance [b]	–3.4	–4.4	–1.2	–0.3	1.6
Terms of trade	2.1	–1.5	–2.9	–0.9	0.1

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

demand. Budget surpluses have made for a rapid decline in the public debt-to-GDP ratio. However, at just below 90 per cent in gross terms and 61 per cent in net terms, the ratio is still high by international comparison. The further rise in the general government financial surplus in 1998 reflects developments at the federal level, with non-federal entities' budgets remaining in broad balance. The February 1999 federal Budget announced limited spending initiatives (especially for health care), which still imply some fall in the expenditure-to-GDP ratio, and some tax relief measures, which should lead to a gradual decline in the revenue ratio. The Government is only committed to "balanced budgets or better", but contingency reserves and prudent planning assumptions mean that substantial surpluses are likely to persist over the next two years. The few provinces which are still in a deficit position are committed to move toward budget balance over the same period. The projections assume that the general government surplus will increase marginally over the next two years, with little change in the structural budget balance.

Growth is projected to continue at a somewhat slower pace…

Recent indicators suggest that economic growth – albeit slowing somewhat – has remained robust and become more broadly based in the early part of 1999. Henceforth, the pace of activity is expected to fall back toward its potential rate, estimated by the OECD to have edged up to over 2½ per cent per annum. Underlying this outlook are several, partly offsetting, influences. The projected slowdown in the US economy would entail a significant decline in Canada's export market growth. At the same time, however, Canadian exporters should be able to gain market share, given the considerable improvement in the country's competitive position due to past exchange rate depreciation and subdued inflation. Moreover, some strengthening in domestic demand in response to the end of fiscal contraction, lower interest rates and rising consumer and business confidence should partly compensate for the reduced stimulus from abroad. There are few, if any, signs of domestic tensions that could jeopardise economic expansion over the projection period. Indeed, although exchange-rate pass through is likely to lead to price increases, inflation is not expected to exceed significantly the mid-point of the official target band, given its current low level and continued economic slack. Moreover, the external deficit is projected to remain limited in relation to GDP, at around 2 per cent, despite little further increase in real net exports, as terms-of-trade losses are expected to come to a halt.

… with risks to the outlook mainly relating to developments in the United States

In the absence of inflation or balance of payments pressures, the risks surrounding the economic outlook would seem to concern mainly developments beyond Canada's borders. In this respect, with the situation in Asia apparently stabilising, the future course of the US economy has moved to the foreground. Trade liberalisation in North America and the effects of the Asia crisis have meant that 85 per cent of Canada's merchandise exports now go to the United States, as compared with around 70 per cent in the late 1980s. Apart from the implied substantial direct trade effects of any significant change to the US outlook, developments in Canada's neighbour country could also complicate the conduct of monetary policy. Even if not warranted by domestic economic conditions, it might be difficult for the authorities not to follow any eventual rise in US interest rates if overheating conditions develop there.

Australia

Economic growth surged to 5 per cent in 1998 on the back of buoyant consumption expenditures. This boosted employment growth, cutting unemployment to 7½ per cent. Growth is likely to slow in 1999 owing to weakening investment and government consumption but to strengthen somewhat in 2000 as investment and exports recover. Recovering export markets and improving terms of trade should lower the current account deficit to just below 5 per cent of GDP in 2000.

The strong economic performance, despite the Asian crisis, can be attributed to sound macroeconomic policies and ongoing microeconomic reform. Fiscal policy should remain geared to preserving consolidation gains so as to maintain financial market confidence in the face of the large current account deficit. In view of the projected slackening in growth and the subdued outlook for inflation (abstracting from the effect of introducing the Goods and Services Tax), monetary policy should remain accommodative.

Growth accelerated further in 1998…

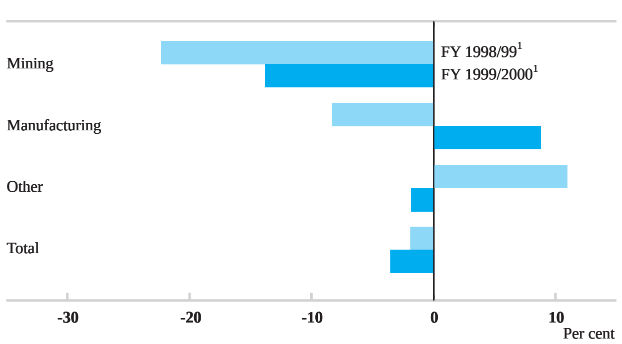
The pick up in growth since early 1997 was sustained through 1998 despite the turmoil in Asia, with growth in GDP close to 5 per cent. The main driving force was private consumption expenditure, underpinned by wealth effects from the Australian Mutual Provident Fund (AMP) demutualisation and stock market capital gains. Consumer sentiment strengthened considerably in the latter part of 1998 and early 1999, to its highest level in four years, with retail sales data suggesting that consumption has remained strong. Investment growth also continued but at a slower pace than in 1997. The latest Survey of Capital Expenditure intentions points to a downturn in new private business investment, although other indicators point to a less weak outcome. The weakening in the investment intentions mainly reflects a sharp fall in mining investment in response to low commodity prices and the completion of Olympic-related construction projects. Although the housing cycle has peaked, there does not appear to be an overhang of excess supply. Buoyant domestic conditions, depressed export markets and a sharp fall in the terms of trade resulted in an increase in the current account deficit to 5 per cent of GDP in 1998 from 3 per cent a year earlier.

… and unemployment fell to the lowest rate since 1990

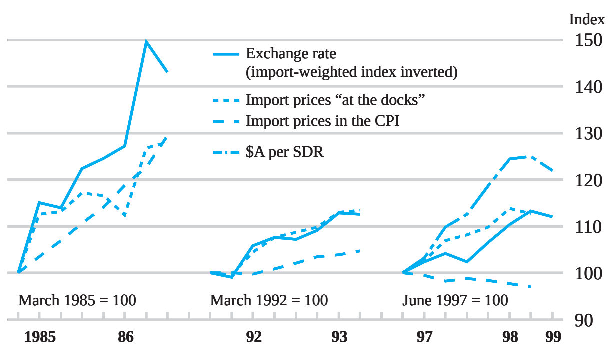
The solid growth in employment in 1998 continued in early 1999, cutting the seasonally adjusted unemployment rate to 7.4 per cent in March, the lowest rate since September 1990; and vacancy data point to further healthy gains in employment in

Australia

New private investment is expected to weaken



Retail prices of imports continue to fall



1. Percentage changes over previous fiscal year using 5-year average realisation ratio.
Sources: ABS, *Private New Capital Expenditure Survey* and Reserve Bank of Australia.

coming months. Even so, wage increases have slowed recently to an annual rate of around 3½ per cent.

Inflation remains low but imported inflation may resume

The inflation rate remains low at around 1½ per cent, below the authorities' medium-term inflation objective (2 to 3 per cent). Prices for imports in the consumer price index have continued to fall, despite a significant depreciation in the exchange rate since early 1997. Owing to competitive pressures, foreign exporters, wholesalers and/or retailers have absorbed the costs of the depreciation. Excess supply in many markets for manufactured goods, following the Asian crisis, has undoubtedly contributed to this outcome, which stands in contrast to historical experience. As these markets recover, imported inflation may return.

Demand, output and prices

Percentage changes, volume (1996/97 prices)

	1995 current prices billion A$	1996	1997	1998	1999	2000
Private consumption	292.6	3.0	3.4	4.3	4.3	4.2
Government consumption	91.1	2.6	2.1	5.5	1.5	3.8
Gross fixed capital formation	110.8	5.3	11.5	5.1	–0.5	1.2
Final domestic demand	494.6	3.4	4.9	4.7	2.7	3.4
Stockbuilding [a]	3.0	–0.3	–1.6	1.8	0.1	0.2
Total domestic demand	497.6	3.1	3.3	6.6	2.8	3.6
Exports of goods and services	93.6	10.5	11.7	–0.8	4.5	7.0
Imports of goods and services	100.6	8.2	10.0	6.1	4.4	6.0
Net exports [a]	–7.0	0.4	0.3	–1.4	0.0	0.1
Statistical discrepancy [a]	–0.1	0.1	0.0	–0.1	0.4	–0.3
GDP at market prices	490.5	3.6	3.6	5.1	3.2	3.4
GDP deflator	–	2.4	1.4	0.7	1.4	2.8
Memorandum items						
Private consumption deflator	–	2.1	1.4	1.7	1.9	3.0
Industrial production	–	4.3	2.9	1.0	0.8	1.5
Unemployment rate	–	8.5	8.6	8.1	7.5	7.4
Household saving ratio [b]	–	6.4	4.3	2.5	1.0	1.3
General government financial balance [c]	–	–2.0	–0.6	0.5	1.1	0.7
Current account balance [c]	–	–3.9	–3.1	–5.0	–5.2	–4.7

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) As a percentage of disposable income.
c) As a percentage of GDP.

Monetary conditions are accommodating and fiscal consolidation is slowing

With inflation low, the officially targeted interest rate (the cash rate) was lowered by 0.25 percentage point in December 1998, to 4.75 per cent. This, together with the previous cuts and the depreciation of the exchange rate, should continue to support activity over the coming year. The ten-year government bond rate has increased slightly to 5½ per cent. Now that both Commonwealth and State budgets have returned to surplus, less fiscal consolidation is planned than in recent years. It is assumed that the government's tax package, involving the introduction of the Goods and Services Tax (GST) in July 2000, is implemented in full. This package entails a net budget cost in fiscal year 2000/01 of about 0.7 percentage point of GDP. The general government budget surplus should rise slightly in 1999 but fall back to ¾ per cent of GDP in 2000.

Economic growth is projected to slow but inflation is likely to rise

Economic growth is projected to slow in 1999 to around 3¼ per cent, mainly as a result of weakening investment expenditures, but to rise somewhat in 2000 as investment and exports recover. With employment growth easing, the unemployment rate is projected to remain around 7½ per cent over the coming two years. Inflation is projected to pick up to around 3 per cent in 2000, including a 1 percentage point contribution from the tax package. With export markets recovering, the current account deficit is projected to decline to 4¾ per cent of GDP in 2000. The major risk to these projections is that the recovery in Asia may turn out to be weaker than expected. A further risk is that foreign exporters and/or import distributors may endeavour to re-build their profit margins, increasing imported inflation.

Austria

After growing rapidly in the first half of 1998, slowing exports and reduced investment activity have led to a deceleration in activity and business sentiment has become less optimistic. However, the slowdown should be contained, since private consumption activity is projected to remain strong and investment should continue to grow moderately. Rising exports should lead to a gradual pick-up in activity in the second half of 1999, with growth projected to amount to 2¼ per cent this year and some 2½ per cent in 2000.

The budget deficit target should be sufficient to ensure adherence to the 3 per cent Stability and Growth Pact commitment under normal cyclical conditions. But decisions about financing of the tax reform are still to be taken, and public spending pressures are growing. Longer-term fiscal sustainability will require tighter control of entitlement spending. Although recent growth performance has been good, competition needs to be promoted in a number of sectors and the barriers to a more entrepreneurial environment relaxed.

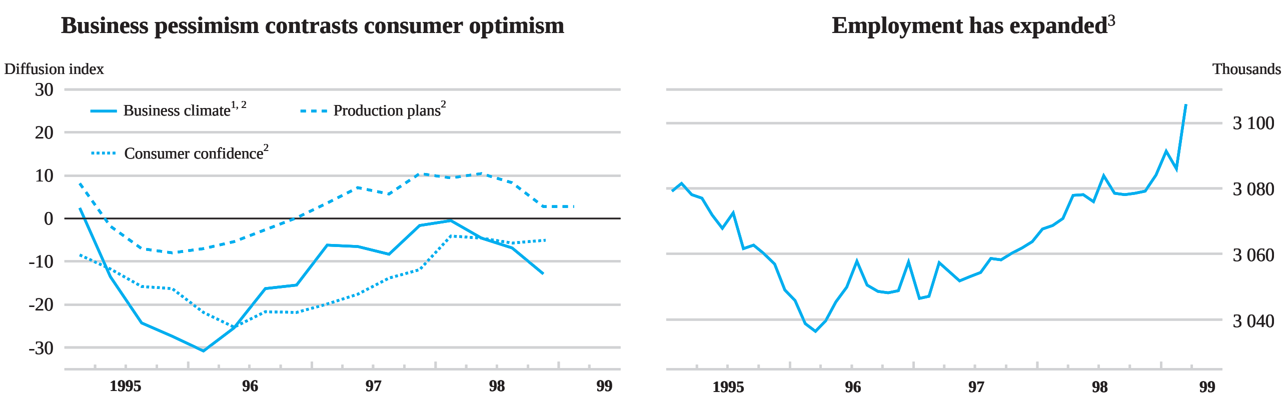
Activity slowed during the second half of 1998

Following very strong growth in the first half, activity decelerated markedly during the second semester and the business climate became less optimistic; GDP nevertheless grew by 3.3 per cent in 1998. Key to the deceleration was a marked slowing in exports, which in turn led to a reduction in the pace of investment in plant and machinery. Other areas of domestic demand remained quite strong. Consumer expenditures grew rapidly driven in part by employment growth, lower price inflation and moderate wage growth. Construction demand was also significant due to apartment renovation, which was encouraged by the impending expiration of tax incentives at the end of the year (although these have now been extended until the end of 1999).

Monetary conditions and fiscal policy are providing a favourable framework for growth

With inflation projected to remain low, monetary conditions in the euro area are expected to remain supportive of growth through this year and next. Since the beginning of the year, the nominal effective exchange rate of the euro has depreciated, partly offsetting the appreciation which occurred in the wake of the Asian crisis. Unit labour costs have also developed favourably in Austria so that international competitiveness has strengthened. Following several years of marked fiscal consolidation,

Austria



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

Demand, output and prices

Percentage changes, volume (1983 prices)

	1995 current prices billion Sch	1996	1997	1998	1999	2000
Private consumption	1 311.1	2.0	0.7	1.8	2.0	2.1
Government consumption	469.4	0.6	–3.9	1.5	1.5	1.5
Gross fixed capital formation	554.0	2.5	2.8	5.3	3.6	4.3
Final domestic demand	2 334.6	1.9	0.5	2.7	2.4	2.6
Stockbuilding [a]	3.8	–0.1	1.4	0.3	0.0	0.0
Total domestic demand	2 338.3	1.7	1.8	2.9	2.3	2.5
Exports of goods and services	900.9	6.9	10.1	7.5	4.0	5.6
Imports of goods and services	910.5	6.3	8.7	6.8	4.2	5.5
Net exports [a]	–9.6	0.2	0.7	0.4	–0.1	0.1
GDP at market prices	2 328.7	2.0	2.5	3.3	2.2	2.6
GDP at market prices in billion euros	169.2					
GDP deflator	–	1.7	1.6	1.2	1.0	1.4
Memorandum items						
Private consumption deflator	–	2.9	2.0	0.9	0.7	1.2
Industrial production	–	0.6	5.9	6.5	3.0	4.5
Unemployment rate [b]	–	6.3	6.4	6.4	6.3	6.1
Household saving ratio [c]	–	7.8	7.4	8.6	9.1	9.7
General government financial balance [d]	–	–3.7	–1.9	–2.1	–2.2	–2.1
Current account balance [d]	–	–2.2	–2.4	–2.1	–2.0	–2.1

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) See data annex for details.
c) As a percentage of disposable income.
d) As a percentage of GDP.

which has directly affected household disposable incomes, fiscal policy is projected to be neutral this year and next. The structural budget deficit should remain at around 2 per cent of GDP. The government has agreed a tax reform to take effect next year with net relief of around ½ per cent of GDP. Financing has not been decided and the reform has not been included in the projection.

Growth is slowing but a pick-up is expected later this year

Less optimistic business sentiment and lower incoming export orders point to a deceleration of growth in the first half of the year, but the downturn should be limited. Business sentiment has not deteriorated to the same extent as in Germany and there are some signs that business plans are stabilising. Moreover, with household disposable incomes rising, consumption should serve to underpin activity. Investment plans, although less optimistic, also indicate continuing growth of capital expenditures. With competitiveness strong, Austria should be well placed to take advantage of the projected acceleration of world export market growth in the course of the year and into 2000. GDP growth is projected to slow to around 2¼ per cent this year and to accelerate to 2½ per cent next year.

External risks remain significant

Risks to the outlook appear to be evenly balanced. Downside risks to the projection would arise if activity in surrounding countries, especially Germany, were to be weaker than projected. With respect to upside risks, the output gap is smaller than in a number of other countries in the euro area, so that area-wide monetary policy could at some stage prove unsuitable. But excess demand would be more likely to be reflected at first in the current account rather than in prices.

Belgium

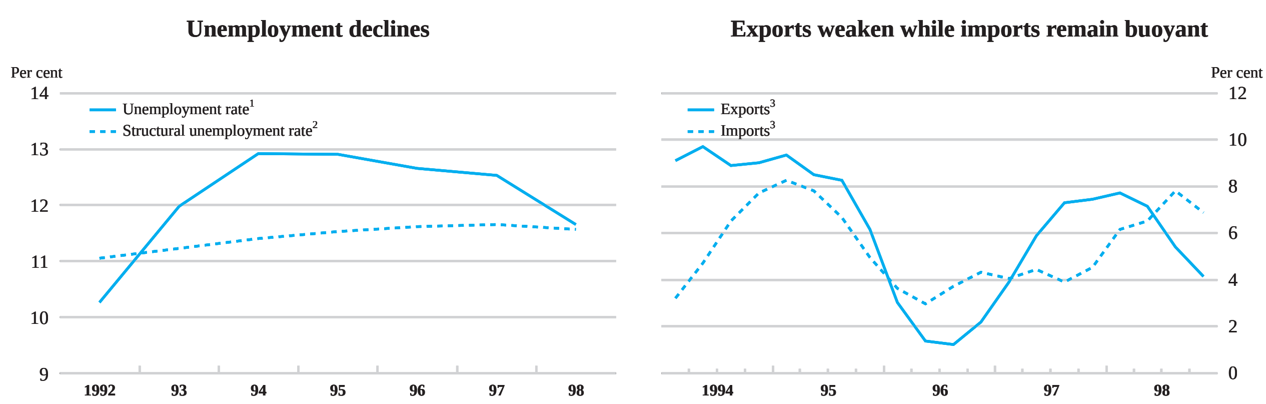
Real GDP growth is expected to slow to 2 per cent in 1999, but may pick up again in 2000 – both developments being essentially export driven and reflecting the evolution of foreign markets. With the output gap progressively closing, the labour market will tighten further, although no major inflationary pressures are expected over the projection period. The general government deficit may edge down to less than 1 per cent of GDP, and the debt-to-GDP ratio may ease to 110 per cent in 2000.

Policy should be focused on enhancing the non-inflationary rate of growth of the economy and increasing the low employment rate. Various structural reforms could be used, the priority being on returning low-skilled workers to the active labour force through better skills and qualifications, stronger incentives to work, and a more flexible wage formation process.

Growth has slowed, reflecting weaker exports

Economic growth slowed markedly during 1998, to 1.6 per cent in the fourth quarter, but is estimated to have been close to 3 per cent for the year as a whole. Foreign trade has become a drag on GDP growth: exports have weakened markedly, due to a fall in demand for intermediate goods; on the other hand, reflecting the strength of domestic demand and private consumption in particular, imports have barely decelerated. The unemployment rate has fallen significantly – to 8.4 per cent in February 1999 on a standardised basis and to 12 per cent on national definitions. The output gap, as estimated by the OECD, has narrowed to 1 per cent of potential GDP. The wage-cost performance has remained relatively good reflecting, among other factors, the Law on Employment and Competitiveness* and a fall in import prices. After declining to around ½ per cent in late 1998, consumer price inflation has picked up to 1.2 per cent in the twelve months to March 1999, partly because of a more rapid increase in food prices.

Belgium



1. National definition (registered unemployment as a percentage of labour force), end-of-June figures, not seasonally adjusted.
2. OECD estimates (NAWRU).
3. Four-quarter moving average, customs basis.

Sources: National Bank of Belgium and OECD.

* 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.

With the stance of fiscal policy broadly unchanged, growth will largely depend on the external sector…

First estimates indicate that the commitment of the Belgian authorities to keep the primary surplus (*i.e.* excluding interest payments) at around 6 per cent of GDP was respected in 1998; and, with (net) interest payments falling, the overall budget deficit may have declined to 1.3 per cent of GDP. The better than anticipated outcome with respect to the budget deficit in 1998 allowed the government to introduce some additional tax cuts and spending initiatives in the 1999 Budget. All considered, the stance of fiscal policy is expected to be broadly neutral over the projection period: the overall deficit may edge down to less than 1 per cent of GDP, and the debt-to-GDP ratio may fall to 110 per cent in 2000. After falling sharply until October 1998, the conjunctural indicators of the National Bank of Belgium – which lead economic activity by only a few months – have rebounded in early 1999. As in the past, this business cycle has been closely synchronised with that on average in neighbouring countries. However, the cycle in Belgium is typically affected by the relative specialisation of the country in the production and export of intermediate goods which react quickly and strongly to the evolution in Belgium's principal markets. Having suffered from this factor in 1998, Belgium now stands to benefit from it from mid-1999 as economic activity in the euro area starts to strengthen.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion BF	1996	1997	1998	1999	2000
Private consumption	5 071.2	1.8	2.1	3.6	2.3	2.2
Government consumption	1 181.9	1.4	0.8	1.5	1.9	1.6
Gross fixed capital formation	1 430.2	0.5	5.4	4.7	3.4	3.6
Final domestic demand	7 683.4	1.5	2.5	3.5	2.5	2.4
Stockbuilding [a]	32.6	–0.2	–0.3	0.3	–0.1	0.0
Total domestic demand	7 715.9	1.3	2.2	3.8	2.4	2.4
Exports of goods and services	5 394.6	2.2	7.1	4.8	3.2	5.5
Imports of goods and services	5 042.4	2.2	6.3	6.1	3.9	5.8
Net exports [a]	352.2	0.1	0.9	–0.8	–0.4	–0.1
GDP at market prices	8 068.1	1.3	3.0	2.9	1.9	2.2
GDP at market prices in billion euros	200.0					
GDP deflator	–	1.6	1.4	1.9	1.5	1.5
Memorandum items						
Private consumption deflator	–	2.3	1.8	1.0	1.3	1.4
Industrial production	–	1.0	4.8	3.4	1.0	2.0
Unemployment rate	–	12.7	12.5	11.7	11.1	10.9
Household saving ratio [b]	–	13.4	12.5	11.6	11.4	11.3
General government financial balance [c]	–	–3.1	–1.9	–1.3	–1.0	–0.8
Current account balance [c]	–	4.2	4.7	4.2	4.3	4.3

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) As a percentage of disposable income.
c) As a percentage of GDP.

… and may pick up again in 2000

After slowing to around 2 per cent in 1999, real GDP growth may reach 2¼ per cent in 2000, driven by the external sector. Exports are projected to strengthen significantly, reflecting somewhat stronger growth in the euro area as well as a recovery of world trade more generally. While imports are also expected to be more buoyant, the negative contribution of the foreign balance to growth – which was of the order of

¾ per cent of GDP in 1998 – may be largely erased by 2000. With real GDP growth slightly exceeding the trend rate, the output gap will narrow further – to around ½ per cent in 2000 – and the employment situation is likely to continue to improve, albeit at a slow pace. In view of the recent global wage agreement between the social partners – who accepted as a guideline for sectoral wage negotiations the wage increases indicated by the Law on Employment and Competitiveness – and rebounding but still subdued import prices, major inflationary pressures are not expected to emerge in 1999-2000. The risks and uncertainties attaching to these projections are mainly related to developments abroad, and particularly to the strength of the upturn in the euro zone.

Czech Republic

GDP fell by 2.7 per cent in 1998 as depressed wages, falling employment and tight credit conditions generated a substantial drop in domestic demand. Initially strong net exports helped maintain output, but as the year progressed the currency strengthened causing exports to slow and the recession to deepen. For the year as a whole, however, trade performance was strong and the current account deficit fell to 2 per cent of GDP. Falling import prices and other external factors contributed to a sharp decline in inflation from about 13 per cent in March 1998 to less than 3 per cent in March 1999. The koruna depreciated by more than 10 per cent early in 1999, which is expected to restore competitiveness along with a modest increase in consumption and contribute to a recovery beginning later this year.

Low interest rates and a historically high general government deficit will contribute to the recovery in domestic demand, but further stimulus should be avoided. The rapid clean up and privatisation of the banking-sector remains a policy priority. In order to hasten consolidation, the government should clarify its policy towards the restructuring of large-scale industry.

The recession intensified in the second half of 1998 and early 1999…

The decline in GDP observed in the first half of 1998 accelerated during the final six months, reflecting weak consumption, falling investment activity and a marked deterioration in net foreign sales over the course of the year. Initially following the 1997 depreciation of the currency, exports grew very rapidly and import growth slowed. However, as the koruna progressively strengthened during 1998 and growth in export markets contracted net exports began to decline, deepening the recession. Despite this end of the year deterioration, trade performance for the year as a whole was much improved over the year before and the current account deficit for 1998 fell to $ 1 billion (from $ 3.3 billion in 1997).

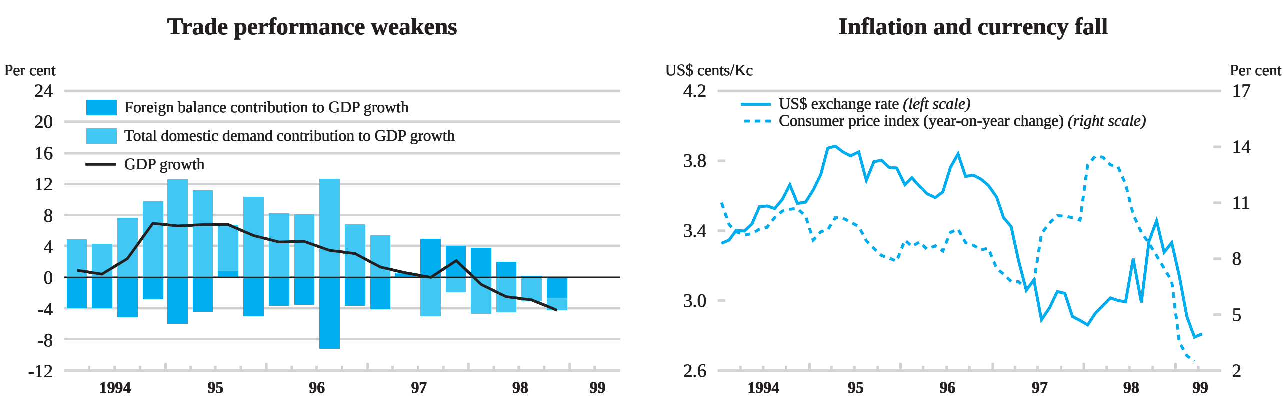
… resulting in further rises in unemployment and falling inflation

Weak demand conditions were reflected in a substantial decrease in retail sales and, in the fourth quarter, falling industrial output – trends that have continued early in 1999. Unemployment continued rising, reaching 7.1 per cent at the end of 1998. These conditions, plus world price developments and the strong currency contributed to the substantial decline of inflation, from 13.4 per cent in March 1998 to just 2.5 per cent by March 1999. Most recently, despite a moderation of nominal wages, this rapid disinflation has translated into rising real wages.

With macroeconomic policy easing, the general government deficit increased significantly…

Net inflation (*i.e.* price increases of non-regulated goods and services) fell to 1.7 per cent at the end of 1998, well below the central bank's target of 6 ±0.5 per cent. Beginning in the summer of last year, the Bank responded with a series of interest rate reductions, and monetary conditions were further eased by a 10 per cent

Czech Republic



depreciation of the koruna between December 1998 and February 1999. The stance of fiscal policy has also been expansionary. Falling revenues and increased expenditures caused the consolidated government deficit to rise to an estimated 2.5 per cent of GDP in 1998, a figure that the 1999 budget projects to deteriorate by a further 12 billion koruna (0.4 per cent of GDP).

… while the slow pace of restructuring limited productivity and output gains

Industrial restructuring and banking-sector privatisation has proceeded only slowly. Of the three large banks with still substantial state shareholdings, one has recently entered into the final stages of its privatisation while the process is only just starting for the two others. The banking-sector remains burdened by bad loans and the central bank has reinforced provisioning requirements. As a result, credit conditions are very tight and a number of client firms that previously had ready access to credit have been forced to undertake long-delayed restructuring efforts. In addition, the prospect of continued direct or indirect government support of large, loss-making firms has delayed their consolidation.

Demand, output and prices

Percentage changes, volume (1994 prices)

	1995 current prices billion Kc	**1996**	**1997**	**1998**	**1999**	**2000**
Private consumption	667.6	7.1	1.7	–2.3	1.2	1.5
Government consumption	281.5	4.1	–2.1	1.0	1.8	0.6
Gross fixed capital formation	442.4	8.7	–4.9	–3.7	–2.0	3.1
Final domestic demand	1 391.5	7.0	–1.2	–2.1	0.3	1.8
Stockbuilding [a]	16.9	1.6	0.9	–1.2	–0.7	0.0
Total domestic demand	1 408.4	8.5	–0.4	–3.2	–0.3	1.8
Exports of goods and services	755.8	5.4	10.2	11.5	5.8	6.7
Imports of goods and services	815.5	12.9	6.7	9.0	5.4	5.5
Net exports [a]	–59.7	–5.0	1.4	0.8	–0.1	0.5
GDP at market prices	1 348.7	3.9	1.0	–2.7	–0.5	2.4
GDP deflator	–	9.4	6.6	10.7	5.4	6.1
Memorandum items						
Private consumption deflator	–	8.0	7.9	9.9	4.3	6.3
Industrial production	–	1.6	4.8	3.4	2.0	3.4
Unemployment rate	–	3.9	4.7	6.5	7.7	8.5
General government financial balance [b]	–	–0.4	–1.2	–2.5	–3.6	–4.0
Current account balance [b]	–	–7.6	–6.1	–1.9	–2.2	–2.2

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) As a percentage of GDP.

Output is expected to begin recovering during 1999…

Real wage gains and the recent depreciation of the koruna will provoke a recovery of both internal and external demand during the course of 1999, but for the year as a whole GDP will decline somewhat before increasing moderately in 2000. Higher food, commodity and import prices should reverse some of the recent falls in inflation while unemployment will continue to rise in 1999 before stabilising in 2000. These weaker than anticipated demand conditions are projected to result in lower than budgeted government revenues and a rise in the general government deficit to around 3.5 per cent.

... but growth prospects could be compromised by a slow restructuring of the banking sector

The slow pace of industrial restructuring and banking-sector privatisation poses the most serious down-side risk for the Czech economy. In the near term, tight credit conditions and poor productivity performance may prevent even the modest output gains projected here. Over the medium term, additional delays in the privatisation of the banking sector or a slow implementation of the government's revitalisation programme that does not include a credible restructuring plan and the sale of bailed-out firms to strategic investors could negatively affect the economy's potential for a protracted period.

Denmark

The economic upswing has slowed as export growth faltered in the wake of adverse cost developments and weaker export market growth, but private consumption growth has remained strong. Falling interest rates and continued high real income growth have offset the effect of the 1998 tax reform aimed at raising household savings. The tight labour market has widened inflation differentials between Denmark and the European Economic and Monetary Union member countries, making for rather low real interest rates. Growth is projected to slow this year to around 1½ per cent, recovering to 2 per cent in 2000, close to potential growth in the economy.

Recent labour market reforms are adding to the supply potential of the economy, but need to be extended. While wage increases are less rapid than would have been expected from past experience, price and wage developments significantly above other European countries are evidence of an economy at full stretch. The general government balance remains in surplus over the projection period, but a stricter control of public expenditure is needed to reduce the risk of an overheating and a further deterioration of export performance.

Growth has been faster than projected

For the fifth year running the Danish economy grew substantially above its potential in 1998, although the pace slowed during the year as business investment and export growth weakened, leading to a surge in inventories. Private consumption growth remained at 3½ per cent, whereas public consumption accelerated to above 2 per cent. Despite a significant negative contribution from net exports, real GDP growth stayed around 3 per cent.

Unemployment has continued to fall and the current account deficit has widened

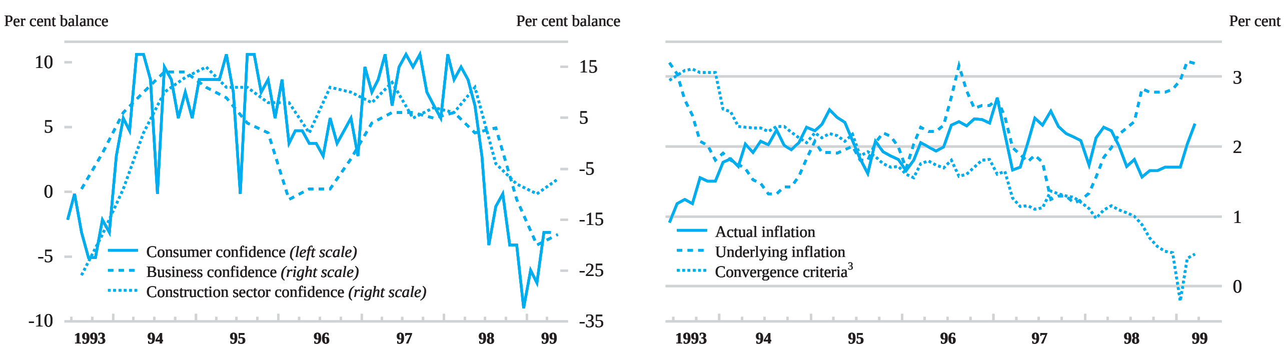
Unemployment fell to 6 per cent in early 1999 as strong private-sector – and to a lesser extent public-sector – employment growth outpaced labour supply growth during 1998. Wage growth picked up during the year, reaching 4½ per cent by the end of 1998, while higher indirect labour costs also added to overall labour-cost growth. Consumer price inflation was running at 2 per cent in early 1999 as lower import and raw material prices continued to suppress overall inflation. However, underlying inflation was running at 3 per cent.

Stimulatory monetary conditions…

Following the widening in spreads due to the international financial market disturbances in the autumn of 1998, interest rate differentials *vis-à-vis* the euro area

Denmark

Confidence has declined[1] | **Underlying inflation is picking up**[2]



1. Seasonally adjusted. Balance between positive and negative answers.
2. Year-on-year percentage changes.
3. Average of the three best performing Euro countries with respect to inflation in early 1999.

Sources: Danmarks Statistik; Ministry of Economics; OECD.

were restored during the first quarter of 1999. Subsequently, the short-term interest rate fell below 3 per cent with long term interest rates about 1¼ percentage point higher. The krone has remained stable against the euro, whereas the nominal effective exchange rate has depreciated by almost 4½ per cent since autumn 1998.

... are accompanied by surpluses in the general government balance

A projected tightening of fiscal policy was supposed to have restricted GDP growth by ½ percentage point in 1998, but current estimates indicate at best a neutral fiscal impact. The 1999 budgets for central and local governments point to a relatively unchanged fiscal stance (when adjusted for a conversion of a forced savings scheme to a direct tax which pushes up the budget surplus but does not affect household behaviour). In the absence of any announced changes in policy, a broadly neutral stance is also assumed in 2000. Combined with a moderation of the GDP growth rate, the surplus in the general government balance should increase to above 2 per cent of GDP in 1999 before falling back to below 2 per cent in 2000.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion Dkr	1996	1997	1998	1999	2000
Private consumption	515.9	2.7	3.6	3.5	2.2	1.9
Government consumption	259.2	3.2	1.1	2.6	1.9	1.0
Gross fixed capital formation	189.2	4.9	10.6	6.1	1.9	2.1
Final domestic demand	964.3	3.3	4.4	3.8	2.1	1.7
Stockbuilding [a]	2.0	0.0	0.1	0.9	–0.8	0.0
Total domestic demand	966.4	3.3	4.5	4.8	1.3	1.7
Exports of goods and services	357.2	3.7	5.5	0.1	1.5	3.5
Imports of goods and services	314.8	3.7	9.8	4.7	0.7	2.8
Net exports [a]	42.4	0.1	–1.3	–1.7	0.3	0.3
GDP at market prices	1 008.8	3.3	3.1	2.9	1.6	2.0
GDP deflator	–	2.2	1.8	1.4	2.6	2.8
Memorandum items						
Private consumption deflator	–	1.5	2.2	1.7	2.3	2.6
Industrial production	–	1.3	4.8	1.5	2.7	2.6
Unemployment rate	–	8.7	7.7	6.3	5.7	5.8
Household saving ratio	–	5.4	4.0	5.8	4.7	5.0
General government financial balance [b]	–	–1.0	0.2	1.0	2.4	1.9
Current account balance [b]	–	1.7	0.5	–1.4	–1.5	–1.0

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) As a percentage of GDP.

Imbalances persist…

A stimulatory monetary stance, combined with continued employment and real wage growth, should underpin private consumption growth of 2 per cent a year over the projection period. The housing investment outlook remains weak, however, and a reversal of the 1998 inventory build-up is also projected. Business fixed investment growth should decelerate in the face of weaker export growth as a softer situation in export markets combines with unfavourable cost developments to lead to continuing market share losses. On balance, GDP growth could dip to 1½ per cent in 1999 before picking up to near potential growth of 2 per cent in 2000. Employment growth will decelerate to more sustainable levels, stabilising unemployment at around 6 per cent, but even so wage inflation is likely to increase. Higher indirect taxes and less favourable external price developments could lead to consumer price inflation of 2½ per cent in 2000.

… implying that inflation and the external account remain at risk

The inflation outlook could be at risk if the recent labour market reforms are less effective than expected in moderating wage increases. Inflation differentials *vis-à-vis* the European Economic and Monetary Union could thus continue to increase, entailing higher premiums on Danish securities in international markets. More generally, without additional tightening of fiscal policy and further labour-market reforms, there is a risk that demand growth will continue to outstrip supply, widening the current-account deficit and increasing inflationary pressures.

Finland

Real GDP growth decelerated in 1998 due to weaker exports but remained far above the euro area average. With external conditions still subdued, economic growth is projected to continue to slow somewhat in 1999. Unemployment is likely to decline further but inflationary pressures should remain low, helped by a further drop in import prices and wage moderation, which will last at least until the current pay agreement expires in 2000.

The sustainability of strong growth largely hinges on realising continued wage moderation. In this context, the outcome of the wage negotiations for 2000 will be crucial. With the euro in place, excessive wage increases could lead to heavy employment losses, as the option to devalue is no longer available. Furthermore, the coming agreement should allow for greater wage flexibility, for instance greater differences in wage rises across industries, thereby decompressing the wage structure.

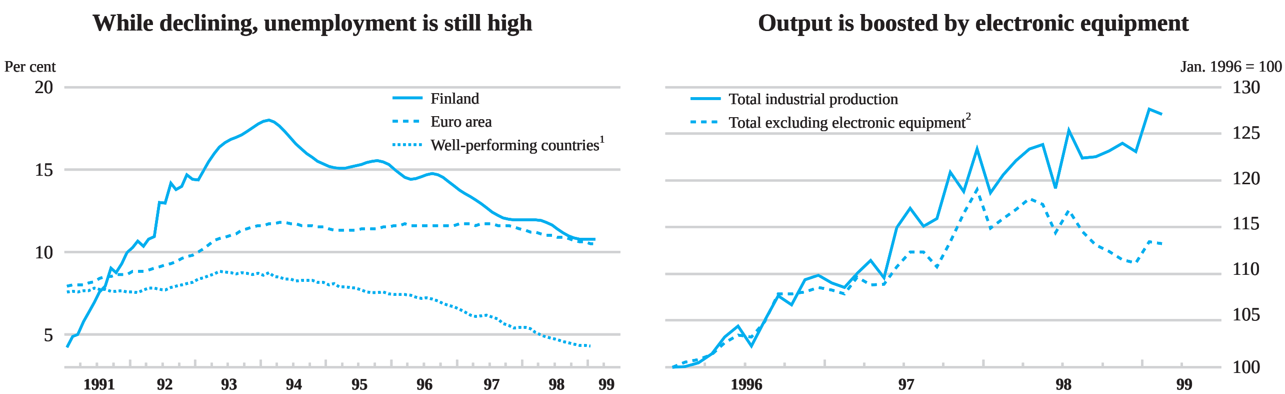
The economy slows down and overheating risks fade away

The Finnish economy continued to perform strongly in 1998, with real GDP rising much more than on average in the euro area, employment increasing rapidly, the current account surplus reaching a new record high and the general government budget moving into surplus, the first positive balance since 1991. As employment and profits grew rapidly and interest rates became very low, domestic demand was boosted and became the driving force of the Finnish economy. During 1998, weaker world demand led to a slowdown in activity and the overheating risk diminished significantly. In early 1999, real GDP was 3 per cent higher than a year earlier, compared with more than 6 per cent in early 1998. Industrial production excluding electronic equipment has even been falling since mid-1998. Exports to Russia plunged after August, but as its trade share has dropped substantially during the 1990s, to 7 per cent, the negative direct impact on real GDP was minor, an estimated 0.1 per cent in 1998. Wage inflation remained moderate due to the two-year wage agreement of December 1997, but the sharp increase in overtime and bonuses boosted incomes. Price inflation edged down further during the year, mainly reflecting the oil price collapse and lower prices of most other imported commodities.

The government budget moved into surplus

Overall, the fiscal stance has remained tight, with the government budget moving into a surplus of 1.5 per cent of GDP in 1998. The 1999 Budget contained a moderate cut in income tax rates by half a percentage point, which was more than

Finland



1. Weighted average of the standardised unemployment rates for Denmark, Ireland and the Netherlands.
2. Total industrial production excluding electronic, electrical and optical equipment.
Sources: Eurostat and Statistics Finland.

Demand, output and prices

Percentage changes, volume (1995 prices)

	1995 current prices billion Mk	1996	1997	1998	1999	2000
Private consumption	291.8	3.5	2.6	4.5	4.1	3.5
Government consumption	128.2	2.5	2.9	0.4	0.5	0.8
Gross fixed capital formation	90.5	8.6	14.1	8.2	5.4	6.6
Final domestic demand	510.4	4.2	4.8	4.3	3.6	3.6
Stockbuilding [a]	7.2	–1.5	0.8	0.0	0.3	–0.1
Total domestic demand	517.7	2.5	5.7	4.3	3.9	3.5
Exports of goods and services	209.3	6.1	14.2	8.3	3.6	5.6
Imports of goods and services	164.6	6.3	11.4	8.9	5.5	6.0
Net exports [a]	44.7	0.4	2.0	0.6	–0.3	0.4
GDP at market prices	561.4	4.1	5.5	4.7	3.3	3.6
GDP at market prices in billion euros	94.4					
GDP deflator	–	0.6	1.7	2.4	1.3	1.8
Memorandum items						
Private consumption deflator	–	1.6	1.9	0.7	1.1	1.5
Unemployment rate	–	14.6	12.7	11.4	10.6	10.0
General government financial balance [b]	–	–3.0	–1.6	1.5	2.3	2.7
Current account balance [b]	–	3.9	5.4	5.8	5.8	6.1

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) As a percentage of GDP.

offset by some further expenditure restraint. The new government, formed in April, will set the final expenditure ceiling for 2000 in August. It has already announced that central government spending will remain constant in real terms over the medium term.

Output growth will slow further before picking up in 2000

Figures for the first months of 1999 indicate that the slowdown has not yet ended, and weak business sentiment suggests that it could persist in the coming six months. Consumer sentiment, however, remains strong. Domestic demand will also be supported by low interest rates. Furthermore, demand should benefit from the solid financial position of households, the sound balance sheets of the business sector and the healthy state of the banking industry. Another supporting factor is the positive supply-side shock generated by the electronic equipment industry. In 1998, the sector contributed 1½ percentage point to GDP growth. The contribution is projected to remain substantial during the projection period. Nevertheless, due to weaker overall export demand, real GDP growth is projected to decelerate further, to 3.3 per cent, which is still markedly above the euro area average. Employment growth will decelerate by less as growth will shift from capital-intensive exports to more labour-intensive domestic demand. With world demand picking up in 2000, output growth is projected to accelerate somewhat, while inflationary pressures should remain low. A key domestic risk to the projection for 2000 is that the further drop in the unemployment rate, to 10 per cent, leads to an excessive wage agreement, which would hurt Finnish competitiveness and reduce export and output growth.

Greece

Growth was robust in 1998, driven by public and private investment, while the current account improved, largely owing to a strong tourist season. After the devaluation in early 1998, inflation has resumed its downward trend and is expected to recede further owing to favourable cost developments. Activity is projected to slow somewhat in 1999 as a result of sluggish export market growth and may also be marginally affected by developments in Kosovo, but should strengthen again in 2000.

Macroeconomic policy should address the sharp rise in credit demand that could slow the pace of disinflation. Monetary policy needs to stay firm and the stance of fiscal policy be tightened by further restraint over primary public spending. Raising the primary surplus would help reduce public debt faster and allow for a smooth transition to an easier monetary stance that will become necessary as European Economic and Monetary Union membership approaches. Bolder public enterprise reforms and enhanced competition in network industries are called for to improve the competitiveness of the economy and to foster real convergence with the other European Union countries.

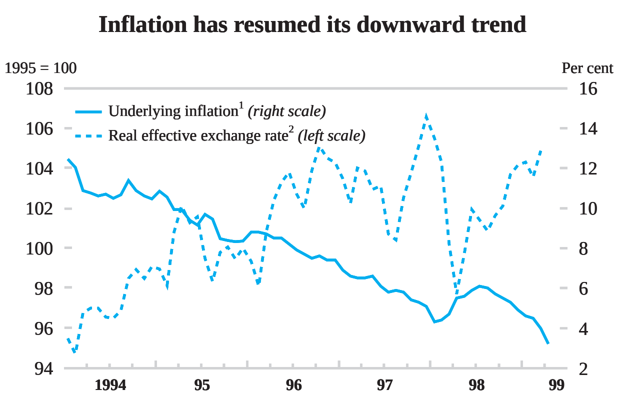
Investment-led growth has been sustained, while disinflation is again on track

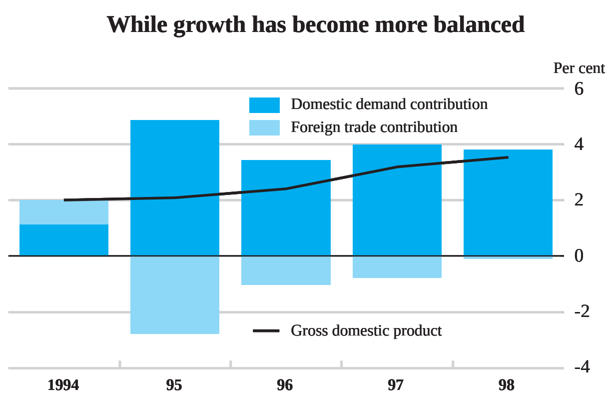
In the fifth year of the current expansion, activity has gathered further steam, with the economy growing by an estimated 3.5 per cent in 1998. Both public investment supported by the European Union (EU) and private investment grew strongly, more than offsetting an easing in consumer spending. Weaker household spending reflected slow growth in real disposable income, as a result of fiscal drag, moderation in wage settlements and a spurt in inflation induced by the March 1998 devaluation. Underlying inflation resumed its downward trend as from September 1998, to reach 3.2 per cent in April 1999. At the same time, the current account improved following a good tourist season that boosted service exports, while the devaluation held down imports. Since late 1998, slackening growth in the EU and in Central and Eastern Europe has been reflected in declining exports of manufacturing industries. Business confidence, however, has been resilient in construction and in retail trade, signalling continuing robust domestic demand prospects.

Policy aims at qualifying for European Economic and Monetary Union by mid-2000

The policy to reach the Maastricht inflation criterion relies heavily on tight monetary conditions. Committed to an end-1999 inflation target of below 2 per cent, the Bank of Greece has allowed an appreciation of the drachma of 8 per cent above its

Greece





1. Excluding fresh food and energy products, year-on-year percentage change.
2. Deflated by the CPI.

central rate in the European Exchange Rate Mechanism, and has refrained from significantly reducing its key intervention rate in tandem with receding inflation. While effective exchange rate appreciation, subdued raw materials prices and a series of indirect tax cuts – that have reduced the consumer price inflation by an estimated 1 percentage point – have dampened inflation, capital inflows resulting from high domestic interest rates have boosted the liquidity of the banking system, triggering lower bank-lending rates in an environment of fierce bank competition. As a result, consumer credit has expanded sharply. Growth in mortgage credit and housing demand has also been burgeoning, probably supported by hefty stock-market gains. At the present juncture, excess credit expansion is of concern, as it fuels domestic demand pressures that may hold back the pace of disinflation. In April 1999 the Bank of Greece introduced temporary interest-free reserve requirements that will delay further cuts in bank lending rates.

Demand, output and prices

Percentage changes, volume (based on previous year prices)

	1995 current prices billion Dr	1996	1997	1998	1999	2000
Private consumption	20 138.8	1.9	2.5	1.8	2.1	2.5
Government consumption	4 178.3	1.0	–0.4	0.4	0.0	0.2
Gross fixed capital formation [a]	4 981.1	8.8	9.6	9.8	8.5	9.1
Final domestic demand	29 298.2	3.1	3.6	3.4	3.3	3.8
Stockbuilding [b, c]	42.2	–0.1	–0.1	0.0	0.0	0.0
Total domestic demand	29 340.4	3.0	3.5	3.3	3.3	3.8
Exports of goods and services	4 258.2	3.0	5.3	7.0	4.0	5.8
Imports of goods and services	6 715.1	4.9	5.4	4.9	4.7	5.8
Net exports [b]	–2 456.9	–1.0	–0.8	–0.3	–0.8	–0.8
GDP at market prices	26 883.5	2.4	3.2	3.5	3.0	3.5
GDP deflator	–	7.9	6.9	5.0	3.1	2.6
Memorandum items						
Private consumption deflator	–	8.3	5.6	4.7	2.7	2.4
Industrial production	–	0.5	1.6	7.3	4.0	5.0
Unemployment rate	–	10.3	10.3	10.1	10.2	10.1
General government financial balance [d]	–	–7.5	–3.9	–2.4	–2.2	–2.1
Current account balance [d, e]	–	–3.7	–4.1	–3.0	–2.9	–2.9

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

The implementation of the tight 1998 budget was on track, setting the debt to GDP ratio firmly on a declining path. In 1999, however, the stance of fiscal policy has become broadly neutral. In the 1999 budget, fiscal adjustment will come mostly from a projected decline in public debt servicing. The budget delayed primary spending cuts, but shifted current expenditure towards investment spending. Apart from lower indirect taxes, the main contribution of fiscal policy to the disinflation effort is to come from a tight public sector incomes policy, with the wage bill targeted to increase at half its 1998 pace.

The inflation target is within reach

Activity is projected to slow in 1999, largely reflecting sluggish export market growth, but then rebound in 2000 as a result of solid public investment, lower real interest rates and strengthening private consumption. Slowing growth of unit labour costs due to moderate wage settlements in 1998-99 and improving productivity will support disinflation. On current policies, consumer price inflation is projected to fall to 2¾ per cent on average in 1999, with year-end inflation above, but very close to the target. Inflation is projected to decline further in 2000, though at a slower pace given the projected recovery in activity. The main risk concerns the pace of disinflation, especially as from the fall of 1999, when the direct effect of indirect tax cuts will have vanished. Persistent cost pressures in sheltered sectors, excess demand fuelled by heavy investment spending, rapid bank credit expansion, as well as uncertain prospects for raw material prices, might offset present favourable domestic cost developments and call for a new set of fiscal and monetary policy measures to fulfil all the criteria for membership of the European Economic and Monetary Union. Recent developments in Kosovo are likely to have some negative spillovers on Greece – principally via weaker tourism, but also through direct trade effects as the Balkans have been of growing significance as markets for Greek goods and investments. But unless the Kosovo problems spread and intensify, overall impacts on GDP should be quite small.

Hungary

Hungary's economic performance in 1998 is estimated to have been one of the strongest in the OECD area as real GDP surged ahead 5.1 per cent, led by a rebound in domestic demand. This contributed to sustained import growth, while the pace of exports slowed over the year causing the current account deficit to widen to 4.8 per cent of GDP. Growth is projected to decelerate slightly in 1999 despite a substantial fiscal deficit, as the pace of domestic demand slackens somewhat and the contribution of net exports remains negative. Both the trade and invisibles balances are expected to deteriorate and the current account deficit could reach just under 6 per cent of GDP in 1999. The disinflation process is projected to slow considerably while, despite relatively strong employment growth, the unemployment rate is anticipated to drop only marginally as more workers are drawn into the labour force.

A tightening of fiscal policy, preferably through expenditure reductions, is needed to combat emerging internal and external imbalances. Such a change should help to support the currency within the crawling peg exchange rate regime, and at the same time allow real interest rates to fall.

The economy grew at a robust pace in 1998 and inflation has fallen rapidly…

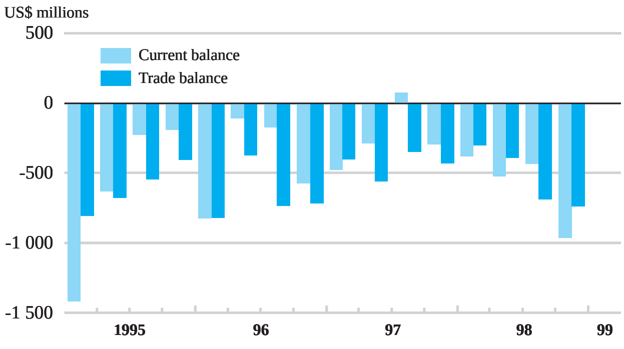
Domestic demand leaped ahead in 1998, led by record investment outlays, a massive inventory accumulation and a pick-up in consumer expenditures, following large real wage gains. Although Hungary continued to expand its international market share, exports of goods and services slowed over the year. This, together with a large increase in repatriated profits, caused the current account deficit to more than double, reaching 4.8 per cent of GDP. The unemployment rate fell to 8 per cent in 1998 as moderate advances in employment outpaced labour force growth. The twelve-month rate of consumer price inflation was down to 9.3 per cent by March 1999. A 4 per cent increase in productivity in 1998 provided only a partial shield, on the cost side, to real wage gains of almost twice this amount.

... but both real interest rates and the external deficit are on the rise...

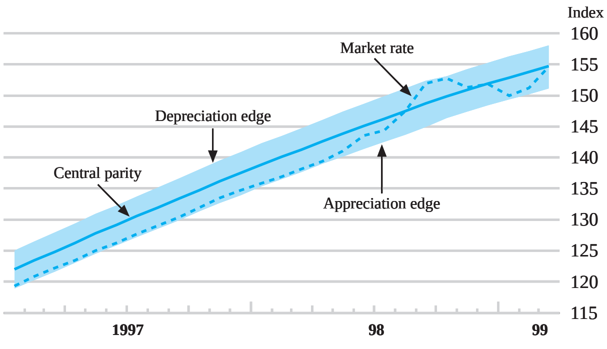
The economy weathered the financial market turmoil surrounding the Russia crisis with limited permanent impact. However, in recent months the forint has once again weakened within its fluctuation band, and bond yields have risen in the face of mounting concern over the sustainability of the external position. The central bank has responded by slowing the downward trend in its policy rate even as inflation continues to fall, allowing real interest rates to rise and further raising the forward premium above 6 per cent on forint-denominated assets by announcing two additional 0.1 percentage point reductions in the currency's rate of crawl.

Hungary

The current account deteriorates



The forint weakens



Demand, output and prices

Percentage changes, volume (1991 prices)

	1995 current prices billion HUF	1996	1997	1998	1999	2000
Private consumption	3 007.1	–3.2	2.6	3.8	4.5	4.2
Government consumption	1 337.3	–2.3	1.5	2.6	2.0	2.0
Gross fixed capital formation	1 059.6	6.7	9.2	11.4	9.0	6.0
Final domestic demand	5 404.0	–1.0	3.8	5.3	5.0	4.2
Stockbuilding [a]	279.7	1.7	0.8	3.1	0.5	0.4
Total domestic demand	5 683.7	0.8	4.4	8.1	5.1	4.2
Exports of goods and services	1 914.8	8.4	26.4	16.0	10.8	9.5
Imports of goods and services	2 036.6	6.6	25.5	22.2	12.1	10.7
Net exports [a]	–121.8	0.6	0.2	–3.0	–1.1	–1.1
GDP at market prices	5 561.9	1.3	4.6	5.1	4.1	3.2
GDP deflator	–	21.2	18.5	14.2	9.0	7.0
Memorandum items						
Private consumption deflator	–	21.2	17.0	14.2	9.1	7.1
Industrial production	–	3.4	10.9	12.6	8.1	6.9
Unemployment rate	–	10.1	8.9	8.0	7.3	7.0
Household saving ratio [b]	–	15.0	18.0	19.3	19.1	19.3
General government financial balance [c]	–	–3.0	–4.9	–4.6	–4.7	–4.8
Current account balance [c]	–	–3.8	–2.2	–4.8	–5.9	–6.2

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) As a percentage of disposable income.
c) As a percentage of GDP.

... while the government budget deficit shows signs of widening

The consolidated government budget deficit narrowed in 1998 to 4.6 per cent of GDP, on the basis of higher than anticipated tax receipts, and despite cost overruns on the social security account. Following a number of tax cuts and spending measures and despite a 50 billion forints cut in authorised spending levels announced in February 1999, early indications are that the budget deficit for 1999 will be much greater than the government's target of 4 per cent of GDP unless additional expenditure cuts are made.

Robust domestic demand should keep output growth sustained…

Based on the technical assumption of an unchanged fiscal policy and exchange rate, real GDP is expected to advance by about 4.1 per cent in 1999 and even less quickly in 2000. Strong domestic demand, fuelled by real wage gains and government-sector dissavings will increasingly have to be met by imports even as the pace of export growth slows. Widening trade and current account deficits are projected to lead to some additional increases in real interest rates, placing further pressure on public finances. Within this scenario, the pace of disinflation is expected to slow while labour force growth reduces the impact of relatively strong job creation on the unemployment rate.

... but rising twin deficits are an area of concern

The principal uncertainty surrounding this projection is the stance of fiscal policy. While the spectre of rising budget and external deficits is reminiscent of the situation in the mid 1990s, further significant cuts in public expenditure could improve prospects for both 1999 and 2000. Such measures would serve to reduce pressure on the current account, allow for a relaxation of monetary policy and enable the government's deficit to come close to its original target of 4 per cent of GDP.

Iceland

Aggregate demand in Iceland continues to surge, in part reflecting substantial terms-of-trade gains. As a result, output is rising smartly, and unemployment is dropping. Wages are increasing rapidly, but consumer price inflation has remained low. Given that these terms-of-trade gains are not expected to continue next year, emerging pressures from strong output growth might begin to push up inflation. Moreover, with domestic demand growing briskly, the current account deficit may remain uncomfortably high.

To check emerging inflationary pressures, the fiscal stance should be tightened. The monetary authorities should also consider raising interest rates further and letting the krona appreciate toward the top end of its band. In addition, given the rapid expansion of credit and foreign borrowing, financial supervisors need to be vigilant to ensure the prudent behaviour of commercial banks.

Output grew rapidly in 1998…

Economic activity continued to expand rapidly in 1998 with real GDP growing by 5 per cent, down only slightly from the previous year. Buoyed by considerable real income growth, consumption soared, while significant large-scale investment projects pushed business investment up by one-third. A large part of the increase in final domestic demand, however, was met by imports, so that net exports entailed a negative contribution to output growth of nearly 7 percentage points. Nonetheless, the unemployment rate moved down ¾ percentage point to 2.9 per cent.

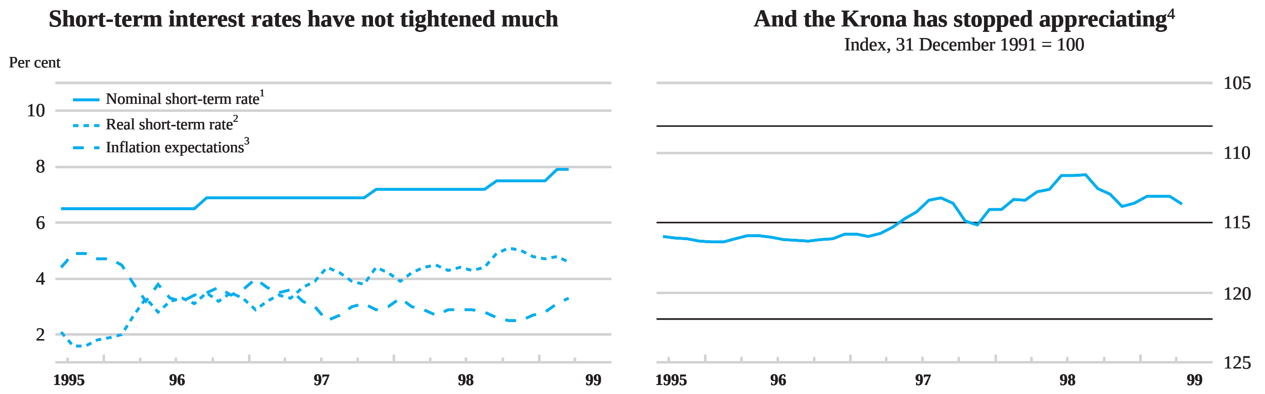
… and benefited from substantial terms-of-trade gains

The increase in aggregate demand was supported by a 4 per cent improvement in the terms of trade. Fish prices rose briskly, while merchandise import prices edged down, helped in part by the plunge in oil prices. Some of this gain was the result of the decision of the monetary authorities to allow the krona to appreciate somewhat in the first part of the year, pushing up its annual average. Subsequently, however, with the turmoil in world financial markets, the krona has eased back.

With only modest policy tightening…

Macroeconomic policy has been only mildly restrictive in the past year. The Central Bank raised short-term interest rates 30 basis points in September 1998 and

Iceland



1. Central Bank Repo rate.
2. Difference of non-indexed and indexed five-year Treasury securities.
3. Difference between the nominal rate and this series for expected inflation.
4. The lower the index, the more the exchange rate has appreciated. However, note the reverse scale. Official bands and midpoint are included.

Source: Central Bank of Iceland.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion Ikr	1996	1997	1998	1999	2000
Private consumption	272.7	6.4	6.0	11.0	8.5	6.2
Government consumption	94.1	1.0	3.1	3.0	3.3	3.0
Gross fixed capital formation	66.0	26.5	11.2	23.4	–6.1	6.9
Final domestic demand	432.7	8.3	6.4	11.7	4.6	5.8
Stockbuilding [a]	2.3	–0.7	0.0	0.3	–0.3	0.0
Total domestic demand	435.0	7.5	6.4	12.0	4.3	5.8
Exports of goods and services	161.3	10.0	5.6	2.6	6.2	5.0
Imports of goods and services	144.7	16.6	8.5	22.1	4.0	7.5
Net exports [a]	16.5	–1.5	–0.8	–6.7	0.6	–1.2
GDP at market prices	451.5	5.6	5.4	5.0	5.1	4.8
GDP deflator	–	1.9	3.3	5.2	4.0	4.2
Memorandum items						
Private consumption deflator	–	2.3	1.8	1.7	2.3	3.8
Unemployment rate	–	4.3	3.7	2.9	2.4	2.0
General government financial balance [b]	–	–1.6	0.0	0.4	0.3	0.3
Current account balance [b]	–	–1.8	–1.7	–6.7	–4.9	–6.3

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) As a percentage of GDP.

another 40 basis points in February of this year, generating a similar rise in short-term real interest rates. With reform of the financial sector, real long-term rates have actually fallen, closing the differential with major trading partners. Furthermore, money and credit growth, especially at depository institutions, has been rapid, with the broad money stock up 15 per cent in 1998. Fiscal policy was not as restrictive last year as previously. While government net lending rose further, to show a surplus in 1998, the increase was less than ½ percentage point of GDP – a slower rate of improvement than the year before even though real output growth was similar.

… signs of overheating have appeared…

The economy now appears to be overstretched in many respects. First, with the low and falling unemployment rate, wages increased 7¾ per cent over 1998, much more than was implied by negotiated contracts, as wage drift has been substantial. Second, inflation expectations, as measured by the difference between five-year non-indexed and indexed Treasury securities, have begun to rise. Third, asset prices have started to increase with housing prices in the capital area rising almost 7 per cent in 1998 after several years of modest growth. Finally, in spite of favourable terms of trade gains, the current account deficit shot up to 6.6 per cent of GDP in 1998, only a portion of which can be explained by foreign direct investment.

… which might lead to an increase in inflation

Output growth is projected to remain robust in 1999 and 2000, supported by strong consumption, whereas business investment and, consequently, imports may cool a bit due to the timing of some projects. Nevertheless, in spite of good export performance, a large current account deficit is projected to persist. Prices are likely to accelerate through the projection period, given the rapid run up in wages and the likelihood that large terms-of-trade gains will not continue. The biggest risk to the outlook is that inflation might surge more quickly than envisaged, thereby creating a wage-price spiral that would necessitate a significant tightening of monetary policy. In such an event, managing the exchange rate could prove difficult.

Ireland

While domestic demand growth is undiminished, real GDP may have slowed slightly in the second half of last year, even though the annual increase was one of the highest of the current boom. The softening in export growth may become more pronounced this year, helping to bring down output increases towards sustainable rates. But labour-supply pressures may continue to rise nonetheless, boosting earnings and hence services prices and raising the risks of a wage-led overheating.

Managing the supply-demand balance in the current circumstances is a formidable challenge. With the advent of European Economic and Monetary Union, the only remaining macroeconomic levers are the budget and the incomes policy process. Despite the healthy surplus, further planned tax cuts should not be allowed to fuel demand, given the increasing severity of supply-side constraints. The government's primary role in the forthcoming wage negotiations should be to temper expectations. When the minimum wage is introduced, careful attention should be paid to setting a level that does not adversely affect the employment prospect of low-paid workers.

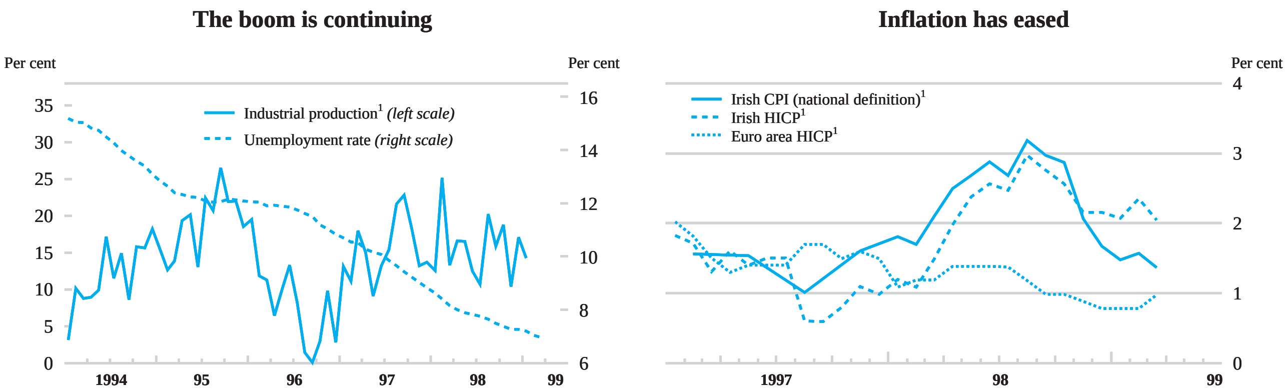
Performance has continued to impress, with strong growth and moderate inflation

Output continues to grow at very rapid rates, steadily stretching available resources. Real GDP growth in 1998 may well have been in double-digit figures, and the unemployment rate has now fallen to 6¾ per cent, down 9 percentage points since 1993, despite robust labour force increases. There are some signs of bottlenecks to further increases in output. Employers report labour shortages and frequent hiring difficulties and have thus been resorting to recruitment of workers from overseas. Wages are accelerating in several important sectors and occupations, despite the agreed limits of the Partnership 2000 pact. After a lengthy boom, housing prices have only recently begun to show signs of deceleration, but at a level nearly double that of just a few years ago. Consumer price rises have, however, eased off mainly as a result of lower mortgage and indirect tax rates and imported oil prices. The current account surplus has diminished, despite a surge in exports in the first half of last year. Survey evidence points to a further slowdown in export sales in coming months.

The main reason for such strength remains foreign direct investment

The economy is benefiting from the same sources of growth that have been operating since 1994. Foreign direct investment is still flowing into modern, high-productivity industries, with favourable spin-offs on domestic demand and, ultimately, on the indigenous, mainly services-producing, sectors. There is anecdotal

Ireland



1. Year-on-year percentage change.

evidence that these inflows have recently peaked, possibly as a result of competitiveness fears and concerns over future export-market prospects.

Macroeconomic policy has also turned stimulative

Macroeconomic policy has done little to resist unsustainable increases in spending and, on balance, has even turned stimulative in recent months. Following the decisions in 1998 relating to the beginning of European Economic and Monetary Union, the effective exchange rate has resumed a downward trend, and shorter-term market interest rates and mortgage rates have fallen sharply, providing households with substantial disposable income gains. In the 1999 budget the government granted sizeable net tax cuts, mainly for individuals, in order to revive the hopes for another "partnership agreement" next year, as well as to improve work incentives. The authorities also tried to keep current spending within its previous 4 per cent average annual target increase, but the relevant aggregate suffers from some weaknesses; for example, it includes interest payments, which are falling. Furthermore, capital expenditure is rising sharply again, as the government is more concerned to relieve infrastructural shortages than to avoid strains on the labour market and the construction sector in particular.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion Ir£	1996	1997	1998	1999	2000
Private consumption	21.841	6.1	6.3	8.0	8.0	6.6
Government consumption	5.871	1.5	4.8	5.0	4.0	3.1
Gross fixed capital formation	6.735	13.6	10.9	12.0	10.9	9.1
Final domestic demand	34.447	6.8	7.0	8.4	8.1	6.7
Stockbuilding [a]	0.401	0.2	0.4	–0.6	0.1	0.0
Total domestic demand	34.847	6.9	7.3	7.5	8.1	6.6
Exports of goods and services	30.837	11.7	16.9	20.9	11.4	10.2
Imports of goods and services	26.369	12.2	15.6	20.2	13.0	10.9
Net exports [a]	4.468	1.5	3.7	4.2	1.0	1.4
GDP at market prices	39.315	7.4	9.8	10.4	7.5	6.7
GDP at market prices in billion euros	49.920					
GDP deflator	–	1.7	2.3	4.0	4.0	3.7
GNP at market prices	34.805	6.4	8.1	9.0	6.6	6.1
Memorandum items						
Private consumption deflator	–	1.4	0.9	2.6	2.9	2.8
Industrial production	–	7.9	15.4	14.8	9.8	9.5
Unemployment rate	–	11.9	10.3	7.7	6.4	5.9
Household saving ratio [b]	–	9.6	10.5	11.2	11.0	11.0
General government financial balance [c]	–	–0.3	1.0	2.4	2.3	2.1
Current account balance [d]	–	2.7	2.8	1.9	0.5	0.0

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) As a percentage of disposable income.
c) As a percentage of GDP.
d) As a percentage of GNP.

With moderating exports, activity could slow

While export increases are already returning to more moderate rates, domestic demand growth is unlikely to abate this year. Real household disposable income growth of around 8 per cent combined with continuing adjustment to recent wealth gains and very high levels of consumer confidence point to persistently robust increases in consumption. The demand for housing remains substantial, and only supply constraints are holding back such investment. Government current and capital spending increases look set to keep up their recent pace. But business investment growth may ease slightly, because of less buoyant export prospects. Overall, real GDP may expand by 7 per cent on average over the projection horizon. This will still be more than can be handled by ongoing increases in the labour force, despite sharp productivity improvements, and the unemployment rate could fall below 6 per cent. Employers will have to compete for scarce labour resources by upping their wage offers, pushing up unit labour costs and services prices, even abstracting from the effects of next year's introduction of a national minimum wage. With domestic demand stronger than exports, the net foreign balance could contribute much less to GDP growth than in recent years. This, along with a reversal in the terms of trade and a deterioration in the investment income balance may lead to an elimination of the current external surplus in 2000.

Korea

The economy appears to have bottomed out, helped by expansionary monetary and fiscal policies, following the worst recession in Korea's post-war history in 1998. A technical rebound based on inventory adjustment is expected to lead to substantial output gains this year and some narrowing of the current account surplus, which reached 12½ per cent of GDP in 1998. However, unemployment is likely to remain high at around 7½ per cent, while inflation remains subdued. A sustained expansion in 2000 and beyond will require a stronger recovery of private consumption and investment, which hinges on progress in restructuring the financial and corporate sectors.

Large injections of public funds have strengthened the banking system and have helped to stabilise the decline in bank lending, although much remains to be done to rehabilitate the financial sector. The introduction of an improved corporate governance system and other reforms has established a framework for market-based restructuring of the corporate sector. Effective implementation of these reforms is essential to facilitate such restructuring. The stance of macroeconomic policy should remain supportive until a genuine recovery is firmly established.

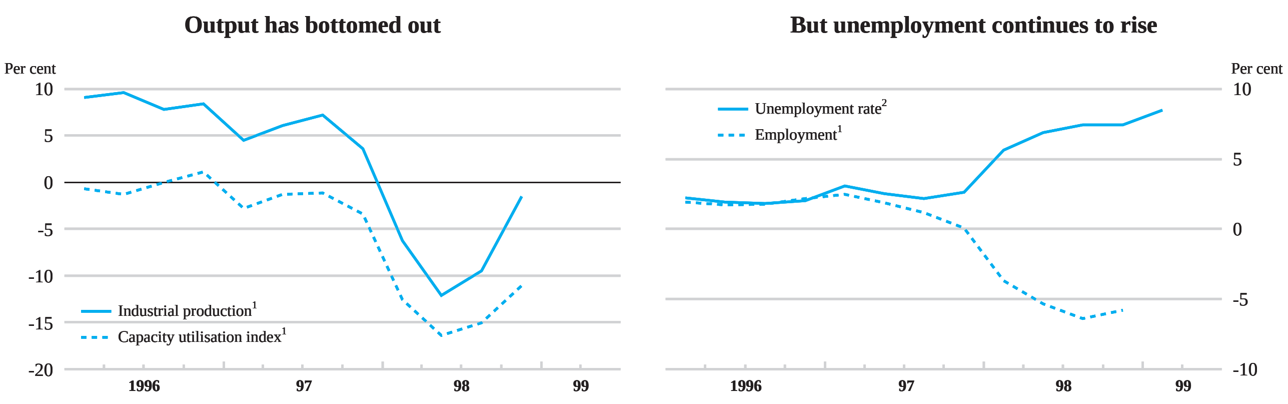
After a severe recession in 1998, output appears to have stabilised…

Output fell by almost 6 per cent in 1998 in the wake of the severe financial crisis as a credit crunch emerged and domestic demand contracted by 19 per cent. In addition to sharp declines in private consumption and fixed investment, inventory adjustment made a large negative contribution to growth. By the end of the year, though, the downturn had stopped, while the de-stocking of inventory had decelerated. Given the depth of the recession, there exists a considerable degree of slack in the economy. The unemployment rate, which was around 2 per cent prior to the crisis, reached 8½ per cent in early 1999 despite a significant fall in the labour force participation rate. Consumer prices have remained flat since February 1998.

… thanks to supportive macroeconomic policies…

The easing of macroeconomic policies has played a key role in attenuating the recession. The reduction of short-term money market interest rates from 23 per cent at the beginning of 1998 to around 5 per cent has substantially lowered borrowing costs. This was accompanied by a sharp deterioration in the consolidated central government budget, which had been in balance prior to the crisis, to a deficit of around 4 per cent of GDP in 1998. The deficit resulted from a decline in tax revenues and a

Korea



1. Year-on-year percentage changes.
2. Estimate for the first quarter of 1999.
Source: National Statistical Office.

Demand, output and prices

Percentage changes, volume (1995 prices)

	1995 current prices trillion won	1996	1997	1998	1999	2000
Private consumption	206.4	7.1	3.5	–9.6	2.5	3.2
Government consumption	36.4	8.2	1.5	–0.1	0.8	4.8
Gross fixed capital formation	138.4	7.3	–2.2	–21.1	–3.9	3.0
Final domestic demand	381.3	7.3	1.2	–12.7	0.3	3.3
Stockbuilding [a]	1.8	0.6	–2.0	–5.6	5.0	1.9
Total domestic demand	383.1	7.8	–0.8	–18.7	6.2	5.7
Exports of goods and services	114.0	11.2	21.4	13.3	6.0	7.5
Imports of goods and services	119.5	14.2	3.2	–22.0	12.0	13.0
Net exports [a]	–5.6	–1.1	5.7	12.2	–0.7	–0.5
Statistical discrepancy [a]	–0.2	0.0	0.1	0.1	0.0	0.0
GDP at market prices	377.3	6.8	5.0	–5.8	4.5	4.3
GDP deflator	–	3.9	3.1	5.3	2.5	2.3
Memorandum items						
Private consumption deflator	–	5.7	5.5	8.6	2.5	2.3
Industrial production	–	8.7	5.3	–7.3	5.5	6.0
Unemployment rate	–	2.0	2.6	6.8	7.6	7.5
Household saving ratio [b]	–	17.3	17.3	14.4	13.7	14.1
General government financial balance [c]	–	4.2	2.3	–0.2	–1.0	–1.0
Current account balance [c]	–	–4.4	–1.5	12.6	5.7	3.5

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) As a percentage of disposable income.
c) As a percentage of GDP.

substantial rise in public expenditures, notably an increase in assistance to the unemployed. The deficit is projected to widen slightly in 1999.

… and structural reforms, including the rehabilitation of the financial sector

The cost of rehabilitating the banking sector has also boosted public outlays. In 1998, the government launched a W 64 trillion programme (14 per cent of GDP), financed by publicly guaranteed borrowing, to address the non-performing loan problem and to recapitalise viable banks, while closing weak banks and establishing a new independent regulatory authority. This has been accompanied by improvements in the corporate governance framework, notably by strengthening the rights of minority shareholders and requiring listed companies to have outside directors. To accelerate restructuring, the government has required firms affiliated with the large conglomerates, or *chaebols*, to reduce their debt to equity ratios, which averaged almost 500 per cent at the end of 1997, to 200 per cent by the end of this year.

A technical rebound in 1999 based on stockbuilding is likely…

Output growth may be as high as 4½ per cent this year. Following a 17 per cent decline in the level of inventories in 1998, a deceleration of inventory de-stocking would be sufficient to provide a substantial boost to growth in 1999. The stockbuilding effect would be partially offset by an increase in imports, which is projected to lead to a decline in the current account surplus from $ 40 billion in 1998 to around $ 23 billion this year. The need for further corporate restructuring to reduce debt is likely to limit any rebound in investment and in employment and wages this year. Consequently, private consumption is expected to show little growth, while unemployment remains high at around 7½ per cent. With substantial slack in the labour market and the appreciation of the currency during the past year, inflation is expected to undershoot the official 3 per cent target.

... but a sustained recovery will depend on successful restructuring

The main risk to a growth rebound in 1999 would be a depreciation of other major Asian currencies, which would undermine the prospects for Korean exports. As the contribution from stockbuilding wanes in 2000 and beyond, sustaining the recovery will depend largely on the growth of private consumption and investment. This requires successful restructuring of the financial sector, where there is a risk of a further rise in non-performing loans. At the same time, it is important to expedite the restructuring of troubled firms, either through voluntary debt workouts or through legal procedures, though this will tend to limit the growth of domestic demand in the short run. Failure to restructure rapidly could lead to a period of stagnation with growth rates well below those achieved in the past.

Luxembourg

The economy seems to have reached a cyclical peak in early 1998. While slowing markedly, real GDP growth is projected to exceed 3 per cent in 1999 and to rebound moderately – to 3¾ per cent – in 2000, as a result of stronger export markets and more buoyant domestic demand. Despite rapid job creation, the continuing increase in cross-border workers prevents overheating in the labour market, and consumer price inflation, although edging up, is projected to remain at low levels.

While overall fiscal conditions remain enviable, budget flexibility could be improved by reducing the widespread use of indexation. Structural reform should be pursued to enhance the adjustment capacity of the economy. For instance, the adaptability in the labour market could be improved by relaxing working-time restrictions, especially for part-time workers.

The economy may have reached a cyclical peak in 1998

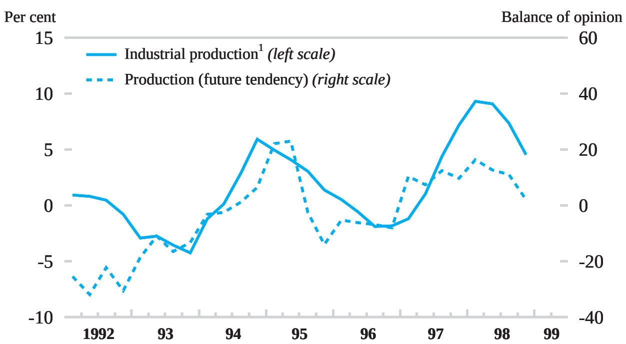
The economy continued to perform well in 1998, with real GDP growth increasing to an estimated 5¾ per cent. Services, in particular communications and financial services, were the main driving force. However, activity in the manufacturing sector has weakened substantially since the second half of 1998, as the financial and economic crises in Asia and Russia have led to increased competition in the steel sector, with a reorientation of world exports and falling prices. Although employment growth has remained robust, labour market conditions have barely tightened, as the strong influx of cross-border workers has continued to expand the labour supply. The unemployment rate has declined only slightly, as more people have been enrolled in active labour market programmes. Consumer price inflation has fallen to around ½ per cent in early 1999, as a result of lower energy and import prices. The underlying rate of inflation – which excludes energy and food prices – has remained at around 1 per cent.

The service sector is the main engine of growth

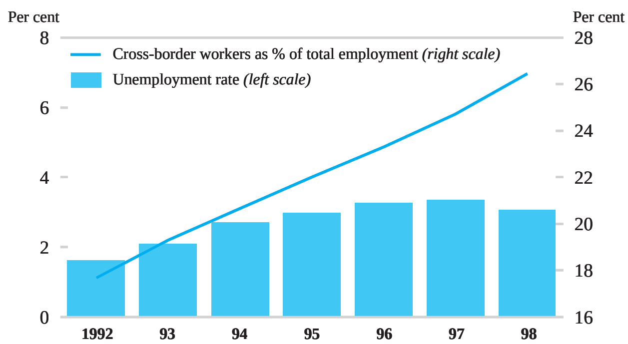
The service sector is likely to remain the driving force of economic growth. The communication sector is expected to gain further momentum, with the rapid expansion of the satellite network and new launches planned in 1999 and 2000. The financial sector, on balance, should also remain buoyant. Following the introduction of the euro, the banking sector has lost part of its earnings on foreign exchange transactions. However, it should profit from more cross-border activities facilitated by the single currency, and

Luxembourg

Production is decelerating



Growing presence of cross-border workers



1. Year-on-year percentage changes.
Source: Statec.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion LF	1996	1997	1998	1999	2000
Private consumption	278.8	1.9	2.5	3.8	2.3	2.5
Government consumption	67.2	3.3	8.4	4.0	3.0	3.0
Gross fixed capital formation	111.4	–1.7	15.2	9.7	4.7	5.0
Final domestic demand	457.3	1.1	6.7	5.5	3.1	3.3
Stockbuilding [a]	11.7	0.7	0.1	0.2	–0.2	0.2
Total domestic demand	469.1	1.8	6.7	5.6	2.9	3.5
Exports of goods and services	467.5	2.3	7.5	8.3	3.0	6.6
Imports of goods and services	419.8	1.0	10.0	8.5	2.5	6.6
Net exports [a]	47.7	1.3	–1.4	0.5	0.7	0.5
GDP at market prices	516.8	3.0	4.7	5.7	3.3	3.8
GDP at market prices in billion euros	12.8					
GDP deflator	–	0.1	2.4	1.7	1.3	1.6
Memorandum items						
Private consumption deflator	–	1.6	1.1	1.0	0.9	1.3
Industrial production	–	–1.9	7.3	4.3	0.7	2.0
Unemployment rate	–	3.3	3.3	3.1	3.1	3.0

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

is well positioned to take advantage of the coming liberalisation of the European pension fund market. The Luxembourg authorities have already prepared legislation to be implemented once the new European Union (EU) directives in this area are adopted. Fiscal policy has become broadly neutral, as higher spending on a multi-annual programme for infrastructure projects and social security, has been largely offset by an increase in social security contributions. The general government budget surplus is estimated to have been a little over 2 per cent in 1998. Given the projected slowdown of the economy, the surplus may decrease somewhat in 1999 and 2000.

Despite a significant slowdown, the outlook remains favourable

Real GDP growth is projected to slow to around 3¼ per cent in 1999 and to pick up to 3¾ per cent in 2000, as exports strengthen in line with the growth of foreign markets, boosting domestic demand. While slowing, job creation will remain robust and exceed the EU average by a wide margin. But the number of cross-border workers is expected to continue to grow, preventing the labour market from overheating. Consumer price inflation should remain low, edging up to around 1¼ per cent in 2000, as a result of rebounding import prices. The risks and uncertainties in the projections are mostly in the external sector and relate in particular to the expected rebound in the euro area and the impact of European Economic and Monetary Union on the Luxembourg financial sector.

Mexico

Strong household and business confidence continued to boost economic activity in 1998, despite the international financial crisis and the decline in oil prices which led to a tightening of monetary and fiscal policies. The disinflation process was reversed and the current account deficit widened. The tight setting of macroeconomic policies is likely to dampen domestic demand and GDP growth in 1999, but also bring inflation down. A moderate recovery is projected in 2000, fuelled by domestic demand as confidence returns. The current account deficit may rise marginally to just above 4 per cent of GDP in 2000.

Given the still uncertain external environment and the upturn in inflation in 1998, macroeconomic policies will have to remain tight until the economy is back on a course of steady disinflation. Structural reform should continue, in particular to further strengthen the financial sector and bolster tax revenue.

Growth remained vigorous during most of 1998, and the disinflation process was reversed

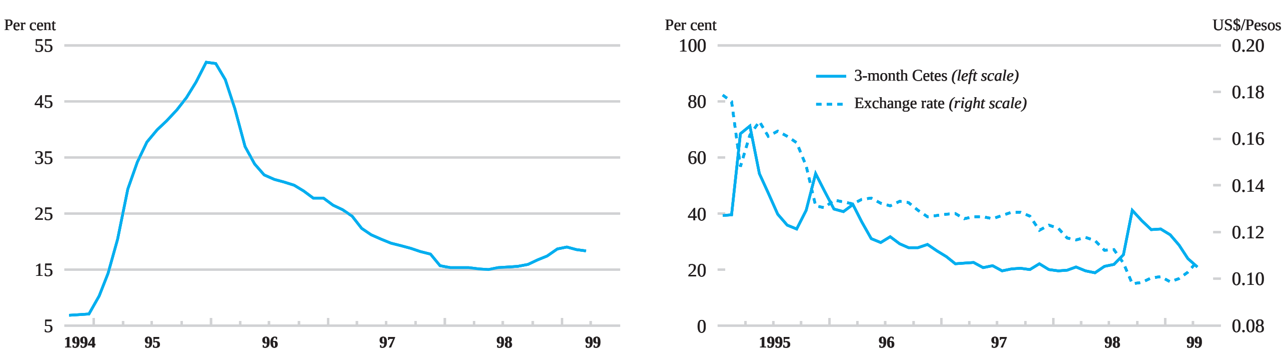
After a period of rapid growth, driven by private demand and foreign trade, signs of a slowdown emerged in late 1998 as fiscal and monetary policies were tightened in response to the global financial crisis and the fall in oil prices. Employment growth remained strong, and significant real wage gains were recorded; but unit labour costs in manufacturing declined, thanks to continuing high productivity growth. Non-oil exports held up fairly well, slowing only late in the year. The trade deficit widened, owing to booming imports and declining earnings from oil exports. The current account deficit reached 3.8 per cent of GDP, which was largely financed by long-term capital inflows – importantly foreign direct investment which amounted to nearly $ 10.2 billion, just below its record 1997 level. The peso, which had been depreciating gradually after the Asian crisis, suffered a bout of weakness in the wake of the Russian crisis in mid-1998. With the inflationary impact of the depreciation compounded by hikes in government controlled prices, inflation rose in late 1998: the consumer price index increased by 18.6 per cent in the twelve months to December 1998, compared with the 12 per cent official target.

Fiscal policy is set to remain tight in 1999...

In 1998, public spending was curtailed to maintain the budget deficit on target (1.25 per cent of GDP) despite lower oil-related revenues (which in total account for one-third of government revenue). In a context of slowing GDP growth, the 1999

Mexico

The disinflation process reversed in 1998[1] — **The Brazilian crisis had a minor and short-lived impact**[2]



1. CPI inflation, year-on-year percentage change.
2. The Brazilian real was devalued in January 1999.

budget aims at maintaining the public sector financial deficit unchanged in relation to GDP through new tax measures and continued spending control.* The recent recovery in oil prices will make the deficit target easier to meet. For 2000, the projections assume that a prudent fiscal policy stance will be maintained.

... and with the tightening of monetary policy financial conditions have been improving

When the Russian crisis broke out in August 1998, pressure against the peso was absorbed through a combination of interest rate and exchange rate changes. After rising by 15 percentage points (to 42 per cent) in September, the three-month Treasury bill rate (Cetes) declined to 32 per cent by the end of 1998. In January 1999, the Brazilian crisis prompted a new policy tightening. But the impact on Mexico was less severe than after the Russian crisis and it was quickly reversed. Since then, the peso has strengthened, and by late April the Cetes rate was close to 20 per cent. The monetary programme, announced in January 1999 against the background of an uncertain international environment and a revival of inflationary pressure, focuses on bringing inflation down to 13 per cent by December 1999 (year-on-year). The OECD assumes that over the projection period, nominal interest rates will come down in line with the decline in inflation, and that the risk premium will also fall somewhat.

Demand, output and prices

Percentage changes, volume (1993 prices)

	1995 current prices billion Pesos	1996	1997	1998	1999	2000
Private consumption	1 232.0	2.2	6.4	6.4	3.3	3.6
Government consumption	192.0	–0.7	2.9	–1.3	0.0	2.0
Gross fixed capital formation	296.7	16.4	20.9	10.7	6.5	9.1
Final domestic demand	1 720.7	4.0	8.5	6.4	3.6	4.6
Stockbuilding [a]	70.8	1.6	1.2	–0.1	0.0	0.0
Total domestic demand	1 791.5	5.6	9.5	6.0	3.5	4.5
Exports of goods and services	558.8	18.2	10.8	9.7	7.8	5.6
Imports of goods and services	509.9	22.9	22.8	14.2	8.8	8.1
Net exports [a]	48.9	–0.3	–2.5	–1.1	–0.3	–0.8
GDP at market prices	1 840.4	5.1	6.8	4.8	3.2	3.7
GDP deflator	–	30.7	17.7	13.8	15.0	10.5
Memorandum items						
Private consumption deflator	–	30.6	16.5	19.2	16.7	11.0
Unemployment rate [b]	–	5.5	3.7	3.2	3.2	3.2
Current account balance [c]	–	–0.7	–1.9	–3.8	–3.8	–4.1

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) Based on the National Survey of Urban Employment.
c) As a percentage of GDP.

Following a slowdown in 1999, growth is expected to pick up next year

Output growth is projected to slow down in 1999 to 3.2 per cent, reflecting more moderate consumer spending in response to uncertainties about employment and real wages, and tight public expenditure. Business investment is also expected to be less buoyant as a result of high real interest rates and some deterioration of export pros-

* For a detailed analysis of Mexico's tax system and the need for strengthening its revenue raising capacity, see *OECD Economic Surveys*, Mexico, April 1999, Chapter III.

pects. In the context of a progressive return of confidence in international financial markets, real GDP growth is projected to strengthen in 2000 to 3.7 per cent, led by private demand and public investment. Disinflation is expected to resume once the first round effects of the 1998 depreciation have worked through. However, renewed financial volatility would force the authorities to further tighten policy to prevent the emergence of major imbalances; and either slower growth or higher interest rates in the United States could have significant negative effects on the Mexican performance. On the other hand, if market confidence continues to improve, the decline in interest rates could be more rapid than projected, generating stronger growth.

Netherlands

After a period of exceptional strength, real GDP growth is projected to fall to around 2¼ per cent in both 1999 and 2000 – well below the trend rate. Nonetheless, tensions in the labour market are expected to persist for some time, and wage increases and inflation may remain relatively high. The fiscal stance is broadly neutral, but the general government deficit is projected to increase somewhat – to 1¾ per cent of GDP in 2000 – as a result of the slowdown of the economy.

While the slowdown of activity reduces the risk of overheating, the government should continue its policy of increasing the non-inflationary rate of growth of the economy and promoting reintegration of workers. This requires initiatives to return to the active labour force the older unemployed and people of working age currently in the disability and social assistance schemes.

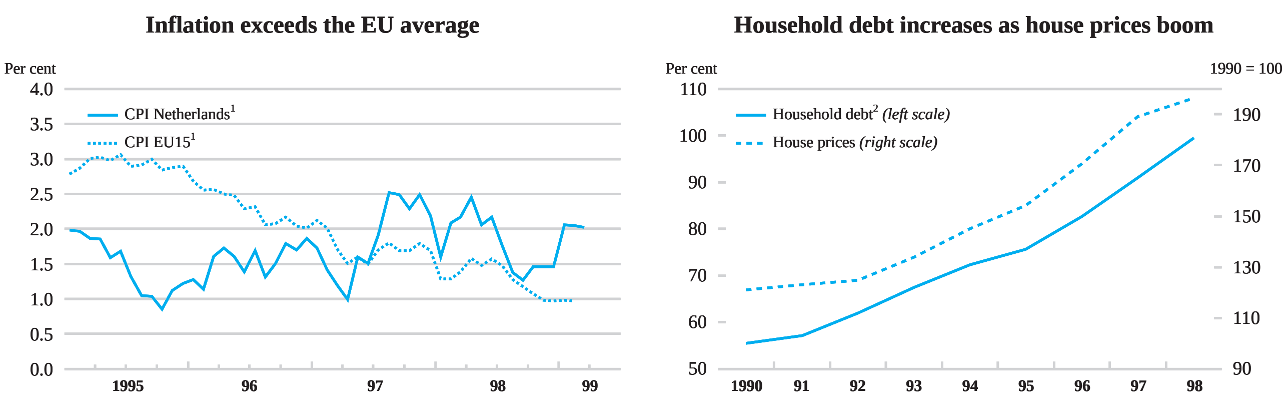
The economy slows as external demand drops sharply

Although slowing markedly over the year, real GDP growth reached an estimated 3.8 per cent for 1998 as a whole, the highest rate since 1991. The economy moved further above potential, with the positive output gap, as calculated by the OECD, reaching an estimated 2 per cent of potential GDP. Private consumption was exceptionally vigorous, underpinned by strong job creation and wage increases, tax reductions and large capital gains on real and financial assets. However, the buoyancy of domestic demand boosted imports and, starting in the second half of the year, exports weakened rapidly, in line with foreign markets. As a result, the contribution to growth of net exports turned negative in 1998. Several indicators point to a tight labour market: the unemployment rate (national definition) fell to 3.8 per cent in February 1999, the lowest level since the late 1970s; unfilled vacancies have increased to a level similar to the peak of the 1988-92 upturn; and shortages are increasingly being reported, especially in the construction, financial service, and professional service sectors. Despite a sizeable decline in import prices, consumer price inflation (harmonised definition) has reached 2.0 per cent in the twelve months to February – compared with an European Union average of 1 per cent.

The stance of fiscal policy is broadly neutral and the domestic boom is maturing…

Most indicators point to a slowdown in domestic demand. Business sentiment has deteriorated markedly due to shortening order books and a profit squeeze as a result of rising labour costs and the low output prices needed to retain market shares. House prices have surged since 1990 and, as noted, have underpinned private consumption. They are, in real terms, close to the peak of the previous housing boom in

Netherlands



1. From 1997 harmonised CPI, year-on-year percentage change.
2. Percentage of disposable income.
Sources: CPB Netherlands Bureau for Economic Policy Analysis; Statistics Netherlands; OECD.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion Gld	1996	1997	1998	1999	2000
Private consumption	382.2	2.7	3.0	4.5	3.5	2.5
Government consumption	91.8	1.2	1.5	2.7	3.3	1.5
Gross fixed capital formation	122.0	5.4	6.8	4.1	0.6	1.2
Final domestic demand	596.0	3.0	3.6	4.1	2.8	2.1
Stockbuilding [a]	1.0	0.0	0.0	0.2	–0.2	0.1
Total domestic demand	596.9	3.0	3.6	4.3	2.6	2.2
Exports of goods and services	339.6	5.2	6.7	6.3	2.4	5.0
Imports of goods and services	296.9	5.3	7.1	7.5	3.1	4.9
Net exports [a]	42.7	0.4	0.3	–0.2	–0.2	0.3
GDP at market prices	639.7	3.1	3.6	3.8	2.2	2.4
GDP at market prices in billion euros	290.3					
GDP deflator	–	1.5	2.2	1.8	1.8	2.1
Memorandum items						
Private consumption deflator	–	1.6	2.0	1.8	1.9	2.0
Industrial production	–	1.5	4.3	2.4	0.4	2.4
Unemployment rate	–	6.6	5.5	4.2	3.9	4.1
Household saving ratio [b]	–	0.5	–0.6	–0.6	–1.1	–0.6
General government financial balance [c]	–	–2.0	–0.9	–0.7	–1.4	–1.7
Current account balance [c]	–	5.5	6.5	5.6	5.3	5.9

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
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.

the late 1970s. Due to the large build-up of mortgage debt, household debt – as a percentage of disposable income – has almost doubled since 1990. Although it has been more than outpaced by the increase in the value of its collateral, this surge in mortgage borrowing has increased the vulnerability of the household sector to asset price shocks. A levelling off of house prices would progressively attenuate the impact of capital gains on private consumption. An actual fall in house prices could have much more damaging effects on consumption and growth. The fiscal stance is expected to remain broadly neutral. The increase in social security contributions in the 1999 Budget has been more or less offset by expenditure increases for infrastructure, education, the health sector, and asylum seekers. The cyclically-adjusted deficit may remain at around 2 per cent of GDP while the actual deficit is projected to widen from ¾ per cent of GDP in 1998 to 1¾ per cent in 2000 as a result of the economic slowdown.

… but stronger exports will progressively boost growth

After slowing to around 2¼ per cent in 1999, real GDP growth is expected to pick up somewhat in 2000, as net exports progressively take over from domestic demand as the driving force of the expansion. This period of growth below potential will largely erase the positive output gap by 2000. Employment creation is projected to slow but, with unemployment remaining at very low levels, tensions in the labour market are likely to persist. Nevertheless, the growth of wages and compensation per employee may abate somewhat in 2000, as no further increases in social security contributions are assumed. With import prices rebounding, consumer price inflation is projected to edge up and remain higher than in neighbouring countries. On the external side, the major risk to growth is that the upturn in the euro area might not take place as expected. On the domestic side, given the tight labour market, wages and prices might rise faster than projected; on the other hand, a reversal of the boom in house prices could have a major dampening effect on consumption and growth.

New Zealand

The New Zealand economy moved out of recession in the second half of 1998 and recent indicators show a broadening in the recovery more recently. The direct adverse influences of the Asia crisis and financial market volatility have been fading and, in the event, been offset by stimulative policy settings, improved competitiveness, and rising business and consumer confidence. Although these forces should continue to underpin economic activity, the current upturn is likely to be gradual, given expected moderate growth in the rest of the world economy and some domestic factors such as the need to restructure household balance sheets and another drought this year.

In the face of ongoing uncertainties about the international environment and given substantial economic slack, maintaining an easy monetary stance would seem to be warranted. As the recovery takes hold, the authorities should increase the fiscal surplus in order to maintain the credibility of the government's long-term fiscal objectives and to create a sufficient buffer against future economic shocks.

Economic recovery is underway…

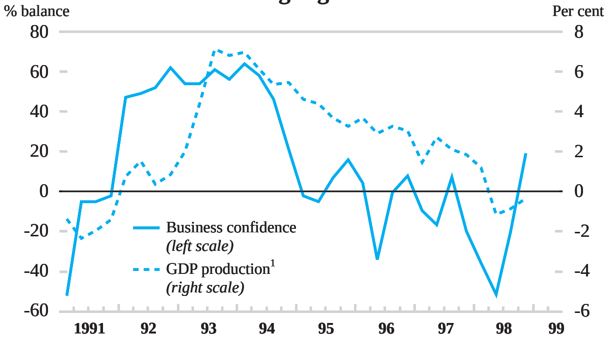
The economic upswing that began in the middle of last year has broadened with both domestic demand and exports contributing to recent growth. Private consumption continues to expand at a moderate rate, supported by tax cuts and the demutualisation of the Australian Mutual Provident Fund (AMP). A turnaround of both fixed and residential investment reflects rising confidence levels and low interest rates. At the same time, exports are being supported by the low effective exchange rate and some export switching from Asia to other markets. A widening of the output gap, slack in the labour market and a number of favourable developments, notably tariff cuts and increased competitive pressures, have reduced consumer price inflation below the mid-point of the Reserve Bank's 0 to 3 per cent target range. Given New Zealand's large external deficit (6 per cent of GDP in 1998), a potentially worrying feature of recent developments is the degree to which the pickup in domestic demand has been met by import growth.

… supported by simulative macroeconomic policies

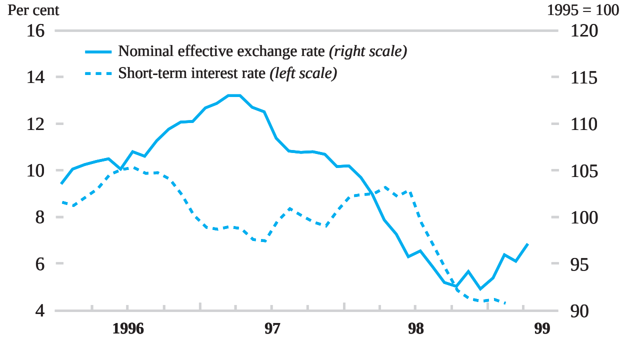
Following a marked easing through the second half of 1998, overall monetary conditions, taking account of both interest and exchange rate movements, have tightened somewhat as the currency has tended to appreciate. Nonetheless, the levels of both real short-term interest rates and the effective exchange rate compare favourably with those in the first half of the 1990s, when growth accelerated rapidly. In mid-March, the Reserve Bank abandoned the use of the monetary conditions indicator

New Zealand

Rising business confidence foreshadows stronger growth



Monetary conditions remain accommodative



1. Year-on-year percentage changes.

Demand, output and prices

Percentage changes, volume (1991/92 prices)

	1995 current prices billion NZ$	1996	1997	1998	1999	2000
Private consumption	55.6	4.4	2.9	1.6	2.3	3.2
Government consumption	13.1	2.4	6.2	–1.0	5.5	–2.5
Gross fixed capital formation	19.0	6.2	3.1	–1.4	3.8	6.7
Final domestic demand	87.7	4.5	3.4	0.6	3.2	3.1
Stockbuilding [a, b]	1.3	–0.6	–0.1	–0.7	0.7	0.0
Total domestic demand	89.0	3.9	3.4	–0.1	3.8	3.1
Exports of goods and services	27.6	3.7	2.9	1.3	4.0	6.6
Imports of goods and services	26.0	8.3	4.0	3.1	7.4	5.1
Net exports [a]	1.6	–1.5	–0.4	–0.6	–1.3	0.3
GDP (expenditure) at market prices	90.6	2.4	3.0	–0.8	2.6	3.5
GDP deflator	–	1.9	0.0	1.6	0.8	1.9
Memorandum items						
GDP (production)	–	3.2	2.0	–0.3	2.6	3.5
Private consumption deflator	–	2.1	1.0	1.9	1.0	1.1
Unemployment rate	–	6.1	6.6	7.5	7.4	6.8
Current account balance [c]	–	–4.1	–7.0	–6.0	–6.2	–5.9

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) Including statistical discrepancy.
c) As a percentage of GDP.

as an operational target, opting instead for an official overnight cash rate. The initial rate was set at 4½ per cent, with future adjustments being considered every six weeks under normal circumstances. This move was motivated by several considerations, namely: providing substantial leverage over other short-term interest rates, enabling the Reserve Bank to influence monetary conditions more directly; simplifying the mechanics of the Bank's interactions with financial markets; and placing the focus on the medium-term goal of price stability, rather than the day-to-day implementation of monetary policy. The monetary relaxation has taken place in the context of a declining fiscal position. While a small surplus – the sixth in succession – is now expected in the current fiscal year ending in June, a budget deficit is likely in 1999/2000 and possibly, in 2000/01. Net public debt is also set to rise temporarily, thus moving away from the ambitious long-term net-debt target of 15 per cent as a share of GDP established last year. To limit fiscal slippage, the authorities have modestly scaled back the three-year NZ$ 5 billion expenditure package announced in late 1996, by NZ$ 750 million.

Growth should accelerate but imbalances persist

Real GDP growth is projected to accelerate gradually and exceed New Zealand's potential growth rate of around 2½ to 3 per cent. The forces making for a sustained recovery include: the low level of the effective exchange rate; low interest rates; a simulative fiscal stance; and rising consumer and business confidence. The expansion is expected to be led by strong growth of investment, together with a revival of foreign demand. With exchange rate depreciation and low domestic inflation having led to a significantly improved competitive position, New Zealand exporters now appear to be well placed to increase their market shares following substantial losses in recent years. The output gap should close only gradually over the medium term, tempering inflation pressures. The main risk to this outlook concerns the possibility of slower world growth that would limit the contribution of exports to the domestic recovery. Given New Zealand's relatively high current-account deficit and external debt, any slowing might lead financial markets to reassess the sustainability of this situation, causing volatility in the exchange rate and interest rates, or an increasing risk premium.

Norway

After several years of brisk growth which led to an overheated labour market, a significant slowdown occurred during 1998 induced by tight policies, a profit squeeze and the oil price collapse. Mainland GDP is projected to be flat in 1999 followed by a modest pick-up in 2000. Weak activity, which will result in labour market slack, will gradually reduce inflationary pressures. This should provide room for further monetary easing.

In recent years, the Norwegian macroeconomic policy framework has failed to deliver sustainable non-inflationary economic growth. Fiscal policy was too loose and did not react to signs of overheating while social partners agreed on excessive wage rises. Fiscal policy should be tight this year and next while wage rises need to be significantly below those in recent years. Failing again to implement sound policies would delay the recovery.

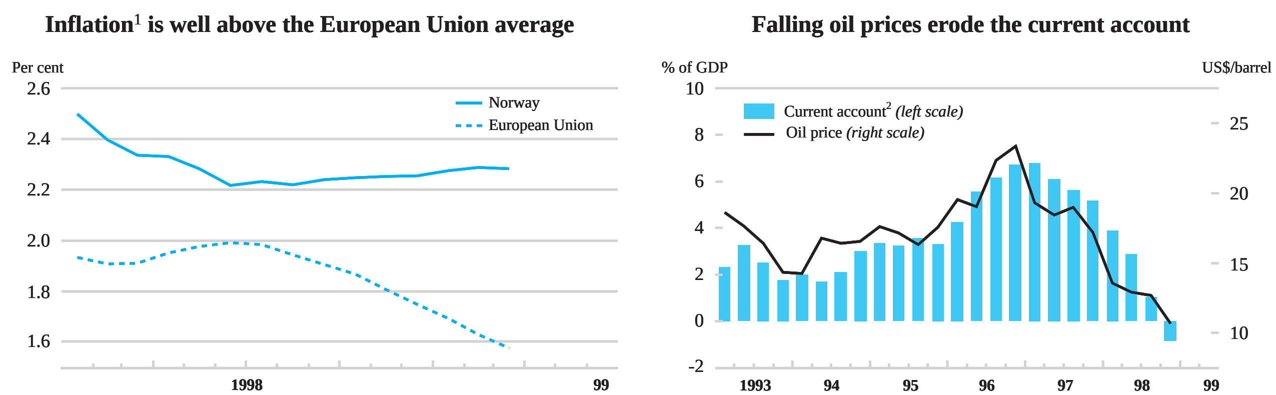
The boom period has ended

The strong performance of the Norwegian economy since 1993 has come to an end. Tight fiscal and monetary policy, market losses due to strong wage rises, and the oil price collapse led to a marked downturn. In the last quarter of 1998, mainland GDP (total GDP excluding petroleum and other activities) was 1.6 per cent higher than a year earlier, compared with 5.7 per cent in the last quarter of 1997. The sharp increase in interest rates hit interest-rate sensitive expenditures, with housing starts and car purchases plummeting. In addition, oil output was down, reflecting delays in the completion of major investment projects and the government's decision to limit production, as part of an agreement with other major oil producers. Most indicators show the slowdown continuing in early 1999, the pick-up in retail sales in January-February being a notable exception. The current account, having reached a record surplus of 6 per cent of GDP in 1996-97, moved into deficit last year, mainly as a result of the oil price collapse.

Wage inflation is double the European Union average

Consumer price inflation hovered between 2 and 2.5 per cent during 1998, as the effect of lower world market prices was offset by the depreciation of the Norwegian krone and persistent inflationary pressures in the sheltered sector. Indeed, with labour market pressures remaining strong, there was a further rise in wage inflation, to 6 per cent, which is twice the European Union average. The resulting profit squeeze and the problems in the oil sector have depressed business sentiment. According to the most recent investment survey, for example, planned investment is down a fifth in 1999.

Norway



1. Twelve-month average index. Percentage change over same period of previous year.
2. Four quarter moving average for both the current account balance and GDP.
Source: Statistics Norway.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion NKr	1996	1997	1998	1999	2000
Private consumption	458.5	5.3	3.7	3.1	1.9	1.8
Government consumption	194.5	2.8	2.8	3.7	1.0	2.2
Gross fixed capital formation	192.5	9.9	15.1	8.1	–9.1	–10.3
Final domestic demand	845.5	5.8	6.2	4.5	–1.2	–1.1
Stockbuilding [a]	27.4	–1.3	0.3	0.9	–0.2	0.0
Total domestic demand	873.0	4.2	6.4	5.4	–1.4	–1.0
Exports of goods and services	353.4	9.3	5.7	0.5	2.8	8.2
Imports of goods and services	297.7	8.0	12.0	9.1	–1.5	0.8
Net exports [a]	55.8	1.5	–1.5	–3.1	1.9	3.6
GDP at market prices	928.7	4.9	4.3	2.1	0.6	2.6
GDP deflator	–	4.3	2.7	–0.4	4.5	2.4
Memorandum items						
Mainland GDP at market prices [b]	–	3.8	4.4	3.3	0.3	0.5
Mainland GDP deflator [b]	–	1.7	2.7	4.2	3.6	2.2
Exports of non-manufactures (incl. energy)	–	13.8	2.7	–2.7	2.5	11.5
Private consumption deflator	–	1.5	2.5	2.6	2.6	2.3
Unemployment rate	–	4.8	4.1	3.2	3.5	4.0
Household saving ratio [c]	–	6.0	6.5	7.1	6.7	6.6
General government financial balance [d]	–	6.6	7.9	3.9	3.0	3.9
Current account balance [d]	–	6.5	5.2	–1.5	2.1	6.3

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) GDP excluding oil and shipping.
c) As a percentage of disposable income.
d) As a percentage of GDP.

Despite some easing, the monetary stance remains tight

Since January 1999, the Norwegian central bank has lowered its key deposit rate by 150 basis points to 6.5 per cent, reflecting the sharp slowdown of the economy and the recovery of the Norwegian krone since mid-December 1998, bringing the currency back into the target range of monetary policy. Monetary policy will probably remain tight, although official rates are projected to be cut gradually as the weak economy brings down inflationary pressures. A more aggressive easing will hinge on the realisation of moderate wage rises. The social partners agreed on a “zero” wage round for 1999, but the strong carry-over implies that wage inflation will remain high even if there is no slippage from this agreement.

Despite the downturn, there is still an inflation risk

Tight policy, weak external demand conditions, falling capacity utilisation rates and depressed business sentiment will probably result in practically no growth in mainland real GDP in 1999, owing largely to a double-digit drop in business investment. The March 1999 agreement with the other major oil producers will prevent a substantial rise in oil production and enterprises supplying goods and services to the petroleum sector will be hit by the delay of investment projects. Weak activity will lead to some rise in the unemployment rate, and the overheating risks should diminish. Labour market pressures, however, may persist in some sectors, particularly the government sector (education and health). For 2000, a modest pick-up in mainland GDP is projected as world trade picks up and monetary policy eases. The key domestic risk to the projection for 2000 is that the unemployment rate, projected at 4 per cent, is still too low to prevent an excessive wage agreement resulting in a deterioration in competitiveness and lower exports.

Poland

After several years of rapid expansion, output growth slowed down markedly in the second half of 1998, reflecting high policy-induced real interest rates, as well as the weakening of exports, notably to Russia. Unemployment increased for the first time since 1994. Most macroeconomic fundamentals nevertheless remain sound: inflation is lower than expected; the financial system is stable; foreign companies continue to invest; and important structural reforms are underway. A resumption of rapid economic growth is expected in 2000.

The main challenge for the authorities will be to ensure that past stabilisation efforts are not compromised by the less supportive economic environment and, in particular, that fiscal balances do not deteriorate. The authorities should continue to implement urgently needed structural reforms.

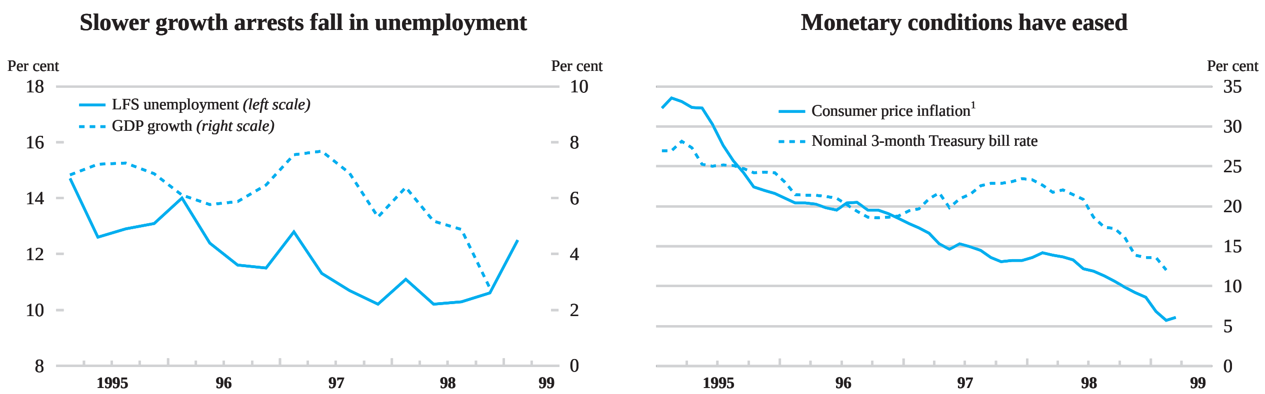
Output has slowed down with weakness in exports…

Real GDP increased by 4.8 per cent for the whole of 1998, but with a marked slowdown towards the end of the year due to a sharp fall in exports to Russia, and a slowdown in exports to the European Union. Domestic demand, although still increasing steadily, was less robust than expected due to the deterioration of business confidence and high real interest rates. The unemployment rate increased to 10.6 per cent at the end of 1998, the first increase in unemployment since 1994. The deterioration of exports in the second half of 1998 led to an increase in the current account deficit from about 4 per cent in 1997 to about 5 per cent of GDP in 1998.

… but macroeconomic fundamentals remain strong

Despite the recent slowdown, most macroeconomic fundamentals remain sound. Inflation has declined markedly, helped by stable food prices and falling commodity prices. Year on year consumer price inflation declined to 6.2 per cent in March 1999 from 13.9 per cent recorded one year earlier. Strong foreign direct investment flows have helped finance most of the current account deficit. The programme of structural reforms has fostered confidence in the economy. In particular, the authorities accelerated the privatisation programme, selling $ 2 billion worth of assets in 1998. In early 1999, they introduced a comprehensive reform of the pension system, which now consists of three tiers (the existing pay-as-you-go system, a new funded scheme, and voluntary individual retirement accounts). Reforms of the health care and education systems and a decentralisation of public finances were also undertaken.

Poland



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

Interest rates have been cut sharply following the Russian crisis

In the first half of 1998, faced with signs of overheating, the National Bank of Poland (NBP) tightened the monetary conditions to set the stage for a soft-landing. But, with the Russian crisis in August 1998, the NBP has cut interest rates several times. The intervention rate was brought down from a maximum of 24 per cent in April 1998 to 13 per cent in January 1999. With lower interest rates, the exchange rate depreciated within the fluctuation band, moving closer to its central parity, thereby helping to boost competitiveness. The NBP now faces the task of helping the economy to return to sustainable growth, while achieving its inflation targets of 6.6-7.8 per cent during 1999 and 4 per cent in 2003. Progress is well underway toward achieving the inflation target for 1999, and the NBP could, therefore, reduce interest rates cautiously in the second half of 1999.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion Zl	1996	1997	1998	1999	2000
Private consumption	182.0	8.6	7.0	4.5	3.4	3.8
Government consumption	53.6	3.4	3.4	1.8	1.7	2.0
Gross fixed capital formation	48.7	20.6	21.9	14.8	9.4	9.7
Final domestic demand	284.4	10.4	10.2	7.0	5.0	5.4
Stockbuilding[a, b]	0.5	1.7	0.8	0.1	0.1	0.1
Total domestic demand	284.9	12.2	10.9	7.0	5.0	5.4
Exports of goods and services	74.8	12.5	9.9	10.3	4.7	8.9
Imports of goods and services	70.9	28.0	18.3	13.9	7.3	8.7
Net exports[a]	3.8	–6.1	–4.6	–2.9	–2.0	–1.0
GDP at market prices	288.7	6.1	6.9	4.8	3.5	5.0
GDP deflator	–	18.5	14.7	12.0	6.2	5.5
Memorandum items						
Private consumption deflator	–	19.5	14.9	11.8	6.1	5.5
Industrial production	–	9.0	11.6	4.7	2.0	6.0
Unemployment rate	–	12.3	11.3	10.5	11.0	10.7
General government financial balance[c]	–	–2.8	–3.8	–3.7	–3.4	–3.0
Current account balance[c]	–	–2.4	–4.2	–5.3	–5.6	–5.6

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) Including statistical discrepancy.
c) As a percentage of GDP.

Additional fiscal measures may be necessary to contain the budget deficit

The general government deficit reached 3.7 per cent of GDP in 1998, exceeding the budget target of 3.2 per cent. The 1999 Budget again sets a deficit target for the general government of 3.2 per cent of GDP based on an optimistic growth projection of 5.1 per cent. The first three months of 1999 point to higher outlays than expected because of the implementation of the pension and the health care reform. New fiscal measures – such as higher excise taxes, increased administered tariffs, and reduced outlays – may be required to contain the budget deficit. This will be all the more necessary since Poland faces high costs to finance its structural reforms in preparation for accession to the European Union (EU), in particular for the coal mining and the agricultural sectors. A tax reform aiming at lowering tax rates and eliminating exemptions is under preparation.

Growth should accelerate again in 2000 pulled by exports and domestic demand

Real GDP growth is projected to slow down to 3.5 per cent in 1999, reflecting weak exports to neighbouring countries and to the EU in the first half of the year. Activity is projected to pick up in 2000 led by a recovery of exports but also assisted by lower interest rates. Inflation should accelerate slightly in 1999 as some temporary disinflation factors may disappear, though it should stay below the target of the monetary authorities. The current account deficit will probably stabilise at the high level of around 5½ per cent of GDP in 2000. An increase of the current account deficit beyond the already uncomfortable level projected for 1999 and 2000 would constitute a serious concern. A higher external deficit might not be sustainable, even if financed by further vigorous inflows of foreign direct investment. Particular caution will hence be necessary to prevent a further deterioration of the external deficit.

Portugal

Economic activity remains strong, boosted by consumer spending and private investment. However, weaker external demand and the end of temporary factors have led to a mild slowdown in output growth starting in late 1998. This has lessened concerns over overheating, helping to stabilise inflation and unemployment. Monetary conditions have eased significantly in the run-up to European Economic and Monetary Union, and the fiscal stance has loosened. Output growth is expected to be weaker in 1999 than last year, reflecting lower import demand in the European Union. A mild pick up is likely in 2000 however, as exports and public investment recover. Consumer price inflation is expected to fall, with unemployment remaining at present levels.

The persistence of significantly higher inflation than in the rest of the euro area and a widening current account deficit make it opportune to set more ambitious targets for fiscal consolidation and to press ahead with structural reforms. If the structural causes of recent public spending overruns are not addressed, the fiscal target for 2000 is unlikely to be met without new budget measures, especially since interest rates are unlikely to fall further and revenue growth is likely to decelerate.

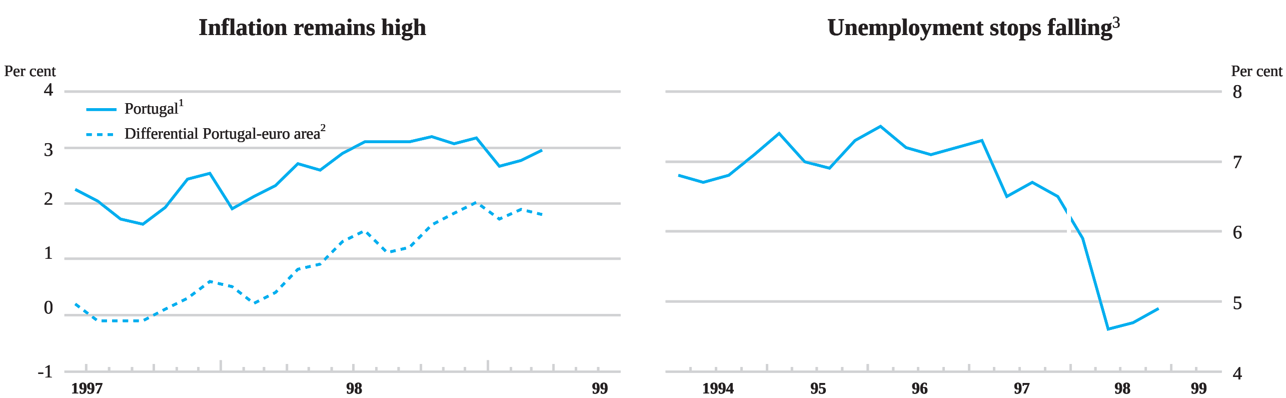
Output growth has slowed, helping to stabilise inflation

The economy has entered its sixth year of expansion, with private consumer and investment spending buoyed by rising disposable income, lower interest rates and the rapid expansion of domestic credit. Real output growth is estimated to have been at 3.9 per cent in 1998. Activity has started to lose momentum however, as a result of a deceleration in merchandise exports and the end of temporary factors that were boosting output, including the Expo98 in Lisbon and some large infrastructure projects. Unemployment fell sharply in early 1998, but then remained at around 5 per cent. Inflation stabilised in late 1998 and early 1999 at close to 3 per cent, as price rises in the non-tradables sector started to decelerate. On the external side, the current account deficit is estimated to have reached 4.3 per cent of GDP in 1998. While tourism receipts increased, in part as a result of Expo98, this was more than offset by a widening trade deficit, as imports were boosted by buoyant domestic demand.

Interest rates have declined, while the budget deficit has continued to narrow

For Portugal, membership of the European Economic and Monetary Union implied a sharp drop in policy-controlled interest rates in late 1998 – from 4.5 per cent in October to 3.0 per cent in December – followed by a further decline in Euro

Portugal



1. Measured by the national consumer price index. Year-on-year percentage change.
2. Measured by the harmonised consumer price index. Year-on-year percentage change.
3. Per cent of total labour force, which excludes conscripts. Break in first quarter 1998 due to changes in the survey methodology.
Sources: Banco de Portugal; European Central Bank.

rates in early 1999. Long-term rates have also moved down, as in the rest of the euro area. As a result, public debt servicing costs have continued to fall. Combined with buoyant tax revenues, resulting from better tax collection and strong domestic demand, this has led to a steady decline in the general government budget deficit in spite of increased primary spending. In 1998, the deficit reached 2.3 per cent of GDP, below the official target for the fifth year in a row. However, the cyclically-adjusted primary surplus has declined, pointing to a loosening of the fiscal stance. The Stability and Growth Programme calls for a cut in the deficit to 2.0 per cent in 1999 and 1.5 per cent in 2000. As in previous years, debt servicing costs should fall sufficiently fast for the target to be met in 1999. In 2000 however, with interest rates no longer declining and the fight against tax evasion bringing diminishing returns, new budget measures are likely to be necessary, especially if the authorities fail to address the structural causes of the spending increases of recent years.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion Esc	1996	1997	1998	1999	2000
Private consumption	10 262.6	2.5	3.0	5.2	3.8	3.1
Government consumption	2 795.0	2.0	2.5	3.3	2.8	2.5
Gross fixed capital formation	3 734.4	5.7	11.3	9.5	6.3	7.0
Final domestic demand	16 792.0	3.3	5.1	6.1	4.3	4.1
Stockbuilding [a]	114.9	–0.5	0.1	0.5	–0.2	0.0
Total domestic demand	16 907.0	2.8	5.2	6.5	4.1	4.1
Exports of goods and services	4 878.8	10.2	8.4	9.3	6.3	7.3
Imports of goods and services	5 968.1	7.5	10.4	13.3	7.3	7.7
Net exports [a]	–1 089.3	0.1	–2.1	–3.5	–1.7	–1.6
GDP at market prices	15 817.7	3.2	3.7	3.9	3.1	3.2
GDP at market prices in billion euros	78.9					
GDP deflator	–	2.8	3.0	3.4	2.9	2.5
Memorandum items						
Private consumption deflator	–	3.6	2.0	2.8	2.5	2.3
Industrial production [b]	–	1.4	2.5	4.0	3.8	3.5
Unemployment rate	–	7.3	6.8	5.0	5.0	5.0
Household saving ratio [c]	–	10.2	10.4	9.6	9.1	9.1
Current account balance [d]	–	–2.1	–2.7	–4.3	–4.5	–4.7

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) Industrial production index.
c) As a percentage of disposable income.
d) As a percentage of GDP.

Activity should pick up in 2000, but uncertainties attach to import demand from the rest of the European Union

Output growth is projected to slow down to a still respectable 3.1 per cent in 1999, as both domestic and foreign demand weaken. Lower job creation is expected to lead to less buoyant consumption, while exports are likely to grow less than last year reflecting the moderation of economic activity in the rest of the European Union (EU). Low interest rates will continue to boost private investment however. A modest recovery is expected in 2000, as export growth picks up in line with more buoyant economic conditions in the euro area, and a new round of infrastructure projects is launched in the context of sustained EU transfers. Unemployment is projected to remain at 5 per cent throughout the projection period, as job losses in construction and the textile industry are more than offset by an increase in employment in other sectors, especially services. Consumer price inflation is likely to moderate, as wage pressures diminish with a slowing economy. The gap between Portuguese and euro-wide inflation is expected to remain significant, however. The current account deficit may reach 4.7 per cent of GDP in 2000, as tourism receipts grow more slowly and the trade deficit widens. The main uncertainty attaching to the projections concerns the external sector, especially exports which will depend on the evolution of demand from Portugal's main trading partners in Europe.

Spain

Growth has been sustained by strong domestic demand, owing to easy monetary conditions and solid consumer confidence supported by strong job creation. As a result of weakening export markets, growth is projected to slow, but to remain solid at around 3¼ per cent this year and next. Despite moderate wage settlements, inflation has remained above the euro area average and is projected to remain broadly unchanged.

Further primary expenditure restraint would provide a cushion against revenue uncertainties related to the tax reform, and would help reduce the debt to GDP ratio faster. Enhanced monitoring of regional governments' deficits should match increasing fiscal decentralisation. Deregulation of product markets should be speeded up further. This would help to contain the persistence of inflation differentials that may undermine competitiveness and employment growth in the new policy setting of the European Economic and Monetary Union. More comprehensive reforms aimed at reducing labour market segmentation and the cost of job creation could further foster employment growth.

Economic performance has easily outpaced the euro area average

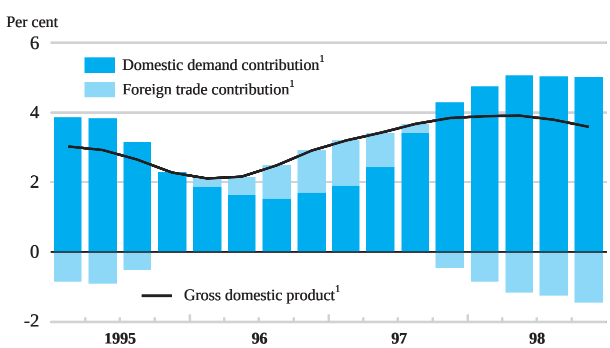
Continuing healthy growth (3.8 per cent in 1998) has put the economy in a cyclical position ahead of most euro area countries. However, activity has lost momentum since the last quarter of 1998 because of an increasing drag from the foreign sector. Exports of goods have faltered since the second half of 1998, the sharp slowdown being only partly offset by the good performance of tourism. Domestic demand remained buoyant, however, expanding by an annual rate of 4.9 per cent in the fourth quarter of 1998, supported by strong business investment and booming purchases of consumer durables. Employment expanded strongly, and the unemployment rate fell by two percentage points, to 18.2 per cent in the last quarter of 1998 – still very high by international comparison. Despite moderating wage demands, underlying inflation has hovered around 2¼ per cent since the beginning of 1998, with inflationary pressures in services being particularly stubborn.

Personal income tax cuts will sustain domestic demand…

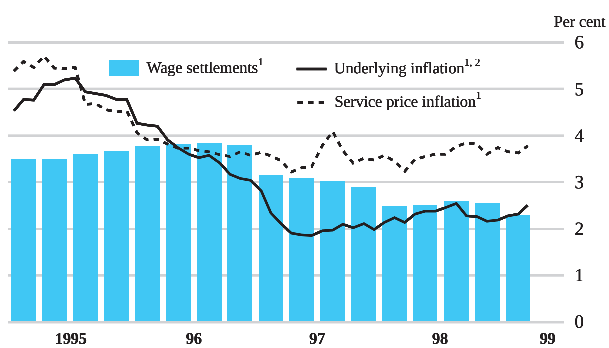
In 1998, the government deficit fell to 1.8 per cent of GDP, outperforming the initial target. Stronger than expected revenues mainly reflected robust economic activity. Part of the windfall served to increase public investment. The 1999 Budget includes a significant personal income tax reform, which lowers marginal rates and better adjusts withholding tax payments to final tax liabilities. The estimated impact

Spain

Domestic demand boosts economic growth



While disinflation has stalled



1. Year-on-year percentage changes.
2. Excluding non-processed food and energy.

on the budget amounts to around ¾ per cent of GDP, and will be spread between 1999 and 2000. The income tax reform will boost disposable income and consumer spending. In addition, the lowering of employers' social security contributions for targeted groups of employees will be extended for two more years. The fiscal stance will, however, remain broadly neutral over the projection period, as the fiscal impulse due to the tax reform will be offset by slow growth in primary spending, as hiring restrictions for civil servants are being maintained. Fiscal decentralisation has also progressed, with the regions now being able to set tax rates – up to certain limits – over a larger share of the personal income tax base that has been ceded to them. In addition, a scheme of guarantees has been set up to protect the regions from excessive cyclical shortfalls of their revenues. Uncertainties remain, however, as to effective compliance of regions with limitations on the recourse to borrowing and on the impact of the new system on the overall budget deficit.

Demand, output and prices

Percentage changes, volume (1986 prices)

	1995 current prices billion Ptas	1996	1997	1998	1999	2000
Private consumption	43 313.6	2.0	3.1	3.8	4.0	3.8
Government consumption	11 650.2	0.9	1.4	1.6	1.9	1.9
Gross fixed capital formation	14 494.2	1.3	5.1	9.1	7.5	7.6
Final domestic demand	69 458.0	1.7	3.3	4.7	4.5	4.4
Stockbuilding[a]	250.5	0.0	–0.3	0.2	0.1	0.0
Total domestic demand	69 708.5	1.6	2.9	4.9	4.6	4.5
Exports of goods and services	16 731.7	10.6	14.8	7.8	5.2	6.2
Imports of goods and services	16 660.1	7.4	12.2	10.6	8.5	8.8
Net exports[a]	71.5	0.7	0.5	–1.2	–1.4	–1.3
GDP at market prices	69 780.1	2.4	3.5	3.8	3.3	3.3
GDP at market prices in billion euros	419.4					
GDP deflator	–	3.2	2.0	2.2	2.5	2.6
Memorandum items						
Private consumption deflator	–	3.4	2.5	2.0	2.2	2.2
Industrial production	–	0.4	6.1	5.4	4.5	5.0
Unemployment rate	–	22.2	20.8	18.8	17.4	16.2
Household saving ratio[b]	–	11.9	10.8	10.5	10.5	10.2
General government financial balance[c]	–	–4.7	–2.6	–1.8	–1.8	–1.4
Current account balance[c]	–	0.0	0.4	–0.3	–1.4	–1.9

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) As a percentage of disposable income.
c) As a percentage of GDP.

… while the main risk stems from uncertain growth in export markets

In 1999, domestic demand is projected to ease only slightly, and remain solid in 2000 growing by close to 4½ per cent in each year. Consumer confidence is supported by brisk job creation and by the tax reform. Although business confidence has been deteriorating in industry, mainly reflecting uncertainties concerning foreign orders, business investment should remain vigorous because the rate of capacity utilisation is close to an historical peak and profits are solid. GDP growth in 1999 will decelerate, but remain robust, net exports accounting for half of the projected slowdown. The unemployment rate is projected to continue falling substantially. With the package of measures to contain inflation announced in April, inflation is expected to remain close to 2¼ per cent. However, in the absence of bolder labour market reforms, and with the output gap closing rapidly, inflationary pressures could emerge. Another risk to the outlook is related to foreign demand developments. These concern the strength of growth in other European Union countries and the prospects of the European automobile sector, one of the main Spanish exporting sectors, which could weaken significantly. A stronger than expected squeeze in export market growth would dampen economic activity, but also reduce the inflation risk.

Sweden

Economic growth remains robust despite weaker external demand, being sustained by a strong expansion of business fixed investment and private consumption. The completion of the 1995-98 fiscal consolidation process is allowing renewed growth of household incomes and public sector demand. Monetary conditions remain highly supportive in an environment of low inflation and moderate wage agreements. Labour-market outcomes should thus continue to improve, although at a slower pace. The underlying strength of the domestic economy will reassert itself in 2000, with projected growth of around 2¾ per cent.

The present mix of fiscal restraint and expansionary monetary policy should sustain the recovery. But 8 per cent of the labour force are enrolled in active labour market schemes and education programmes, so that there is a continued need for reducing labour-market imbalances. Further efforts are needed to improve labour and product market efficiency, including a lowering of the high marginal effective tax rates embedded in tax and transfer systems and a strengthening of competition.

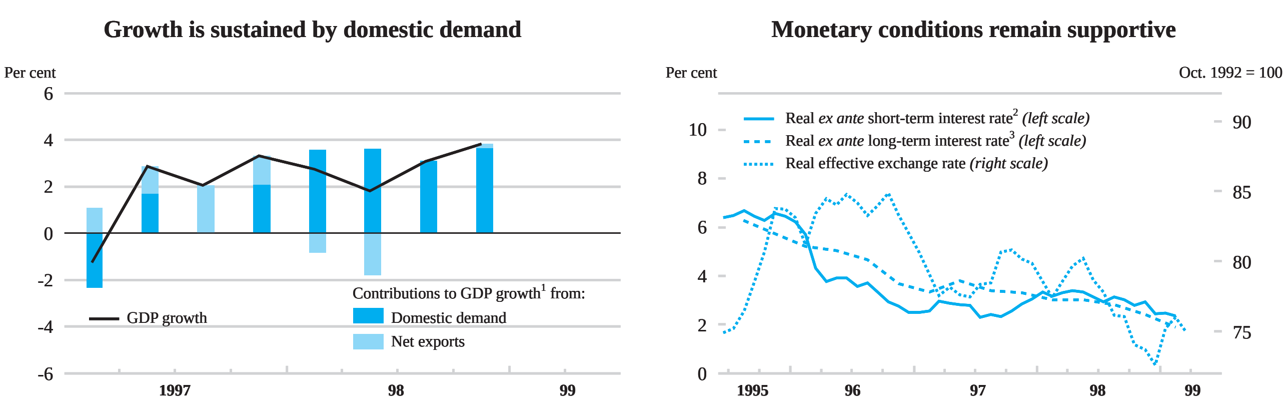
Export weakness has been offset by strong domestic demand growth

Economic growth remained robust throughout the second half of 1998, as domestic demand benefited from stimulatory financial-market conditions and rising real incomes. Both private consumption and public sector demand increased and business fixed investment registered year-on-year growth rates of 15 per cent. Export growth, which had weakened in mid-year, recovered somewhat as Swedish exporters continued to make gains in market share. Import penetration continued at a rapid pace, entailing a negative contribution to activity from net exports for the year as a whole and limiting annual GDP growth to 2.9 per cent.

Labour demand is strong, but wage growth remains subdued

Labour demand strengthened during 1998 and employment is now rising at an annual rate of 2½ per cent. The inroads made into joblessness have been substantial. Although the labour force has begun to pick up, an unemployment rate of 5.4 per cent was recorded for March, compared with an average rate of 6½ per cent in 1998. Wage growth slowed to 3½ per cent in 1998, reflecting the 2¾ per cent agreement at central level and moderate locally-determined wage drift. The headline inflation rate was zero in March, having been negative from September, depressed by the fall in

Sweden



1. Contributions to changes in real GDP (as a percentage of real GDP in the previous year) over the past four quarters.
2. Rate of 3-month Treasury bills adjusted for the CPI change expected by households in the coming year.
3. Rate of 5-year government bonds adjusted for bond investors' CPI expectations over the next 5 years.
Sources: SCB; Sveriges Riksbank; OECD.

long-term interest rates, cuts in indirect taxes and falling import prices. Excluding these influences, domestically-generated inflation is around 2 per cent.

The budget remains in surplus, with a supportive monetary policy

Fiscal consolidation has been rapid over the past few years, underpinned by three-year expenditure ceilings for central government expenditure and the legal obligation that local governments balance their books by 2000. The general government balance has moved from a deficit of 7 per cent of GDP in 1995 to a surplus of 2 per cent in 1998. The medium-term aim is to generate a structural surplus of this magnitude, which should be within reach. In the short term, tax revenues relative to GDP may slip as capital gains fall back from an extraordinarily high level, and as a result of tax cuts for lower incomes and a higher threshold for the top income tax rate. Following the turbulence in international markets, which caused a strong rise in the premium on Swedish bonds and a weaker exchange rate, the long-term interest rate differential against German rates has fallen to just over ¼ percentage point and the krona appreciated by 5 per cent against the euro in early 1999. From November 1998 the central bank has reacted to lower inflation by gradually lowering the repo rate, which stood at 2.90 per cent in late March.

Demand, output and prices

Percentage changes, volume (1991 prices)

	1995 current prices billion SKr	1996	1997	1998	1999	2000
Private consumption	863.5	1.3	2.0	2.6	3.0	2.5
Government consumption	425.7	–0.2	–2.1	1.9	1.0	1.0
Gross fixed capital formation	240.4	3.7	–4.8	9.6	5.0	6.0
Final domestic demand	1 529.6	1.3	–0.3	3.6	2.8	2.7
Stockbuilding [a]	14.2	–1.1	0.7	0.3	–0.4	0.1
Total domestic demand	1 543.8	0.1	0.4	3.9	2.4	2.8
Exports of goods and services	675.4	6.1	12.8	7.3	3.8	5.5
Imports of goods and services	569.2	3.7	11.7	11.0	4.0	6.2
Net exports [a]	106.2	1.2	1.4	–0.6	0.2	0.2
GDP at market prices	1 649.9	1.3	1.8	2.9	2.4	2.8
GDP deflator	–	1.0	1.2	0.8	0.6	1.2
Memorandum items						
Private consumption deflator	–	1.2	2.2	0.5	0.7	1.0
Industrial production	–	2.3	7.4	4.7	2.0	4.0
Unemployment rate [b]	–	8.0	8.0	6.5	5.6	5.3
Household saving ratio [c]	–	4.4	1.1	1.2	1.7	1.4
General government financial balance [d, e]	–	–3.5	–0.7	1.9	0.7	2.0
Current account balance [d]	–	2.3	3.2	2.1	1.5	1.8

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

Growth will slow in 1999, but is set to rebound

Underpinned by adherence to fiscal and inflation objectives, Swedish interest rates, both short and long, should remain close to comparable euro rates. Supportive monetary conditions and substantial real-wage gains will allow domestic demand to continue to support the economic upturn this year and next, giving further impetus to employment growth. The contribution from the external sector is likely to be close to neutral. An inventory correction and some slowing of investment growth may hold back the rise in GDP to below 2½ per cent in 1999, with growth strengthening to above 2¾ per cent in 2000.

Risks to the outlook are evenly balanced

In recent years, significant imbalances have been eliminated in the balance sheets of households, enterprises and the public sector, while resources are still available to support the upturn. On both the output and inflation side, the risks thus seem to be evenly balanced. However, this relatively benign short-term outlook rests on continued emphasis on budget consolidation to prevent fiscal policy from turning overtly pro-cyclical and re-igniting labour market pressures.

Switzerland

Robust domestic demand more than offset the effect of slowing exports so that real GDP grew by 2.1 per cent in 1998 – the best performance in eight years. Economic activity is estimated to have weakened in the first half of 1999, but forward-looking indicators point to stronger growth later on, helped by easy monetary conditions and recovering export markets. Supported by an improving labour market, household consumption should remain the main engine of economic growth. In spite of the value-added tax rate increase in January 1999, inflation is likely to remain very low, reflecting a significant output gap and intensified competitive pressures from deregulated domestic markets and from abroad.

The projected slowdown of growth this year and the absence of inflation pressures motivated the National Bank to cut the discount rate to 0.5 per cent in April 1999, following the intervention rate cut by the European Central Bank. Hence, scope for any further monetary easing has narrowed. The new constitutional mandate to balance the federal budget by 2001 requires some fiscal tightening, which appears appropriate in view of the future budgetary burden from population ageing.

A temporary slowdown of economic growth…

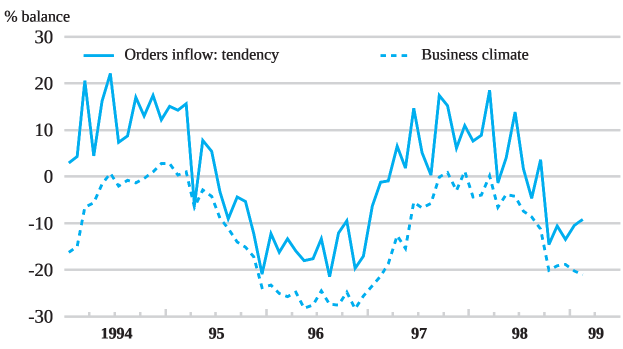
Export growth slowed markedly in the second half of 1998, reflecting weakening export markets in response to the crises in Asia and Russia. The resulting contractionary effect was more than offset by buoyant final domestic demand – household consumption and machinery and equipment investment in particular.* Current indicators signal a deterioration of the business climate, a more pessimistic assessment of order flows and stocks by entrepreneurs, and a fall in industrial capacity utilisation. Nevertheless, surveys of expected orders and production prospects suggest a pick-up in business optimism for the future.

… combined with falling unemployment and stable prices

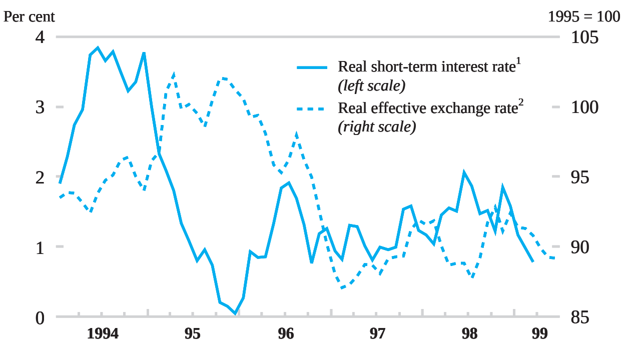
Employment recovered further, and the unemployment rate continued to fall sharply, to 3.0 per cent in March 1999. However, a large part of the fall was due to reforms, such as the tightening of unemployment benefit eligibility and the implementation of active labour market programmes, many of whose participants are not

Switzerland

The business climate deteriorates



Monetary conditions remain easy



1. 90-day euro-Swiss franc rate deflated by the 12 month-change in the consumer price index.
2. CPI based.

* Stockbuilding also made a significant contribution to GDP growth in 1998. But this was essentially the counterpart of strong imports of gold and precious stones, and thus had no net effect on GDP. After reprocessing in Switzerland these goods are likely to be exported again.

Demand, output and prices

Percentage changes, volume (1990 prices)

	1995 current prices billion SF	1996	1997	1998	1999	2000
Private consumption	215.9	0.4	1.2	1.8	1.8	1.9
Government consumption	55.0	1.4	–0.1	0.6	0.4	0.3
Gross fixed capital formation	77.6	–2.7	1.5	3.8	3.3	4.0
Final domestic demand	348.5	–0.2	1.1	2.1	2.0	2.2
Stockbuilding [a]	0.4	0.2	0.0	1.9	–0.5	0.4
Total domestic demand	348.9	0.0	1.0	4.0	1.5	2.6
Exports of goods and services	127.5	2.5	9.0	4.1	2.8	4.0
Imports of goods and services	113.0	2.7	7.2	8.8	3.4	5.8
Net exports [a]	14.6	–0.1	0.7	–1.9	–0.3	–0.9
GDP at market prices	363.5	0.0	1.7	2.1	1.2	1.8
GDP deflator	–	0.4	–0.2	1.1	1.0	1.2
Memorandum items						
Private consumption deflator	–	1.1	0.6	0.2	0.6	0.8
Industrial production	–	–0.1	5.4	3.7	2.1	3.1
Unemployment rate	–	4.7	5.2	3.9	3.0	2.7
Current account balance [b]	–	7.4	8.9	8.1	7.8	7.6

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) As a percentage of GDP.

counted as unemployed. Consumer inflation averaged zero in 1998 and has remained very low so far in 1999, in spite of the value-added tax rate increase by 1 percentage point to 7.5 per cent in January. Price stability has been underpinned by the substantial output gap, falling import prices, unchanged rents due to declining mortgage rates, and intensified competition from deregulation.

Easy monetary conditions…

In spite of the base money's marked overshooting of its medium-term target, the National Bank (SNB) kept the three-month interest rate at around 1½ per cent in 1998. With the (consumer-price-index based) real effective exchange broadly unchanged, monetary conditions have remained rather easy, all the more so after the SNB lowered the discount rate from 1 to 0.5 per cent in the wake of the refinancing rate cut by the European Central Bank in April 1999. The projection assumes that the SNB provides sufficient liquidity for short-term interest rates to stay slightly below 1 per cent in 1999 and 2000 – about ½ percentage point below the average level of 1998.

… and improving government finances should support…

Following two years of broadly stable deficits of around 1½ per cent of GDP, the Confederation's budget balance improved sharply in 1998 to a surplus of SF ½ billion (0.1 per cent of GDP). A major factor contributing to this outcome was the partial privatisation of Swisscom (telecommunications); abstracting from this transaction, the deficit fell to SF 2½ billion (½ per cent of GDP). The fiscal policy stance is assumed to be about neutral in 1999 but to tighten thereafter, in accordance with the objective of a broadly balanced federal budget in 2001. Nevertheless, the Confederation's programme of 1997 to bring forward maintenance expenditure on public infrastructure is supporting construction investment during the first half of 1999, while later on activity will benefit from the start of some large public projects.

… a continuing upswing

The projections embody a further slowdown of export growth for 1999 due to a negative carry-over from 1998 and still weak export markets; but the projected recovery of foreign demand and restructuring of exporting industries should permit a rebound of exports in 2000. This, combined with improved company profitability, low capital costs and falling prices of imported investment goods, will provide a stimulus to growth of machinery and equipment investment. Increased public infrastructure expenditure in 1999-2000 should help the mild upswing of construction investment to continue. Private consumption is likely to remain a mainstay of domestic demand, supported by improving labour incomes and growing optimism about the labour market. The unemployment rate may fall further, in response to rising employment and labour market reform. In 1999 inflation is likely to remain very low.

The exchange rate remains the major uncertainty

Given Switzerland's traditional role as a "safe haven" for international investors at times of financial markets crises, and the resulting tendency for large exchange rate fluctuations, the external value of the Swiss franc remains the major uncertainty attached to the projections. A weaker franc could impart an additional stimulus to exports while further exchange rate appreciation would entail a dampening effect on the exposed sector of the economy.

Turkey

The Turkish economy slowed sharply in 1998, initially reflecting the government's stabilisation programme and then the emerging market crisis in the second half. The slowdown was accompanied by a strong deceleration in inflation and a shift in the current account to surplus. The external shock, together with domestic political uncertainty, pushed up real interest rates to unsustainable levels. Assuming a gradual decline in real rates over the projection period, a return to moderate growth is expected in 2000.

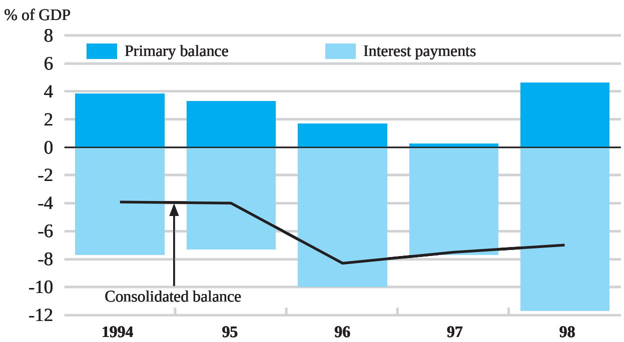
Public expenditure restraint and tax reform led to a welcome tightening of fiscal policy in 1998. However, progress in structural reform has been less satisfactory. A strengthened programme involving reform of the social security system, banking reform, privatisation and restructuring of the state enterprises and agricultural subsidies will be needed in order to re-establish investor confidence and bring a durable decline in public deficits, inflation, and real interest rates.

The stabilisation programme and the global crises have caused a sharp slowing in domestic demand

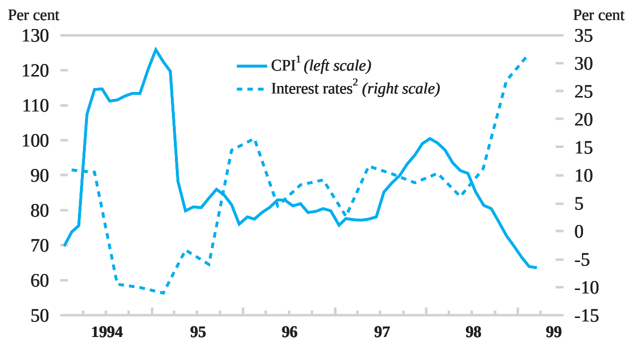
Following three years of growth in the 7 to 7½ per cent range, economic activity cooled markedly from the second quarter of 1998. Domestic demand growth began to weaken in response to tax reform and a tight monetary stance in the first half of the year, and was hit by a sharp credit squeeze in the second half. The latter resulted from a substantial ($ 7 billion) withdrawal of foreign liquidity from the Turkish market as foreign investors withdrew from emerging markets in the wake of the Russian debt moratorium in August 1998. To ensure the continued financing of the government debt, real interest rates in the domestic market rose sharply. A domestic political crisis, which caused the fall of the government in November, increased real interest rates further, to 40-50 per cent (deflated by the wholesale price index). The stock market fell by some 50 per cent in dollar terms.

Turkey

Budget deficit remains high



Inflation decelerates but real interest rates rise



1. Year-on-year percentage changes.
2. Short-term interest rate deflated by CPI inflation.
Source: State Planning Organisation.

External demand has also weakened

On the external side, the demand for exports suffered from the emerging market crisis, which led to global demand weakness and increased competition from devaluing countries. The impact of the Russian crisis was most severe: exports to Russia and neighbouring countries (which, inclusive of estimated "suitcase trade", accounted for perhaps one quarter of exports in 1997) have fallen off markedly. The current account has, nevertheless, shifted into surplus, reflecting the impact of domestic demand weakness on imports and a rise in both "other goods and services" exports and workers' remittances.

Inflation has fallen and macroeconomic policies have been significantly tightened

Consumer price inflation has fallen sharply, from 100 per cent at the start of 1998 to 64 per cent by April 1999 (50 per cent in terms of wholesale prices), as a result of weakening domestic activity, declining import prices, and administered price restraint. High inflation in Turkey has historically been associated with large fiscal deficits and monetary accommodation. To anchor the disinflation process, an eighteen-month International Monetary Fund (IMF) Staff Monitored Programme was adopted in mid-1998, based on reducing the fiscal deficit and ending monetary accommodation. Tighter spending discipline and higher tax receipts, reflecting a major tax reform, allowed the government's primary surplus to rise to 4½ per cent of GNP, from near-balance in 1997, in line with programme targets. This contained the budgetary impact of higher interest payments, allowing the overall deficit to fall slightly in 1998, to 7 per cent of GNP. The Central Bank, for its part, has had to balance the operational objective of maintaining stability in the real exchange rate with the need to provide sufficient liquidity to the banking system to ensure an orderly financing of the government debt, including a very high rollover of existing debt.

Demand, output and prices

Percentage changes, volume (1987 prices)

	1995 current prices trillion TL	1996	1997	1998	1999	2000
Private consumption	5 458	8.5	8.4	0.1	2.0	3.8
Government consumption	837	8.6	4.1	5.0	5.0	5.0
Gross fixed capital formation	1 854	14.1	14.8	–2.4	0.0	5.2
Final domestic demand	8 149	10.0	9.9	–0.3	1.6	4.3
Stockbuilding [a]	127	–2.3	–0.9	1.1	0.0	0.0
Total domestic demand	8 276	7.6	9.0	0.7	1.6	4.3
Exports of goods and services	1 544	22.0	19.1	10.5	2.5	7.0
Imports of goods and services	1 890	20.5	22.4	2.2	3.0	8.0
Net exports [a]	–346	–0.6	–1.9	2.2	–0.3	–0.6
Statistical discrepancy [a]	–164	–0.4	–0.1	–0.2	0.0	0.0
GDP at market prices	7 766	7.0	7.5	2.8	1.4	3.9
GDP deflator	–	77.8	81.5	74.8	50.0	31.0
Memorandum items						
Private consumption deflator	–	68.0	82.2	80.7	54.0	32.0
Unemployment rate	–	6.0	6.4	6.3	6.5	6.4
Current account balance [b]	–	–1.3	–1.4	1.5	0.4	–0.7

a) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
b) As a percentage of GDP.

The outlook is subdued by still-high real interest rates

The projections assume continuing fiscal discipline, and a gradual recovery in foreign investor confidence following the formation of a new government and a stabilisation of emerging markets globally. This should allow real interest rates to decline steadily, though they may remain relatively high. With a still-weak external environment this year, and lagged effects of extremely high real interest rates on domestic demand, activity will remain weak in 1999. Next year, domestic and external demand should both recover somewhat, but overall growth could still be held back by fiscal restraint. Inflation will continue to drift downward, in line with continued fiscal discipline.

The main risks relate to domestic policy implementation

The risks attaching to this projection are quite large. If implementation of the stabilisation programme is incomplete, foreign confidence could weaken and high real interest rates would stifle the projected recovery of demand. Conversely, a reinforced (IMF-financed) stabilisation programme, with a strengthened structural reform component, could enhance the credibility of disinflation policy, leading to a more dramatic inflow of foreign capital and a sharper fall in real interest rates.

III. DEVELOPMENTS IN SELECTED NON-MEMBER ECONOMIES

Economic conditions improved in some non-member economies over the last six months but worsened in others. Activity in the Dynamic Asian Economies has bottomed out and growth in China has picked up under the impetus of the government's fiscal stimulus. In Russia, output has recovered somewhat following a sharp decline in the immediate aftermath of the financial crisis of August 1998 and rather tight financial policies have so far prevented runaway inflation and slowed the depreciation of the currency. The Russian crisis has accentuated the deterioration in growth performances in South America that were already underway. In Brazil, following the currency crisis and tough fiscal tightening, GDP could undergo a severe recession; while Argentina is suffering large spill-over effects from the downturn in Brazil.

Considerable risks remain to the outlook in the individual regions. Conditions are in place for a mild rebound in economic activity to begin this year in Dynamic Asia, but recovery is unlikely to become firmly established before next year. China needs to make substantial progress during the next several years in reforming its financial and enterprise sectors – which will require substantial improvement in public finances – if growth is to be sustained beyond the near term. In Russia, formidable pressures on economic policy from the state budget, the challenges of finding the resources to meet upcoming foreign debt service payments and upcoming elections pose major uncertainties to near-term economic prospects. In other transition countries, progress in economic restructuring is heavily dependent on increased foreign investment, which could be complicated by the present crisis in Kosovo. For South America, Brazil remains the key source of uncertainty. The Brazilian government is delivering on its fiscal promises, and the fall of the exchange rate was halted in early March. Interest rates have also started to come down, but this process will have to continue in the next few months for the situation to become sustainable.

Dynamic Asia and China

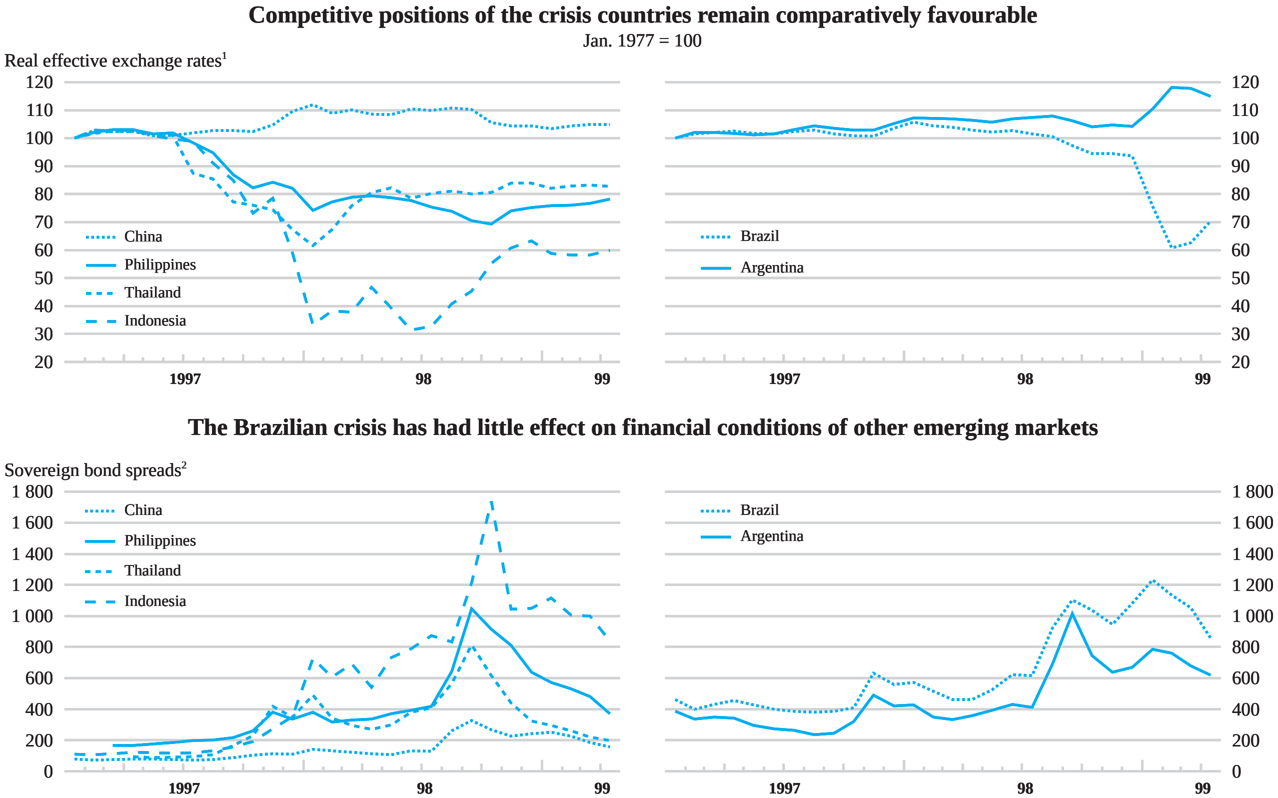
Economic activity in Dynamic Asia has stabilised

Economic activity stabilised in most of the Dynamic Asian Economies (DAE) during the latter half of 1998. Imports, which contracted by nearly 19 per cent in dollar terms for 1998 as a whole, began to revive in the closing months. However, unemployment is still rising and, as of early 1999, there were few signs of a recovery in domestic spending or production.

Conditions now favour a revival of activity...

Conditions are now favourable to a rebound of economic activity. Fiscal policy, focusing on income maintenance and employment creation, has become increasingly more supportive since the middle of 1998. Resources to support the fiscal stimulus in the crisis countries have been augmented by funds being provided by the Japanese government under the "Miyazawa" plan. The Brazil crisis has had little if any adverse effect on financial conditions in the DAE. Interest rates have fallen considerably, in some cases to levels below those prevailing before the crises began. Inflation is declining rapidly, which should allow interest rates to come down further and for monetary policy to remain accommodating throughout the forecast horizon. However, banks remain reluctant to lend and credit growth is still stagnant or negative on a year-over-year basis in most countries. Nonetheless, fiscal stimulus together with restocking of inventories back toward levels more in line with present production levels should kindle a bounce-back in activity sometime during 1999. Export growth

Figure III.1. **Real effective exchange rates and sovereign bond spreads**



1. OECD estimates based on consumer price indices.
2. Spreads are basis points difference between yields on longer-term public and publicly guaranteed bonds in comparable US Treasury bonds.

Sources: Bloomberg and OECD.

will also help to support a revival, as the countries that have gained most in competitiveness should be able to make further gains in market share. Exporters in Malaysia, the Philippines, Singapore and Chinese Taipei will also benefit from the expected recovery in world demand for electronic products.

… but a durable recovery is unlikely to start before 2000

A durable recovery will require self-sustaining increases in domestic private income and spending that are unlikely to become established before next year. The scope for fiscal stimulus in 2000 will almost certainly be less than in 1999, given the substantial budget deficit levels that will be reached this year, the need for further public outlays for financial restructuring, and the likelihood that official external financing for the deficits will be more limited. Export growth is likely to moderate for Indonesia, Malaysia, the Philippines, and Thailand, as the effects of their gains in competitiveness run their course. With low capacity utilisation rates – now below 60 per cent in Thailand and Indonesia – and with credit availability limited in several countries, capital spending is likely to be confined to cost-cutting efforts and to export sectors. Rising unemployment and falling real wages will continue to depress household incomes through at least this year. Given these conditions, business and consumer confidence will have to improve significantly for the recoveries to be sustained.

Recovery prospects vary

Overall, prospects for a recovery that gains momentum during 2000 appear brightest in Singapore and the Philippines, where the downturns have been milder than in the other crisis countries and the banking sectors are still in reasonably sound condition. Recovery prospects in Malaysia also appear somewhat better than they did six months ago, although there remain worries that government-imposed minimum lending targets will lead to further increases in problem loans and that the capital control regime will depress foreign investment in the manufacturing sector. In Hong Kong, China, the banking sector remains sound and financial market confidence appears to have improved noticeably; but recovery prospects are subject to uncertainties arising from the weakness in property markets, concerns over China's economic performance, and the risk of renewed external shocks.

More progress is needed on financial restructuring in Thailand and Indonesia...

Recovery prospects are particularly uncertain in Thailand and Indonesia and depend critically on a near-term acceleration in the pace of bank and corporate sector financial restructuring – which has gone more slowly than expected. Although the pace has picked up substantially since the third quarter of last year, less progress has been made in either country than in Korea, where the authorities intervened aggressively during 1998 to replenish banks' capital and to restart lending to the corporate sector. In Thailand, arrangements to deal with the bulk of the external debt of the banking system have been put in place and progress has been made in selling off assets of failed finance companies. But despite severely depleted capital, most banks have stayed out of the government's recapitalisation programme to avoid the severe write-downs of equity and potential loss of management control it entails. These banks have sought instead to try to raise capital from foreign or alternative domestic sources – but their efforts have met with only partial success. More institutions are expected to subscribe to the government programme around mid-1999 when increased provisioning requirements come into force. However banks will probably continue to give priority to bolstering their capital over extending new loans to the corporate sector through much of this year. Restructuring of corporate sector debt has been further delayed by the weakness of foreclosure and bankruptcy laws, which has limited creditors' leverage in bringing debtors to terms and encouraged corporations to delay servicing their debts even when they are able to pay. The recent passage of reforms to these laws, although nearly six months behind the original schedule, should help in this regard. While some time is likely to be required to implement the reform measures, their availability should improve debtors incentives to come to terms. Corporate restructuring efforts are also likely to be facilitated by the agreement, in March 1999, among 61 foreign and domestic financial institutions on expedited procedures for negotiations with corporate debtors, including provisions for agreement by a qualified majority of creditors.

… and recovery in Indonesia is still some way off

In Indonesia, plans announced by the government in March 1999 to restructure and recapitalise the private banking sector and to complete the reorganisation of the state banking sector represent a major step toward restoring the ability of banks to resume lending to the corporate sector. Efforts to restructure the corporate sector's external debt have also picked up considerably with the Jakarta initiative announced last September. More than 125 firms representing about $ 17.5 billion of the total debt were participating in the programme by March 1999; separate initiatives are also underway between the largest Indonesian corporations and their foreign creditors. However, only limited progress has been made to date in bringing restructuring deals to completion. Although reforms to the bankruptcy code instituted in 1998 should eventually help restructuring efforts, the outcomes in the cases that have been brought so far indicate that effective implementation is likely to take more time. Given the size and complexity

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

	1997	1998	1999	2000
China				
Real GDP growth	8.8	7.8	7.2	6.8
Domestic demand growth	6.7	7.7	7.7	7.0
Inflation	0.8	–2.6	–1.0	1.0
Current account balance ($ billion)	29.7	30.1	18.9	16.3
Current account balance (% of GDP)	3.3	3.1	1.8	1.5
Hong Kong, China				
Real GDP growth	5.2	–5.1	0.0	4.0
Domestic demand growth	7.7	–8.5	–0.5	4.0
Inflation	5.9	2.6	–0.5	1.5
Current account balance ($ billion)	–6.0	0.5	–0.4	–0.3
Current account balance (% of GDP)	–3.5	0.3	–0.2	–0.2
Indonesia				
Real GDP growth	4.7	–13.7	–3.0	3.0
Domestic demand growth	6.0	–20.0	–6.5	4.3
Inflation	6.6	60.0	30.0	12.0
Current account balance ($ billion)	–4.9	4.4	4.9	3.6
Current account balance (% of GDP)	–2.3	5.2	4.1	2.6
Malaysia				
Real GDP growth	7.8	–6.7	0.5	3.5
Domestic demand growth	6.4	–25.9	0.5	5.0
Inflation	2.7	5.3	4.0	4.5
Current account balance ($ billion)	–4.8	9.2	8.2	6.2
Current account balance (% of GDP)	–4.8	13.0	10.9	7.6
Philippines				
Real GDP growth	5.1	–0.5	2.5	4.5
Domestic demand growth	4.4	–8.0	0.7	5.0
Inflation	5.0	9.4	7.5	4.5
Current account balance ($ billion)	–4.3	1.3	1.8	1.4
Current account balance (% of GDP)	–5.2	1.9	2.6	1.8
Thailand				
Real GDP growth	–0.4	–8.0	1.0	3.5
Domestic demand growth	–7.6	–23.5	–0.5	5.0
Inflation	5.6	8.1	2.5	3.5
Current account balance ($ billion)	–3.0	14.3	12.9	10.4
Current account balance (% of GDP)	–1.9	12.3	9.5	7.1
Memo: **Dynamic Asian Economies**[b]				
Current account balance ($ billion)	–0.1	50.8	49.0	42.5

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

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

Source: Preliminary data for 1997-98 from the national sources or OECD estimates, and for 1999-2000 OECD projections.

of the remaining debts to be resolved, genuine recovery of economic activity in the corporate sector is unlikely to begin before the end of next year.

Growth in China has picked up…

GDP growth in China picked up beginning in the second half of 1998, due to large increases in government infrastructure investment and reinforced by an easing of monetary policy. Growth for calendar year 1998 was 7.8 per cent, slightly below the government's target of 8 per cent. Although exports were flat in dollar terms due to falling prices, they rose in volume terms and increased their share of markets in the United States and several other countries. Real GDP growth should remain in the 8 per cent range (at an annual rate) through the first half of 1999 before moderating

Box III.1. China's structural reforms: progress and problems

China has weathered the Asian financial crisis rather well overall, but its success is due partly to the insulation from external financial disturbances provided by its relatively closed capital account. The domestic economy suffers from major structural problems of excess and outmoded industrial capacity, high levels of non-performing loans in the banking sector, and poor corporate governance structures that in some respects are worse than those in other Asian countries and whose extent is not fully known. The adverse effects of these structural problems have so far been moderate, but largely because market mechanisms have not yet been fully established. But unless the problems are reduced substantially over the next several years, growth will almost certainly falter as deteriorating enterprise cash flow constrains investment; productivity growth slows; risks of a crisis of confidence in the financial system build; and rising job uncertainty further depresses consumption. Reforms slowed last year as concerns about unemployment mounted, but have since been redoubled in an effort to substantially reduce structural problems over the next several years.

Extensive reforms are underway in the financial sector. The People's Bank of China has been restructured into nine regional branches to improve supervision of the financial sector and the implementation of monetary policy. The state-owned commercial banks are receiving injections of capital financed by last year's issue of special government bonds worth 270 billion yuan ($ 32.6 billion). The government has also established an asset management company to take on the problem loans of the Construction Bank of China; this program is expected to provide a model for dealing with problem loans of other major commercial banks. The commercial banks are also being given greater latitude to factor commercial risks into their lending rates and are making strong efforts to tighten lending standards and improve internal accounting and financial control systems. Spurred by the bankruptcy of Guangdong International Trust and Investment Corporation in October 1998, the authorities plan a major restructuring of trust and investment companies during the next two or three years, and intend to tighten supervision of urban credit co-operatives by converting them into banks and consolidating their operations.

Reform of state enterprises is also regaining momentum. Restructuring of the textile and coal industries, whose problems are especially serious, is well underway. The textile workforce was reduced by nearly 660 000 workers in 1998 and a similar reduction is planned for 1999. Estimates suggest that more than half of the "excess" workers in state enterprises have been taken off their payrolls, although the majority have been shifted to retraining or other transitional programmes. Mergers and acquisitions to restructure medium-sized corporations have been extensive; and, although precise figures are lacking, a large portion of smaller state-owned enterprises have been sold off or otherwise separated from direct state control. Several government ministries previously responsible for enterprise operations have been disbanded as part of a broader effort to increase management autonomy of state-owned enterprises. Measures are also planned to improve the environment for the non-state business sector, which has been the main engine of China's growth and whose importance will increase as reforms proceed.[1]

However, despite these efforts, overall progress is difficult to assess and major questions remain about whether current reform efforts are sufficiently broad and whether their successes will be sustainable. Effective replacement mechanisms to ensure management accountability and improve corporate governance of larger enterprises largely remain to be developed. The competitive viability of restructured medium and smaller enterprises remains to be tested and further restructuring is likely to require more extensive use of measures, such as bankruptcy, that have been used rarely so far. To contain unemployment to acceptable levels, new jobs will have to be found for workers now in transition programmes and for those newly displaced by further enterprise downsizing. Until financial positions of enterprises improve substantially further and their need for government-directed bank credit abates, it will be difficult to prevent new bank problem loans from mounting or to establish commercial standards as the basis for bank lending.

Weaknesses in budget mechanisms are a further impediment to reforms. Although the official budget deficit and public debt ratios are low by international standards, unofficial estimates, including off-budget operations, suggest that the overall fiscal situation is more problematic. This is particularly the case if the non-performing loans of the banking sector are recognised as implicit government obligations. A fundamental problem is revenue scarcity; both the overall share of government revenue to GDP (about 18 per cent for taxes plus other explicit revenues) and the revenue share of the central government (about 50 per cent) are quite low by international standards. Revenue scarcity has been an important contributor to structural problems, notably the use of bank lending to cover losses of state enterprises. It also constrains current reforms: for example, mergers of financially stronger with weaker enterprises have been favoured as a means to limit demands on the government's budget. Moreover, demand for revenues will rise further as government takes on pension, health, and other social welfare obligations now borne by enterprises. Measures to ease the revenue scarcity are high on the reform agenda but are at an early stage.

1. To this end, the Ninth National People's Congress approved in March 1999 constitutional amendments upgrading the role of the non-state sector to an "important component" of the so.cialist market economy. Previously, the non-state sector was seen as merely "complementing" a predominantly state-owned economy.

in the second half. Fiscal stimulus will provide the key engine of growth during 1999, as increases in household consumption, investment by non-state enterprises, and exports are likely to remain subdued.

… and the government is stepping up efforts to boost consumer spending

The direct effects of the fiscal stimulus programme are expected to abate in 2000, so that growth will become more dependent on private consumption and enterprise investment. To boost consumer spending, the government is stepping up efforts to tap the country's massive savings deposits. In particular, government investments in rural water, electrical and transportation infrastructure are intended in part to stimulate consumer demand and markets in rural areas. Commercial banks are being urged to begin making loans to individuals for purchases of housing, automobiles and other durable goods. Efforts are also being made to increase the availability of bank credit to non-state enterprises, which have been the most dynamic component of the economy but whose growth has slowed markedly over the past two years. Pressures for currency devaluation should be quite limited in the near-term, given that exports are still reasonably competitive overall, the current account is in substantial surplus, and foreign exchange reserves are nearly equal to China's external debt. The government is taking various measures to promote exports and the inflow of foreign investment, which is an important source of job creation in China. However, prospects for foreign investment are uncertain due to the economic weakness in the rest of Asia and have been further clouded by concerns over the health of China's financial institutions. These concerns underscore the need for decisive progress during the next several years in alleviating the problems of the financial and enterprise sectors if risks to China's growth performance are to be contained.

Russian Federation and Central and Eastern Europe

Output has shown some signs of recovery

GDP and industrial output in the Russian Federation fell sharply after the eruption of the financial crisis in August 1998. Preliminary figures also indicate a further decline in fixed capital investment. But output has shown signs of recovery since September. The sharp drop in GDP in the immediate aftermath of the financial shock of August 1998 appears to have been associated with a temporary breakdown in the payments system. A subsequent upward trend in output follows largely successful measures to reactivate this system. Given the low dependence of Russian firms on financial markets in recent years relative to most other emerging market economies, the impact of the financial crisis on output could be less than might be assumed from the severity of the crisis itself. The depreciation of the currency also appears to have given a boost to some import-substituting industries, while opportunities for exports are also expanding. On the other hand, the crisis has hurt many small businesses and entrepreneurs that depend on import trading.

The pace of inflation has slowed, but future prospects remain uncertain

The short-term prospects for inflation and the exchange rate remain uncertain. After consumer prices increased by 4.3 per cent over the first seven months of the year, inflation surged during the remaining 5 months, bringing December-on-December inflation in 1998 to 84 per cent. Since August, the Central Bank has allowed the exchange rate to float based on limited trading on the interbank currency market. In this context, the rouble depreciated from 6.2 to over 20 to the dollar between mid-August and December 1998. The new government and the Central Bank have demonstrated their awareness of the dangers of a hyperinflationary spiral

Table III.2. Projections for Russia and the Slovak Republic[a]

	1997	1998	1999	2000
Russia				
Real GDP growth	0.4	–4.6	–1.0	2.0
Inflation	11.0	84.4	80.0	80.0
Unemployment rate	11.3	11.8	11.5	11.5
Fiscal balance (% of GDP)[b]	–8.4	–4.9	–3.0	–2.0
Current account ($ billion)	2.9	2.4	20.0	20.0
Current account balance (% of GDP)	0.6	0.5	4.7	4.5
Slovak Republic				
Real GDP growth	6.5	4.5	2.0	2.0
Inflation	6.4	5.6	9.0	8.0
Unemployment rate	11.5	12.0	15.0	14.0
Fiscal balance (% of GDP)[b]	–4.4	–5.3	–2.0	–2.0
Current account ($ billion)	–1.9	–2.0	–1.3	–1.0
Current account balance (% of GDP)	–9.7	–10.0	–6.0	–4.0

a) GDP growth and inflation are percentage changes from the previous period. Inflation refers to end-of-year consumer price index. Unemployment definitions may differ significantly across countries; where available, survey-based estimates (International Labour Organisation definition) are used.
b) The consolidated balance, including federal, regional, local budgets and extra-budgetary funds.
Source: Preliminary data for 1997-98 from national sources or OECD estimates, and for 1999-2000 OECD projections.

and have struggled to maintain tight financial policies. These policies helped to slow the pace of inflation and currency depreciation in the first quarter of 1999, during which time the consumer price index increased by 16 per cent and the rouble declined to close to 25 to the dollar. Pressures coming from the budget, the demands of foreign debt service, and the upcoming parliamentary elections will continue to challenge the government's goal of restoring macroeconomic stability. Gross foreign currency and gold reserves are still weak, having declined to a low of $ 10.7 billion (6.7 billion in currency) by 1 April 1999. Foreign debt service requirements are a primary source of pressure on reserves.

Problems in taxation and the budget remain central to Russia's economic dilemma

Problems in taxation and budgetary execution, which contributed greatly to the crisis in 1998, are still central to Russia's economic dilemma. These difficulties, in turn, reflect structural problems in the tax system, bankruptcy procedures, corporate governance, and fiscal federal relations. The default on government debt payments in the second half of the year kept the cash deficit from reaching much higher levels. The 1999 federal budget, although broadly consistent with the government's commitment to financial restraint, has been controversial due to apparently unrealistic assumptions on inflation and the exchange rate, proposed tax changes, and the severity of planned expenditure contraction. While reported federal tax collection has recently shown some degree of improvement, the federal government has again chosen to resort to tax offset operations for a substantial share of tax revenue, a decision that may have negative medium-term implications. Offsets also remain a major source of budgetary fulfilment at the regional level of government, accounting on average for over half of regional tax revenue in 1998. Since the collapse of the market for government debt in August 1998, both federal and regional governments have been severely constrained in their ability to finance deficits.

The current account has strengthened from a contraction of imports

Declines in the prices of key export commodities explain most of the serious deterioration in Russia's current account between mid-1997 and mid-1998. Figures for the first three quarters of 1998 show a current account deficit of over $ 5 billion, most of which was incurred during the second quarter of the year. A severe contraction of imports following the depreciation of the rouble, however, was sufficient to generate a current account surplus of $ 2.4 billion for 1998. Preliminary figures show a decline in the dollar value of imports in the last quarter of 1998 of roughly 50 per cent. Lower imports should be the primary factor behind a much stronger current account in 1999 than 1998, although the degree of this strengthening will also depend on movements in key export prices, notably oil, gas, and metals.

Living standards have declined

The crisis has brought a shock to the standard of living of a large part of the population. Nominal incomes and wages have lagged far behind inflation. Preliminary estimates show real average household income and wages at the end of 1998 to be 18 and 14 per cent lower than their respective values at the end of 1997. Substantial wage and pension arrears imply a further burden. Low-income households had also formerly consumed a significant amount of imported basic food products and were affected by the increase of those prices along with the depreciation of the currency. The estimated rate of unemployment (International Labour Organisation definition) reportedly crept up to a transition period high of 11.8 per cent of the active labour force by the end of 1998.

Foreign debt service is severely strained

The events since August 1998, particularly the sharp depreciation of the rouble, have strained foreign debt service to the point of requiring a major restructuring agreement to get Russia back on track. The 1999 budget makes explicit provisions for $ 9.5 billion of an estimated $ 17.5 billion in scheduled foreign debt service, along with a clause that 50 per cent of "surplus" revenue can be also be used for this purpose. Negotiations with international financial institutions and foreign creditors continue on the issue of debt restructuring and partial compensation for holders of short-term government domestic debt that was frozen on 17 August 1998. The agreement with the International Monetary Fund (IMF) this March, which included a more ambitious target for a primary budgetary surplus of 2 per cent of GDP for 1999, could facilitate these negotiations.

The overall situation is somewhat encouraging relative to late 1998, but still difficult

While the situation in the Russian economy remains quite difficult and potentially unstable, the overall economic outlook in the country is perhaps a bit more encouraging than in late 1998. The new Russian government has so far succeeded in maintaining a degree of financial control, while output appears to be recovering and the current account strengthening. The financial pressures on the government are substantial, however, and the spectre of parliamentary and presidential elections in 1999-2000 pose obvious complications for the strong medium-term structural reform that is necessary for the future robust recovery and growth of the economy.

Other transition countries are facing a downturn of macroeconomic conditions…

The Russian crisis has affected other transition countries through tighter financing constraints. For the Baltic States, the loss of the Russian markets has also induced a noticeable slowdown of past buoyant growth. Outside the Baltic States, factors other than the Russian crisis are important for driving economic developments. In the Slovak Republic the accumulation of high budget and current account deficits put an end to the unsustainable growth process of recent years. The 1999-2000 period will be characterised by a slowdown of growth and the main part of the adjustment will come from a reduction of public investment. This year, the new government adopted a reduction of the fiscal deficit from 5 to 2 per cent of GDP. The central bank has continued a prudent and restrictive monetary stance, although the flexibility of the exchange rate in place since last October has allowed for some easing in real interest rates.

… although further progress on structural reforms can be expected

In order to put macroeconomic stabilisation on track and attract foreign direct investment, the much-awaited structural reforms of the banking and enterprise sectors need to be implemented and this is the major source of uncertainty in the outlook for the Slovak Republic. An even more pressing need for structural reforms certainly applies for a country like Romania where, after much time lost and presently serious financial pressures, the government seems finally to be moving in the right direction. Since 1997, Bulgaria has been making important progress in structural reform, particularly in privatisation and in rebuilding the banking system. Nevertheless, both countries still require major restructuring in the enterprise sector and in supporting institutions, including more effective bankruptcy and liquidation procedures. Spill-over effects from the Kosovo crisis constitute a major risk for these countries, though one which is difficult to assess.

South America

Economic activity slowed down in 1998 and the region will enter recession in 1999

South America was fully hit by the effects of the crisis in emerging markets and, in the second half of 1998, there was first a slowdown of growth and then a contraction of output in most countries. The decline of capital inflows, the resultant tightening of domestic credit conditions, a sharp deterioration in the terms of trade and the effects of climate disturbances (*el Niño*) all contributed to the deterioration of economic performance. In early 1999, Brazil's currency crisis further raised external financing costs and limited capital inflows, pushing the region as a whole into recession. Most of the contagion effects from Brazil's crisis on Mercosur member countries – notably Argentina – have come from direct trade effects. However, contagion effects on Chile are reflected in the emerging conflict between the lower interest rates needed to stimulate depressed activity and the need for currency stability. Added volatility also pushed Ecuador into a serious banking crisis, with severe restrictions applied to bank deposits withdrawals. A public finance law passed in Congress in April could enable the reduction of the fiscal deficit, but the economic situation remains worrying.

Brazil will suffer a deep recession but, if able to restore credibility, recovery might start in 2000

Despite significant gains in competitiveness throughout 1998, associated with rapidly falling inflation, steadily rising pressures on the exchange rate led the Brazilian central bank to float the Real in mid-January 1999 (first within a band and freely shortly after). Exchange rate depreciation, extremely tight credit conditions and the fiscal tightening needed for stabilisation is projected to result in a fall of some 3 per cent in GDP in 1999, which would be one of Brazil's worst recessions. A new IMF plan agreed in early March halted the depreciation of the exchange rate and created conditions for a return of confidence. If the government is able to implement the programme, some timid recovery could start in 2000. For now, the government is delivering its fiscal promises, and the International Financial Institutions are delivering their financial support. The success of the plan is highly dependent on the continuation of a positive response of the private sector, both domestic and foreign. The key positive signal that credibility is being restored would be a significant decrease of real interest rates in 1999. In order to stabilise the public debt ratio at around 50 per cent of GDP, a substantial primary surplus of over 3 per cent of GDP is required, but even so interest rates need to fall significantly in coming months to limit the build-up of government debt. Overnight

Table III.3. **Projections for Brazil and Argentina**[a]

	1997	1998	1999	2000
Argentina				
Real GDP growth	8.6	4.2	–3.0	2.5
Inflation	0.3	0.7	0.2	0.5
Fiscal balance (% of GDP)[b]	–1.3	–1.1	–1.5	–1.5
Current account balance ($ billion)	–12.0	–14.7	–14.5	–15.0
Current account balance (% of GDP)	–3.8	–4.2	–4.5	–4.5
Brazil				
Real GDP growth	3.7	0.2	–3.0	2.0
Inflation	6.1	1.7	15.0	10.0
Fiscal balance (% of GDP)	–6.1	–8.0	–10.0	–4.0
Primary fiscal balance (% of GDP)	–0.1	0.1	3.2	3.5
Current account balance ($ billion)	–33.8	–35.0	–20.0	–20.0
Current account balance (% of GDP)	–4.2	–4.5	–3.5	–3.0

a) GDP growth and consumer prices are percentage changes from previous year. Inflation refers to end-of-year consumer price index. The Brazilian inflation figure refers to the INPC-IBGE index.
b) Federal government only.
Source: Preliminary data for 1997-98 from national sources or OECD estimates, and for 1999-2000, OECD projections.

interest rates were around 34 per cent at the end of April, down from 45 per cent two months earlier. The external debt (30 per cent of GDP) is another potential source of financing pressures. But with the trade adjustment projected for 1999 and the likelihood that major international private creditors would maintain their credit lines, the situation in this regard seems manageable.

The major source of uncertainty for the outlook is related to the successful management of public debt

Recent indicators show inflation developments on a favourable path. Despite a 30 per cent depreciation of the Real from mid-January to the end of March, consumer prices[1] increased by only 1.3 per cent in the month of March. If the exchange rate now stabilises, inflation is expected to be contained at around 15 per cent by end-year. Nevertheless, inflation remains an uncertainty for the outlook. A new framework for monetary policy based on the principle of inflation targeting was instituted following the appointment of a new central bank governor in early March. However, this will require some time to be implemented and the central bank also needs to gain independence from political pressures. The key element of uncertainty is connected with the public debt. If the authorities cannot control the debt because interest rates do not come down rapidly enough, then a possible monetisation of the public deficit could still re-ignite an inflationary process; the alternative, a debt restructuring, would put the domestic banks into a fragile position. A positive effect of the crisis has been a reinforcement of the position of the federal government vis-à-vis the state governors. This political leverage helped the government to pass the necessary legislation to implement fiscal tightening. Notably, the controversial increase of the financial transactions tax from 0.2 to 0.38 per cent was approved in a second reading in Congress.

Brazil's crisis is pushing Argentina into a recession in 1999

Argentina is suffering the largest spillover effects from the currency crisis in Brazil. Those effects are compounding already depressed economic conditions resulting from the high interest rates prevailing for most of 1998. The strong GDP

1. Consumer price inflation references for Brazil in this note are based on the National Consumer Price Index (INPC) published by the Instituto Brasileiro de Geografia e Estatistica (IBGE).

growth of 1997 came to a halt by mid-1998 and turned negative in the fourth quarter (-½ per cent year-on-year). Industrial production figures for the first four months of 1999 show a sharp contraction in output. Brazil's crisis is also having a very negative impact on consumer and business confidence in Argentina. In some sectors, like the automobile industry, production has already been halved and significant labour shedding is underway. Economic activity is likely to continue to decline until the end of the year, when more stable financial markets may allow for lower interest rates and prospects for exports to Brazil improve. Inflation was very low in 1998 and might turn into deflation during this year. In March, the consumer price index actually fell by ½ percentage point (year-on-year). Contracting imports due to both depressed domestic demand, notably for investment goods, and terms-of-trade gains from cheaper Brazilian imports, should help to contain the large current account deficit at present levels.

The main risks for Argentina's outlook relate to the management of public liabilities and public budget performance

Overall financial contagion effects on Argentina have been smaller than those experienced in the past episodes of international financial crisis (see lower panel of Figure III.1). Although still high, interest rate spreads on sovereign debt over US equivalent bonds came back to pre-crises levels by mid-April.[2] Apart from risks of further contagion effects following any sharp deterioration of Brazil's situation, the main risks for Argentina's outlook lie with the management of public liabilities and on the fiscal front. Depressed domestic demand will result in declining budget revenues while high interest rates are increasing debt service costs. Some fiscal tightening might be necessary at a time of rising unemployment and increasing calls for subsidies to help depressed export sectors. Presidential elections scheduled for October further complicate fiscal policy choices.

The near term outlook for the region is grim, and there are risks on the downside

To sum-up, the near term outlook for South America is grim with output contracting in most countries in 1999. A modest recovery is however projected for 2000 when lower real interest rates will provide some stimulus for economic activity. Current account deficits, a major weakness for most South American countries, will be reduced in 1999 but mainly through a sharp compression in imports. Increased export growth and some further gains in the terms of trade may allow additional improvement in 2000. Although fiscal balances may decline with the downturn in economic activity, avoiding excessive fiscal slippage will be a major source of concern in most countries and this could call for further tightening. There are still important downside risks to the outlook linked to developments in Brazil. A reversal of the current progress towards financial stability in that country would undoubtedly damage the area's creditworthiness, raise capital costs and deepen the recession in the region as a whole. Additional downside risks are associated with the assumption underlying the projections of stabilisation and gradual recovery of commodity prices. If this assumption fails to materialise and the terms of trade for primary commodity producers continue deteriorating, external imbalances will worsen in many countries (Argentina, Chile, Ecuador, Venezuela, and Colombia) and necessary adjustments would imply the postponement of economic recovery.

2. Spreads reached 807 basis points in mid-January as compared to 1 013 basis points in the wake of Russia's currency crisis in August 1998 or to 2020 basis points after 1995 Mexico's currency crisis. Spreads by mid-April 1999 were 623 basis points.

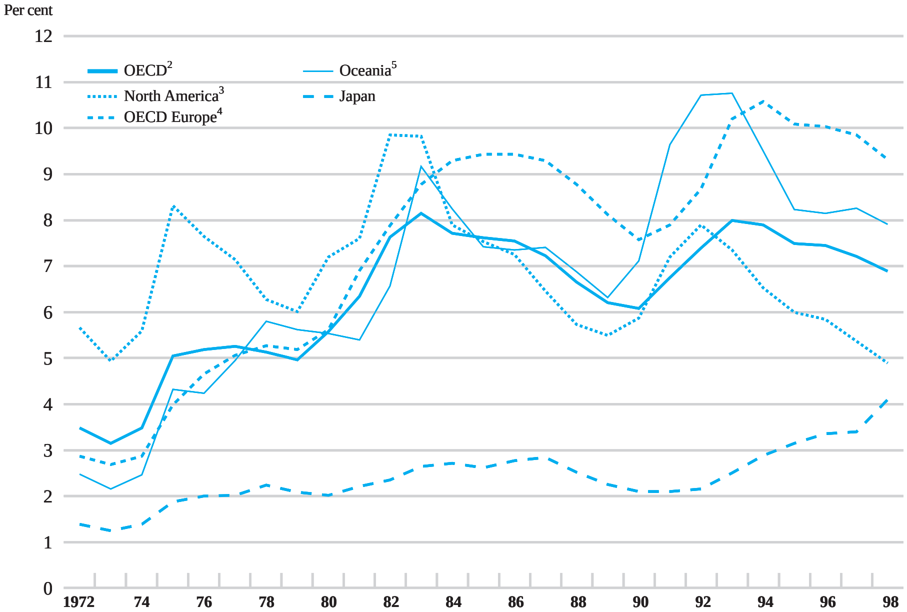
IV. LABOUR MARKET PERFORMANCE AND THE OECD JOBS STRATEGY

Introduction

High and persistent unemployment remains a major problem…

High and persistent unemployment remains a major economic and social problem for many OECD countries. Currently, some 35 million persons, or about 7 per cent of the labour force, are unemployed in the area as a whole (Figure IV.1). Many, particularly in Europe, have been without a job for a prolonged period. These people, and their dependants, may be threatened by poverty in addition to loss of self-esteem and contact with working life. At the same time, many others are not even trying to find a job, discouraged by high unemployment or by the undesirable side effects of some of the policies intended to deal with it. But getting a job and keeping it does not solve all problems. There is increasing concern about precarious jobs and in-work poverty in some countries.

Figure IV.1. **Standardised unemployment rates in OECD regions, 1972-98[1]**



1. Standardised unemployment rates for all countries except for Greece, Iceland and Turkey, where national definitions are used.
2. Excluding Czech Republic, Hungary, Korea, Mexico and Poland.
3. United States and Canada.
4. EU-15, Iceland, Norway, Switzerland and Turkey.
5. Australia and New Zealand.

Source: OECD, *Labour Force Statistics.*

***... but it can be durably reduced through comprehensive and sustained reforms as outlined in the* Jobs Strategy**

The problems of high unemployment, discouragement and in-work poverty are not new. In 1994, they prompted Member countries to agree on the OECD *Jobs Strategy*, which sets out a wide-ranging and balanced set of policies to tackle them (the main policy orientations are presented in Box IV.1). Subsequently, these policies were tailored on a country-by-country basis to take account of the institutional, social and cultural characteristics of each of them, and the country-specific policy recommendations were published in the *OECD Economic Surveys*.[1] In 1997, a report to Member countries (OECD, 1997*b*) drew a number of key lessons on the implementation of the *Jobs Strategy*. The most important of these is that the strategy could durably reduce unemployment – especially if undertaken comprehensively. However, policymakers have to stay the course because it takes time before reforms lead to better labour market conditions.

Box IV.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 competencies 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.

***This chapter provides an up-to-date assessment of labour market performance and progress made in implementing the* Jobs Strategy**

These conclusions have been reinforced by a more recent report to Member countries (OECD, 1999). This chapter summarises the main findings of that report, first looking at labour market performance over the 1990s and then linking that performance to progress made in implementing the *Jobs Strategy* as well as to structural reforms more generally. Particular attention is devoted to the employment prospects and the quality of jobs of specific groups (youths, older workers and certain categories of women) who have tended to experience above-average unemployment and non-employment.

1. Country-specific recommendations were also based on five thematic reviews on key aspects of structural policy conducted in the context of the *Jobs Strategy*: 1) *Enhancing the effectiveness of active labour market policies* (OECD, 1996*a*); 2) *Making work pay: A thematic review of taxes, benefits, employment and unemployment* (OECD, 1997*a*); 3) *Interactions between structural reform, macroeconomic policy and economic performance* (OECD, 1996*b*); 4) *Technology, productivity and job creation* (1996*c*; 1998*a*); 5) *Fostering entrepreneurship* (1998*d*).

Labour market developments over the 1990s

Unemployment

Unemployment has fallen from its 1994 peak and over most of the decade in a few countries...

Despite some decline from the recession years of the early 1990s, the unemployment rate for the OECD as a whole will almost certainly be higher at the end of the decade than at its beginning. At the same time, disparities across countries have increased (see Annex Tables in this *Outlook*). Unemployment in the United States has fallen to rates last seen in the 1960s, and it has drifted up in Japan to record post-war highs (although remaining considerably lower than the OECD average). Europe presents a mixed picture over the decade, with some countries at a later stage of the business cycle (*e.g.* United Kingdom, Denmark, Ireland and the Netherlands) experiencing falling unemployment. In most other European countries, unemployment has shown only modest reductions from the 1994 peak, despite the recovery in output, and unemployment rates remain higher than at the beginning of the decade. The Secretariat's projections in this *Outlook* point to a further modest reduction of unemployment in Europe, and some rise elsewhere, reflecting the different stages of the economic cycle of the main OECD regions.

... but its trend component has differed markedly across countries...

Rapid economic growth can reduce unemployment only insofar as the unemployment is cyclical, and differences in cyclical positions complicate the assessment of countries' performance. It is therefore instructive to look behind the purely cyclical influences on unemployment rates. There is no single agreed method for doing so, but the different measures tend to move closely together. The Secretariat's measure of trend unemployment[2] and its evolution over the 1990s point to the following picture (Table IV.1):

– The United States, Norway and Portugal have maintained low levels of unemployment over the decade (and in the United States there has even been a reduction).

– Other countries, including Japan, Austria and Switzerland, have experienced some increase in trend unemployment, but the level remains well below the OECD average.

– Some countries with relatively high levels of trend unemployment at the beginning of the decade have achieved significant reductions: the United Kingdom, Denmark, Ireland, the Netherlands and New Zealand and, more recently, Australia, Canada and Spain. Nevertheless, Spain still has the highest rate of trend unemployment, whilst rates in Denmark and the Netherlands are now well below the OECD average.

2. Trend unemployment is measured by the OECD time-series estimates of the non-accelerating wage rate of unemployment (NAWRU). The NAWRU indicates the rate of unemployment that, in a given year, and based on the actual history of unemployment, would be associated with a constant rate of nominal wage increases. It should be stressed that it is a short-term concept, and in the presence of slow adjustment of the labour market to exogenous shocks, a lower (or higher) rate of unemployment may be associated with stable wage inflation in the long run. However, the longer-run equilibrium rate of unemployment cannot be reached within a single year without setting off changes in wage inflation, see OECD (1999).

Table IV.1. **Trend unemployment[1] in the OECD countries: levels and changes over the period 1990-98[2]**

Trend unemployment rate is:		Trend unemployment has: risen	remained stable	fallen
	high	Finland Greece Italy France		Spain
	intermediate	Sweden Germany	Belgium	Canada Australia New Zealand United Kingdom Ireland
	low	Switzerland Japan Austria	Norway Portugal	United States Denmark Netherlands

1. Trend unemployment data are based on OECD estimates of the *non-accelerating wage rate of unemployment* (NAWRU).
The NAWRUs are calculated using the commonly used definition of unemployment rates. For Germany, Belgium and Denmark, standardised unemployment rates were used instead to improve comparability with other countries.
2. A change is considered significant (in absolute terms) if it exceeds one standard deviation. The latter was calculated for each country over the 1986-98 period. Countries are classified as having low, intermediate or high unemployment rates according to their distance from the 1998 OECD weighted average trend unemployment rate (6.9 per cent). Countries within one half of the (weighted) standard deviation of country trend unemployment rates were classified as having intermediate levels of unemployment.

– There are also a number of countries where trend unemployment has risen to high levels: France, Italy and Greece are in this group.[3] Moreover, in Finland and Sweden the increase in actual unemployment in the aftermath of the steep recessions of the early 1990s was partially translated into higher trend unemployment.[4]

... as has the incidence of joblessness among youths and women

These overall unemployment trends have been reflected in unemployment of specific groups within the labour force, and also in the average time spent out of work by the unemployed. Countries posting significant falls in trend unemployment have often experienced trend reductions in youth and female unemployment and a fall in long-term unemployment (more than 12 months). In contrast, high (or increasing) trend unemployment has been generally accompanied by high (or worsening) joblessness amongst youths and prime-age female workers,[5] and a high incidence of long-term unemployment.

Employment

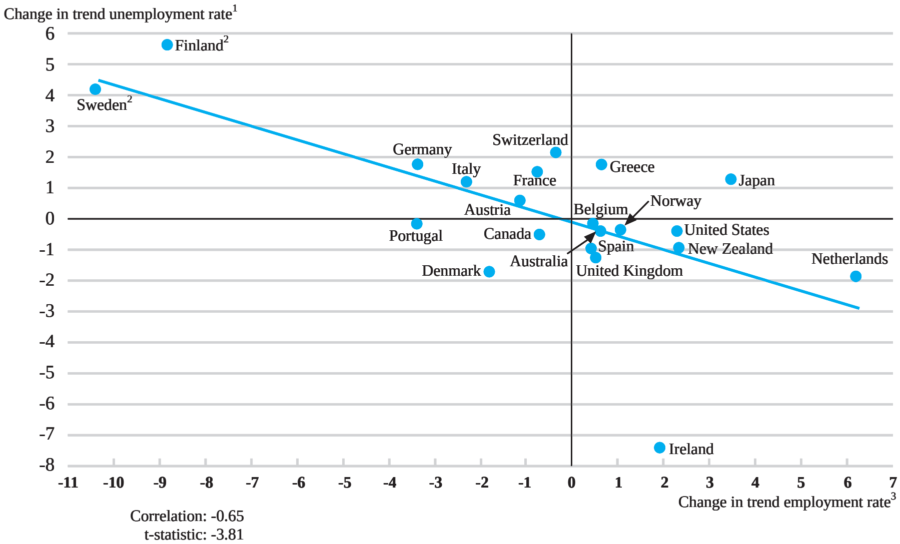
Employment growth has been a key factor in reducing unemployment...

Movements in unemployment and employment rates have been closely linked (Figure IV.2). In particular, most of the countries where unemployment fell also posted significant increases in their trend employment rates. And only two (Japan and Greece) of the nine countries experiencing significant increases in unemployment recorded increases in overall employment rates.

3. Germany also recorded a substantial increase in trend unemployment, related not least to the particular problems generated by the reunification and the subsequent high unemployment in the Eastern Länder.
4. It is, however, particularly difficult to assess the evolution of trend unemployment in Finland, and to a lesser extent in Sweden, in the 1990s given the abruptness of the rise in actual unemployment. The OECD estimates of the NAWRU for these two countries are, therefore, subject to greater uncertainties than those for other countries.
5. "Prime-age" adults are those aged between 25 and 54 years.

Figure IV.2. **Change in trend unemployment and employment rates, 1990-98**

Percentage points



1. Trend unemployment data are based on OECD estimates of *the non-accelerating wage rate of unemployment* (NAWRU).
2. Changes in trend unemployment for Finland, and to a lesser extent for Sweden, have to be judged with care given the uncertainties surrounding the evolutions of the NAWRUs for these two countries. See main text.
3. The employment rate is defined as the ratio of total employment to the population of working age, *i.e.* the age group 15-64. Trend employment rate series have been estimated in the following way: *i)* for each series of employment (x), a linear regression was performed as: x= a + b ∗ GAP, where GAP is the difference between real output and real output smoothed with a Hodrick-Prescott filter (*i.e.* an estimate of the output gap); *ii)* the non-cyclical estimate of each variable (x') was then obtained as: x' = x-b ∗ GAP; and *iii)* a Hodrick-Prescott filter was then used to smooth the x' series.

… with a significant role played by "atypical forms" of employment…

In a number of countries, there has been a rise in so-called atypical forms of work (*i.e.* temporary and part-time work). In particular, the long-term rising trend in part-time work has continued across almost all OECD countries over the 1990s, going hand-in-hand with increases in female labour-force participation. However, cross-country differences in the incidence of part-time work remain considerable, ranging from 29 per cent in the Netherlands to less than 10 per cent in the Czech Republic, Finland, Greece and Spain (Figure IV.3, upper panel).

Part-time work has made a positive contribution in most countries…

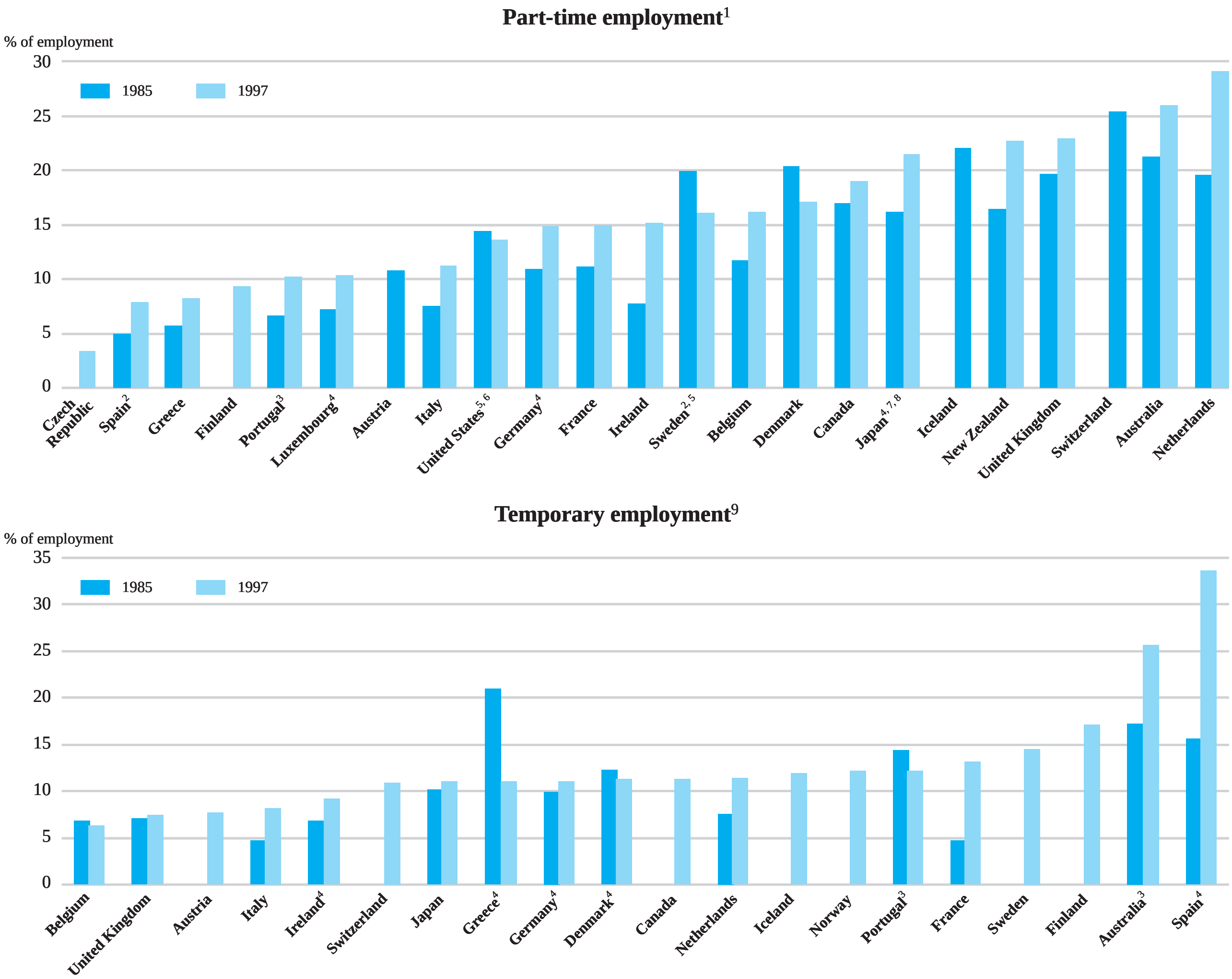
In recent years, growth in part-time employment has made a significant positive contribution to total employment growth across a wide range of OECD countries. It has partially offset declining full-time employment in a number of them (especially in those with increasing unemployment, such as Germany, France and Italy). And it has also made a significant contribution to employment growth in countries with declining unemployment such as Ireland, the Netherlands and New Zealand.

...but sometimes it is a second-best choice

The extent to which rising part-time work has been a deliberate choice of workers ("voluntary" part-time) or a second-best choice, due to the lack of full-time jobs, marks a clear divide between countries with different overall labour market conditions. During the recovery from the recession of the early 1990s, involuntary part-time employment has accounted for a large proportion of the growth in total part-time employment in a number of countries with high and persistent unemployment**.** For example, between 1993 and 1997, growth in involuntary part-time jobs was at least as great as the growth in voluntary part-time employment in Germany,

Figure IV.3. **Part-time and temporary employment, 1985-97**

Per cent of total employment



1. See OECD, *Employment Outlook*, 1998, Table E.
2. 1987 and 1997.
3. 1986 and 1997.
4. 1985 and 1996.
5. Data for 1985 are not fully comparable to those for 1997 due to breaks in the series. See OECD, *Employment Outlook*, 1995, Table E for details.
6. Dependent employment.
7. Part-time work is defined by actual hours worked instead of usual hours worked.
8. Part-time work is defined by less than 35 hours worked.
9. Data refer to employees. See OECD, *Employment Outlook*, 1996, Table 1.5 for definitions of temporary employment in each country.

Source: OECD, *Employment Outlook*, 1998.

France, Italy, Greece and Spain, all countries with high or rising unemployment. In most other countries growth in part-time work has been almost exclusively voluntary.

Temporary work is becoming an important feature of employment in some countries…

The evolution of temporary employment contracts has often raised concerns as to the quality of jobs being created in the OECD countries.[6] Although, less than 15 per cent of employees are in temporary work in most of them, there are exceptions: in particular, Australia, Finland and, especially, Spain where about one-third of employees are in temporary employment (Figure IV.3, lower panel).

… also reflecting attempts by employers to bypass strict employment protection for permanent workers

Similar to part-time work, temporary work has been an important component of employment growth in many OECD countries since the early 1990s. It has offset declining (or stagnating) permanent employment in some of the countries with high or increasing unemployment (*e.g.* Germany, France, Italy, Austria and Sweden), while a more balanced composition between temporary and permanent employment growth has been observed in countries posting improving (or good) labour market conditions. The shift towards temporary employment in some countries may reflect an attempt by employers to bypass strict regulations on permanent employment, a move that has also been encouraged by a further de-regulation of fixed-term contracts and temporary work agencies in a number of countries (see below).

Participation rates

Participation rates have remained fairly stable over the decade, with persistent differences across countries

The proportion of the working-age population that participates in the labour market varies a great deal across the OECD countries, and these differences are to some extent related to overall labour market conditions. Thus, some of the countries with high unemployment have particularly low participation rates (*e.g.* Italy, Greece, Spain), whilst higher participation rates are often found in countries with, at least until recently, prolonged periods of low and stable trend unemployment (*e.g.* Japan, Norway, Sweden, Switzerland and the United States). However, trends in participation over the current decade only partially reflect developments in unemployment. While the Netherlands and New Zealand have combined falls in unemployment with significant increases in participation rates, and Italy, Finland and Sweden low or falling participation with high and rising unemployment, other countries have maintained broadly stable rates despite significant changes in unemployment.

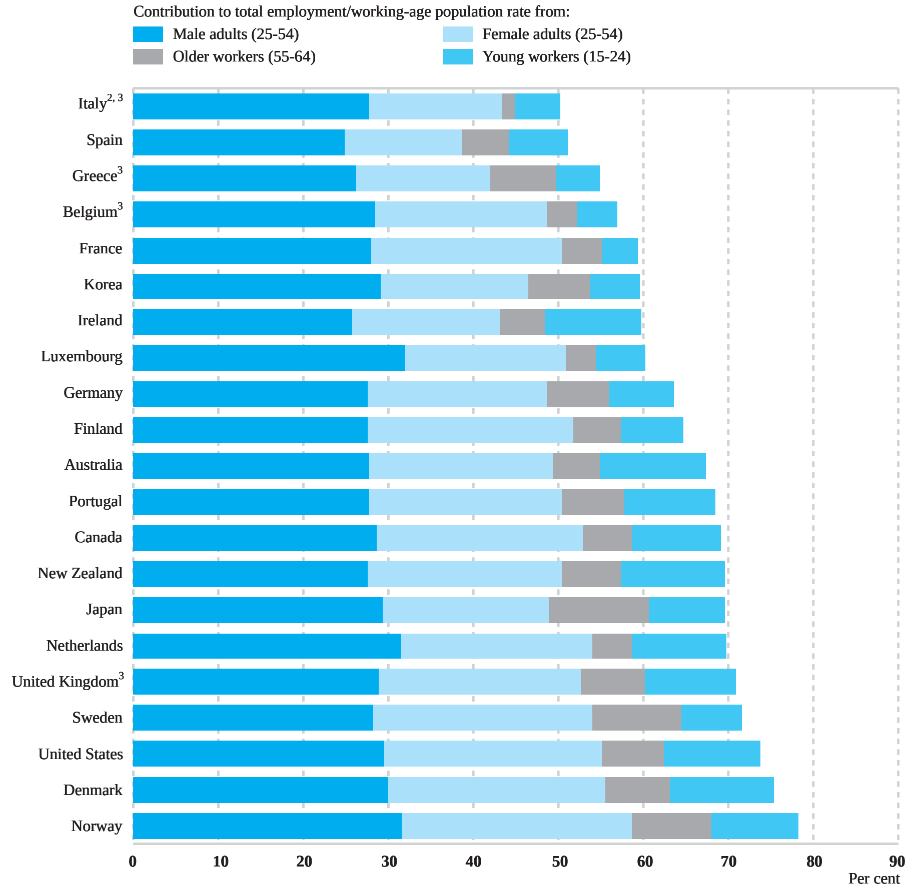
Growing disparities amongst population groups

Employment rates diverge across labour market groups, especially in countries with high unemployment

Aggregate figures of labour demand and supply hide striking disparities between different groups in the working-age population, which tend to be particularly acute in countries with large overall labour market slack. The analysis of employment rates offers interesting insights in this respect. It suggests that prime-age males – often referred to as "core" workers – have very similar employment prospects in all OECD countries. By contrast, the employment prospects of other groups: prime-age women, youths and older workers, are very different and account for most of the large cross-country variations in overall employment rates (Figure IV.4). These differences partly reflect different social and cultural factors. However, especially in countries with high unemployment, youths, prime-age women and older people – as well as the low skilled in general – are particularly affected by joblessness, or may not even look for work because of the scant job opportunities in the labour market. In addition, those

6. Temporary work is typically defined as work under a fixed-term contract in contrast to permanent work where there is no end-date. Employment under temporary contracts often entails a different set of legal obligations on behalf of employers; in particular, certain aspects of employment protection legislation do not apply to temporary contracts.

Figure IV.4. **Decomposition of employment rates in OECD countries, 1998**[1]



1. The contributions of individual demographic groups to the overall employment rate were calculated as the group-specific employment rates multiplied by the share of individual groups in the population of working age.
2. Adults: 25-59 years of age; older workers: 60-64 years of age.
3. 1997.

Source: OECD, *Labour Force Statistics* and *Employment Outlook,* 1999 (forthcoming).

choosing to engage in alternative activities to paid employment may be doing so partially in response to financial incentives arising from tax and benefit systems.

While youths are spending more time on education they are also discouraged by high unemployment

Employment rates among youths, especially teenagers, have been falling partly because of the increasing enrolment rates in secondary and higher education. However, country differences in education patterns persist, with some countries experiencing relatively low enrolments, and for individuals at the bottom of the educational ladder the incentives and opportunities either to continue education or to enter the labour force can both be weak. In this context, high unemployment exerts a strong disincentive effect on young workers to participate in the labour market, especially for those with low education levels. Thus, policies to reduce overall unemployment are likely to be the first-best approach to raising youth employment. However, discouragement among young people exists in countries which span a wide range of labour market conditions, suggesting that certain types of economic exclusion cannot be solved by broad labour market reforms and reflect deeper social problems that need to be tackled by more targeted policies.

A smooth transition from school to work is key…

Countries which have succeeded in ensuring a smooth transition from school to work for those with poor qualifications have placed a strong focus on providing these young people with recognised vocational qualifications after compulsory schooling, and on reinsertion programmes for school drop-outs. Moreover, gaining some form of work experience whilst studying appears to enhance the rewards to education, resulting in better labour market outcomes when youths leave school. This seems to apply in countries with long-established dual-system apprenticeship programmes (Germany, Austria, Denmark and Switzerland),[7] as well as in some English-speaking countries where an informal combination of work and school is common amongst youths because of a highly developed market for part-time work (*e.g.* United States, United Kingdom, Canada, Australia).

… but the quality of jobs available for young persons is also important

Youths have been disproportionately affected by policy moves to increase flexibility in working hours and employment contracts, especially in countries with high and persistent unemployment. As stressed above, the increase in part-time work among youths may partly be a response to the wish of young people to combine work with continuing education. Likewise, temporary contracts may facilitate job matching, by providing an initial work experience for youths, while also allowing employers to screen suitable candidates. However, in presence of stringent regulations for permanent workers, firms may also use temporary contracts to increase their workforce flexibility over the business cycle, with potential negative implications for youths' longer-term employment prospects. Under these circumstances, temporary employment may not be an initial stepping stone to better jobs for them, but rather lead to a persistent precarious situation, with potentially negative consequences for human capital formation and work experience. Thus, if not accompanied by relaxation of the protection for permanent workers, measures to increase work flexibility through relaxation of regulations governing temporary contracts run the risk of increasing the segmentation of labour markets. In addition, wage pressure may increase as the development of temporary contracts leads to even higher job security among permanent workers.[8]

... and their employment prospects are also affected by high wage floors

Youth employment prospects are also potentially sensitive to wage floors. Most OECD countries have some sort of minimum wage, set either by government or collective agreement. The level of the minimum wage varies greatly across countries and there is evidence that, if set too high, it may have dis-employment effects, especially amongst young workers (OECD, 1998*f*).

7. However, recent evidence suggests that, in a period of rapid technological changes, formal apprenticeship programmes may be encountering greater difficulties in providing trainees with the right qualifications. See OECD (1999).
8. Saint Paul (1996) discusses the effects on the level and dynamics of employment of the liberalisation of temporary contracts, while leaving in place rigid regulations on permanent contracts. He suggests that the effects of such reform on employment levels are ambiguous, while the variability of employment over the cycle may increase. The reform will also increase the job security of permanent workers, whilst workers with temporary contracts will bear the burden of employment adjustment and have much less employment security.

Older workers are retiring earlier, especially in countries with high unemployment and with strong financial incentives to retirement

At the other end of the age spectrum, older workers have withdrawn from the labour market at earlier ages over the past two decades, especially in countries with high unemployment. Policies in many countries have, until recently, tended to increase the financial incentives for early retirement *via* an earlier access to old-age pension systems under favourable conditions.[9] Moreover, older unemployed workers, who were not yet entitled to old-age pensions, have *de facto* been able to use other non-employment benefits (*e.g.* unemployment benefits and invalidity benefits) as a bridge from labour earnings to pensions.

Attempts to redistribute jobs from old to young workers have proved to be ineffective and potentially burdensome

Incentives to early withdrawal from the labour market have helped soften some of the effects of industrial change on older generations and may have reduced pockets of high unemployment within certain localities. In a broader context, this policy has been justified in some countries as a way of "creating" jobs for younger workers, by redistributing employment opportunities from the old to the young. But lower employment rates at one end of the age spectrum have not translated into higher or rising employment rates at the other end. Indeed, as a general rule, countries that have high employment rates among older workers also have high employment rates for the young. In addition, this policy option increasingly conflicts with the need to improve the financial viability of public pension systems in the context of ageing populations, which can best be achieved by encouraging people to work longer (see OECD, 1998*e*).

Prime-age women are increasing their active role in the labour market…

In contrast to the decreasing labour-force participation among young and older workers, prime-age women have continued to integrate more fully into the labour markets of most OECD countries. However, the breadth and depth of women's involvement in working-life continues to differ widely across countries as evidenced by persistent differences in participation rates. Working women are often in part-time jobs, frequently as a matter of choice, and the development of markets for this type of work is thus a factor in encouraging more women to enter the labour market. Recent measures in some countries to make part-time work more attractive through deregulation and adjustments to tax-benefit incentives are therefore particularly relevant to women.

... although material living conditions have not improved for some of them

Nevertheless, material conditions for households headed by young mothers with only a marginal attachment to the labour market have not necessarily improved: their relative and, in some cases absolute, disposable incomes have fallen in a number of OECD countries. These households are often heavily dependent on transfer systems that often fail to keep pace with increasing incomes of those who can devote more time to market work. In response, a number of countries are exploring ways of making work more rewarding for single parents through changes in tax-benefit systems and through encouraging them to search actively for work (see below).

The employment prospects and earnings potential of low-skilled workers are poor in most countries…

Difficult labour market conditions amongst people with low qualifications are found across all age-gender groups. Their unemployment rate is very high (particularly in Europe), and they face a higher risk of being persistently in low pay (especially in North America and the United Kingdom). Cross-country differences in the share of low-skilled prime-age workers in unemployment or in low pay depend on a number of economic and social factors, including the dispersion of earnings and the characteristics of the social transfer systems. For example, the existence of high wage floors may prevent low-skilled people from getting a foothold in employment, and a long spell of joblessness may reduce even further their human capital and, thus, their re-employment probability. At the same time, however, workers with persistently low

9. These issues were discussed in detail in Chapter IV "Low-income dynamics in four OECD countries" in *OECD Economic Outlook*, 64, December 1998.

earnings may not perceive their social and economic prospects as being significantly better than if they were chronically unemployed.

… although low pay does not necessarily lead to poverty

However, differences across countries in the incidence of low pay are greater than in *per capita* disposable income, also because of the redistributive effects of tax and transfer systems. Moreover, the incidence of poverty is generally higher in workless households than in households with at least one member at work. Indeed, work attachment (the number of household members in employment) is the most important factor determining the relative income position of households: households with no workers are often at the bottom of the income distribution and have the highest poverty rates.[10]

Implementing the *Jobs Strategy*: progress made and lessons from countries' experience

Many countries have implemented structural reforms over the 1990s

How do the labour market developments discussed in the previous section compare with the reform effort that countries have made over the 1990s? Figure IV.5 presents evidence on progress in implementing reforms. It does so by highlighting the follow-through of *Jobs Strategy* recommendations in the four broad policy areas of: *i)* labour market; *ii)* education and training; *iii)* the business environment and *iv)* macroeconomic policy. The follow-through of recommendations in the first three areas is calculated by assigning a different score to recommendations that were entirely followed, partly followed, not pursued at all, or where policy went in the opposite direction to the recommendations.[11] Major reforms that had been undertaken before the *Jobs Strategy* recommendations – and implying that no further action was required – have been included in the calculation of the follow-through rates.

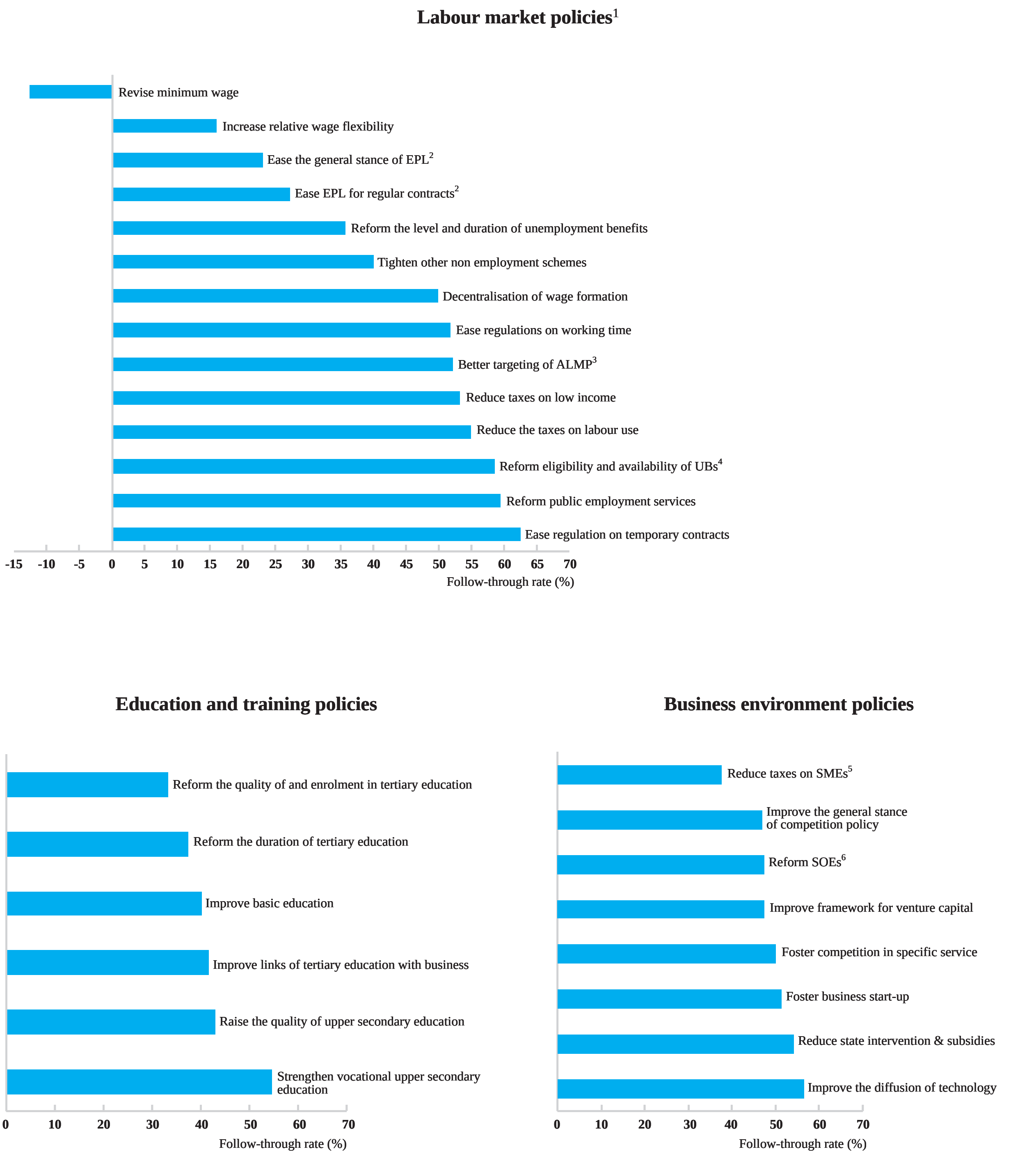
Although there are inherent difficulties with this exercise,[12] Figure IV.5 illustrates that in general OECD countries have made a significant effort to implement structural reforms, although differences exist as to the scope and pace of the policy action (Box IV.2).[13]

Some countries have been hesitant in embarking on reforms that affect core workers, preferring to focus on actions at the margin…

Progress in the labour market area has been uneven. In particular, a number of countries with high and persistent unemployment have been hesitant to implement reforms that affect core workers. For example, relatively few changes have been made to stringent employment protection legislation for workers with regular contracts, whereas many countries have eased regulations for fixed term contracts and temporary work agencies. Moves towards more decentralised wage bargaining have been implemented in a number of countries, but most of them have been reluctant to reform minimum wages or, more generally, to allow for a widening of earnings distri-

10. These points were elaborated in Chapter IV "Low-income dynamics in four OECD countries" in *OECD Economic Outlook,* 64, December 1998. See also Burniaux *et al.* (1998).
11. The benchmarks for judging countries' progress in implementing the Jobs Strategy are based on the recommendations included in the OECD *Economic Surveys*. See OECD (1999) for more details.
12. In particular, judging the extent to which a country followed a recommendation is difficult in some cases. Recommendations also differ in *scope* and *importance*. Differences in the scope of recommendations were taken into account by re-grouping the original recommendations into a smaller number of thematic areas. In addition, within each of these policy subjects, more weight was given to recommendations referring to the *general* policy stance than to those referring to *specific* policy aspects. See OECD (1999) for more details.
13. The figure reports the weighted proportion of recommendations which were followed. The weights were assigned as described in the previous footnote.

Figure IV.5. **Follow-through on policy recommendations to implement the Jobs Strategy**



1. The follow-through rates in this area include significant reforms which had been undertaken before the Jobs Strategy recommendations, which implied that no further action was requested.
2. Employment protection legislation.
3. Active labour market policies.
4. Unemployment benefit and related welfare benefit systems.
5. Small-and medium-sized enterprises.
6. State-owned enterprises.

Box IV.2. **Key structural policy reforms in the 1990s**

This box presents the most significant structural policy developments in Member countries over the 1990s, based on the assessment made in the 1997 report (*Implementing the Jobs Strategy: Member Countries' Experience*) and evaluation of more recent policy developments in the 1999 Report to Ministers (*The OECD Jobs Strategy: Assessing Performance and Policy,* 1999).

- *Transfers and taxes.* Unemployment benefit support levels have been cut back in Germany, Canada, Austria, Belgium, Denmark, Finland, Ireland, and the Netherlands whereas the level of benefits and other unemployment-related welfare benefits was increased in Italy (albeit from a very low level), Greece (also from a low level), Iceland and to some extent Switzerland. In France reforms were introduced to reduce benefit support although recent policy initiatives have seen some reversal of this. Maximum duration of benefits was lowered in Germany, United Kingdom, Canada, Belgium, Denmark, Iceland and Norway, while Switzerland increased it. Many countries tightened eligibility, availability or willingness-to-work requirements, as well as rules concerning temporary layoffs. Some countries have implemented – or plan to phase in – changes in early-retirement schemes, including Germany, Italy, Austria, Belgium, Denmark, Finland, Greece and the Netherlands. In a number of countries decisions have been taken or are under consideration to raise the standard age of entitlement to old-age pensions (*e.g.* United States, Japan, Italy, United Kingdom (women), New Zealand and Portugal (women)). At the same time, conditions for access to invalidity or sick-pay schemes have been tightened in Germany, Italy, Austria, Hungary, the Netherlands, Norway and Spain. Evidence suggests reductions of the overall tax wedge on the use of labour in ten of the 25 Member countries for which data are available, and significantly so in Ireland, the Netherlands, New Zealand and Norway. Moreover, the tax wedge for low-wage workers was reduced in Germany, France, United Kingdom, Canada, Austria, Belgium, Denmark, Finland, Greece, Ireland, the Netherlands, Mexico and New Zealand. Also, measures to reduce "unemployment traps" through the use of employment-conditional benefits were introduced or expanded especially in some English-speaking countries.
- *Employment protection legislation.* Finland and Spain are the only two countries to have significantly eased employment protection for permanent workers, although from very stringent levels. In contrast, employment protection became tighter in France and Luxembourg. Most Member countries eased regulations for fixed-term contracts and temporary work agencies (TWAs). In particular, Italy, Greece, Spain and Sweden have allowed the use of TWAs, while restrictions on fixed-term contracts were eased in Germany, Italy, Austria, Belgium, Finland, the Netherlands, Portugal and Sweden and tightened in France and Spain.
- *Working-time flexibility.* Regulations restricting unusual working hours were eased in Germany, France, Austria, Belgium, Finland, Greece, Portugal and Spain, but measures to discourage overtime were introduced in France and Finland. At the same time, an overall maximum on weekly work hours was introduced at the European Union (EU) level. Regulations concerning part-time work were eased in Germany, France, Italy, Austria, Belgium, Denmark, Greece, Luxembourg, Spain and Switzerland, and tax incentives for part-time work have been introduced in France, Italy, Austria, Finland and Spain. France has, however, restricted the normal working week to 35 hours, and a similar move is under consideration in Italy.
- *Wage formation.* A major reform of the industrial relations system was made in New Zealand with the Employment Contracts Act in 1991, which turned the labour market in this country to one of the least regulated in the OECD. Australia also promoted enterprise-level bargaining and in 1993 the United Kingdom supplemented the reforms of industrial relations legislation of the 1980s. In the continental European countries, reforms in the industrial-relations system have generally been more gradual, maintaining bargaining among the social partners as the key element of wage determination, but trying to improve co-ordination among the different levels of negotiation (national, sectoral, firm level). A number of European countries have also introduced income policy agreements focusing on wage setting and labour market reforms, including the Netherlands and Ireland since the 1980s. Italy, Denmark, Spain and, more recently, Portugal moved in the same direction in the 1990s. Significant relative reductions in legal minimum wages have taken place in the Netherlands, while both the United States and New Zealand have recently raised their minimum wages, although from relatively low levels. Furthermore, the United Kingdom introduced a statutory minimum wage that allows for a sub-minimum rate for young workers and Ireland proposes to introduce a minimum wage in the near future.
- *Active labour market policy.* The most notable change in the orientation of active labour market programmes is the increase in targeting towards job-search assistance (especially in the English-speaking countries, Austria, Belgium, Finland and Switzerland). Several countries made efforts to improve the evaluation of active programmes (in particular, the United Kingdom and Belgium). Significant improvements in the targeting of programmes to disadvantaged workers occurred in many countries for which recommendations were made. Reforms have also been made to rules regarding re- qualification for unemployment benefits via active labour market policies (*e.g.* Germany, Denmark, Finland and Norway). As a notable policy change, Australia made the market for employment services fully contestable, and public monopolies on job placement services have been eliminated in Germany, Italy, Austria, Denmark, Finland and Spain.

Box IV.2. Key structural policy reforms in the 1990s *(cont.)*

– *Education and training.* The length of compulsory education has been extended in Italy, Belgium, Czech Republic, Iceland, Mexico, New Zealand, Norway, Portugal and Turkey; while national testing at key stages has been introduced in France, England, New Zealand, Sweden and Spain. Reforms aimed at establishing clearer curriculum frameworks were advanced in countries with decentralised education systems (*e.g.* United States, United Kingdom, Australia and New Zealand). In these and other countries, secondary schools were allowed greater management autonomy. Steps have been made to improve the quality of vocational and technical education and training in many countries. Purposeful combinations of work and learning were introduced more widely or strengthened in a number of countries, including the United States, Italy, United Kingdom, Canada, Australia, the Netherlands, Portugal and Spain. France, the Netherlands, Norway and Spain introduced financial incentives to employers to offer apprenticeship places, which are also an important feature of "Modern Apprenticeships" in the United Kingdom. Several countries also undertook to reform tertiary education by putting under scrutiny the contents of studies and in some cases modifying and diversifying them (including shortened programmes, either distinctive or as the first stage of a longer study programme), not least to prepare students better for evolving job destinations and paths (Japan, United States in some individual states, Austria, Denmark, Finland, Portugal, Sweden, United Kingdom, France, Germany); facilitating entry routes and varied pathways through flexible admissions, crediting and transfer arrangements, thus enabling students to find more easily the learning options and mixes they need (United States, Japan, France, Belgium – Flemish Community); altering governance arrangements, among other things to foster increased contact and new partnership with businesses and local authorities (Austria, Finland, France, New Zealand); and introducing or reinforcing incentives or processes for improvements in teaching and in learning outcomes, partly *via* such financing mechanisms as user charges, lending and outcome-based funding for students or providers (Australia, New Zealand, Japan, United States in some individual states, Denmark, Belgium – Flemish Community, Finland, France, Germany, Netherlands, Portugal, Sweden, United Kingdom).

– *Product market competition.* Tariff and non-tariff barriers in most OECD countries have been significantly reduced in the context of international and regional trade agreements.[1] Moreover, unilateral reductions of trade barriers took place in Australia, New Zealand and Switzerland. Various aspects of competition law were strengthened in a large number of countries. Measures to ease general licensing requirements have been taken in the Netherlands, and barriers to inter-regional competition are being lowered in Canada, Australia and Switzerland. A few countries (Germany, Australia, Austria, Finland, Ireland, Spain and Switzerland) took action to introduce more competition in professional services (*e.g.* lawyers, architects) and crafts sectors, which are usually subject to regulation of entry and operational control, enforced by law or by self-regulating bodies. Some progress was also made on the recommendations for liberalising shop-opening hours (Germany, Italy, Austria, Belgium, Denmark, Finland, Greece and the Netherlands) and Japan eased restrictions on large-scale stores, while France has tightened the latter type of regulation. Competition in the financial sector is due to increase in Japan, Mexico and EU countries. Steps towards further liberalisation have been taken in telecommunications (*e.g.* United States, United Kingdom, Australia, Finland, Sweden), electricity (*e.g.* United Kingdom, Australia, Finland, Norway, Sweden) and railways (*e.g.* Germany, United Kingdom, Denmark, Mexico, Sweden), and EU-wide liberalisation is taking place in the telecommunications, airlines and electricity sectors.

– *Innovation and technology.* Innovation and technology diffusion policy has changed considerably over the past decade. Direct public support for research and development (R&D) has been reduced. Greater demand for accountability has led to more emphasis on commercially relevant R&D and on ways to enhance the efficiency of public spending. Market mechanisms for innovation and partnerships with the private sector have been fostered and policies increasingly focus on networking. Recent policy initiatives reflect this new agenda. A number of countries, including Japan, France, Austria, Korea and Mexico, took major initiatives to reform innovation policy. Most initiatives focused on measures to stimulate the diffusion of technology, and to facilitate the growth of new technology-based firms. A few countries (Japan, Finland and Korea) are committed to a substantial increase in public spending on R&D. Other countries, such as the United Kingdom, Austria, the Czech Republic and New Zealand plan to increase public spending on R&D, but these efforts are less ambitious than those of the first group of countries. Changes to R&D support regimes included the reform of the R&D tax credit in France, Mexico and, recently, Portugal. France and Austria have also introduced new thematic research networks, based on public/private partnerships, which aim to stimulate innovation and make public support more effective. Several countries have also undertaken initiatives to enhance the access of firms to finance and risk capital, including broad reforms to financial markets (Germany), reforms to stock markets (Germany, Austria) and

1. There has been a notable increase in anti-dumping cases in the 1990s. See Chapter VII "Trends in market openess" in this Outlook.

Box IV.2. Key structural policy reforms in the 1990s *(cont.)*

measures to ease access to venture capital (Japan, Germany, France, Austria, Belgium, Sweden). Recent initiatives on technology diffusion policies include incentives for the development of technology transfer institutions (Austria), and measures to enhance the exploitation of patents and promote their commercialisation (Japan, France, Austria, Belgium).

– *Entrepreneurship.* A number of countries have introduced, or are planning to introduce, reforms aimed at reducing "red tape'' for business start-ups (Germany, France, Italy, United Kingdom, Australia, Austria, Finland, Mexico, the Netherlands, Portugal and Spain). Germany has also extended exemptions for very small companies from employment protection requirements. Measures to ease financing constraints for small and medium-sized companies have been taken in many countries, including Japan, Germany, France, Italy, the United Kingdom, Canada, Australia, Austria, Denmark, Finland, the Netherlands, New Zealand, Norway, Spain, Sweden and Switzerland. In Germany, France and Austria, steps have been taken to strengthen links between small and medium-sized entreprises (SMEs) and research centres.

butions. In addition, only a few countries have significantly reduced the level and maximum duration of unemployment benefits and other non-employment benefits. On the other hand, many countries have preferred to tighten the eligibility conditions for these benefits.

... although there has been a more general tendency to help low-paid workers

More determined actions have been taken in a number of countries to reduce labour costs or increase work incentives for low-paid and inexperienced workers, in recognition of their severe problems in the labour market. Payroll taxes for low-income workers have been lowered in several countries (Box IV.2), while remaining high for other workers in many European countries. In-work benefit schemes have been fostered in some English-speaking economies, and efforts have been made in many cases to improve the targeting of active labour market programmes towards workers with long spells of joblessness and low re-employment probabilities.

Quality in secondary education has been promoted more convincingly than in other areas of education…

In the area of education and training, many countries have made reforms of secondary education, in particular by reinforcing the link between vocational and general education. A relatively lower follow-through on recommendations to reform basic education can be partly explained by the important efforts made before the *Jobs Strategy* recommendations in several countries. Reforms of basic education were largely concentrated on improving educational infrastructure and the enrolment rates of marginal groups. Recommendations concerning tertiary education also had a lower follow-through than those related to secondary education. There are, however, significant differences across countries in this respect.

... with efforts to ease the transition from school to work

Efforts to improve the transition from education to work have been made in a number of countries by easing the access to part-time work. Moreover, the workplace component within secondary vocational education has been reinforced in many countries. In addition, a number of countries, attempted to either introduce or expand apprenticeship-type systems for youths.

Progress has also been made to improve the business climate, though much remains to be done in fostering competition and reducing taxes on SMEs

Countries have made some progress in most of the policy areas relating to the *business environment.*[14] Several countries have implemented recommended reforms to improve the creation and diffusion of technology, to reduce state intervention and subsidies and to encourage business start-up. Furthermore, countries to which it was recommended made efforts to increase competition in certain service sectors. How-

14. See also two OECD thematic reviews on these issues (OECD, 1996*c*, 1998*a*).

ever, further reforms are still needed in these areas. In the case of competition policy, for example, comprehensive reforms are still lacking. In addition, recommendations to lower the tax burden on small and medium-sized enterprises (SMEs) had a relatively lower follow-through rate, probably because the major fiscal consolidation efforts in the recent past left little room for manoeuvre for tax reductions.

Structural policy reforms and labour market outcomes

Countries that undertook reforms saw progress in the labour market

Bearing in mind the tentative nature of the indicator on follow-through rates, Figure IV.6 suggests that countries that acted on a high proportion of the recommendations of the *Jobs Strategy* concerning labour market policy often enjoyed improved labour market conditions.[15] In particular, most of the countries posting significant falls in trend unemployment and improved overall labour market conditions (the United Kingdom, Canada, Australia, Denmark, Ireland, the Netherlands and New Zealand) have been amongst the most determined in pursuing the *Jobs Strategy.* In addition, they have often tackled key policy aspects for the functioning of the labour market, including unemployment benefits, taxes on labour and the wage formation process (see Box IV.2). By contrast, the majority of countries with high or rising trend unemployment are those which have so far been reluctant to implement labour-market-related recommendations of the *Jobs Strategy* in a comprehensive way.

A comprehensive approach is desirable…

Figure IV.6 also suggests that a relatively high follow-through rate may be required before significant declines in unemployment materialise. One explanation for such a finding is that labour market policies (and institutions) have complementary effects on the labour market, and thus reforms in several areas have a compounded impact.[16] The comprehensive nature of the reform strategy in countries with high follow-through rates may also help to explain the support that reforms received from the population. Reforms on a wide front have affected most workers – including those who play a dominant role in wage-bargaining process – and not just people at the margin, as it is often the case with piece-meal reforms. In addition, the direct involvement of the social partners in the design and implementation of reforms in some countries is likely to have contributed to a favourable environment. Likewise, labour market reforms in countries with high follow-through rates have often been accompanied by measures aimed at fostering product market competition. Thus, it is likely that wage moderation – which has generally been a component of the labour market adjustment process – has translated into lower prices rather than higher producers’ rents.

... but it takes time for the effects of reforms to emerge in the labour market

Evidence also suggests that the effects of structural reforms materialise in terms of improved labour market performance with a relatively long lag. Workers and firms have to adapt to the new conditions set by the reforms and there might be short-term adjustment costs. Indeed, some of the countries with significant falls in trend unem-

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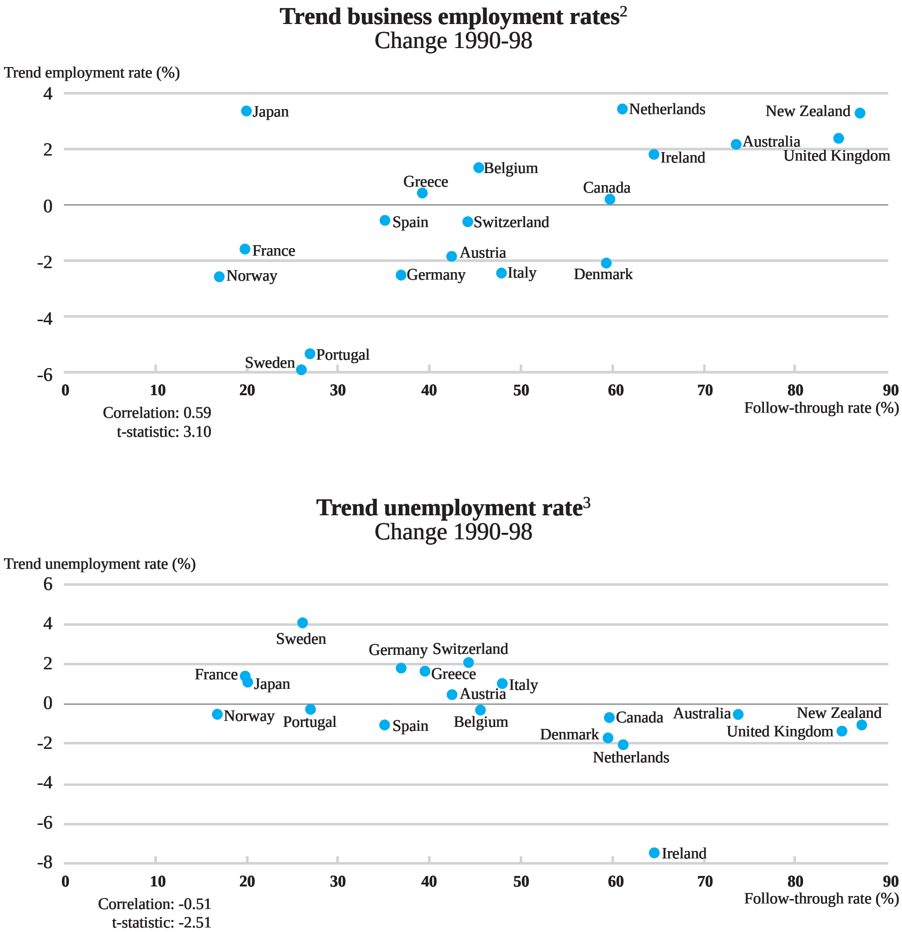
15. The figure focuses on labour market reforms because policy changes in the other two areas (education and business environment) are too recent to have had a major impact on the labour market. This is especially the case with reforms of the education system, where the effects are likely to materialise in the labour market only over the medium to longer run.
16. Coe and Snower (1997) provide a theoretical justification for the complementarities of labour market policies and institutions, and Elmeskov, Martin and Scarpetta (1998) offer some preliminary empirical evidence. In particular, they suggest that employment protection regulations and taxes on labour use may have a more significant dis-employment effect in countries with industry-level bargaining with little co-ordination where wages do not fully adjust to higher labour costs.

Figure IV.6. **Follow-through in implementing labour market reforms and performances, 1990-98**[1]



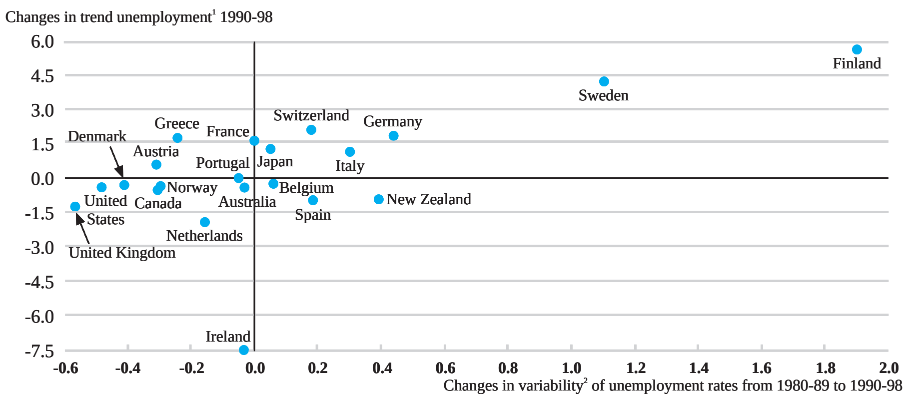
1. The United States has been excluded from the sample because of the very few recommendations it received in specific areas; Finland has been excluded because of the very abrupt increase in unemployment at the beginning of the 1990s which makes it very difficult to assess the evolution of its trend component as well as trend employment. If the two countries were added to the country sample, the correlation between follow-through and evolution of trend unemployment will remain statistically significant while that with trend employment will not.
   See OECD(1999*a*) for more details.
2. Trend business sector employment rates are calculated on the basis of a regression against the output gap (see Figure IV.2).
3. Trend unemployment data are based on OECD estimates of the *non-accelerating wage rate of unemployment* (NAWRU).

ployment and overall improvements in labour market conditions (United Kingdom, Denmark, Ireland and the Netherlands) began implementing reforms in the early to mid-1980s and even in Australia and New Zealand the start of key reforms can be dated back to the 1980s. In other countries that have implemented major reforms only in the early to mid-1990s (*e.g.* Canada, Spain), significant reductions in trend unemployment have emerged only in the most recent past and other measures of labour market performance have not yet improved.

A macroeconomic framework geared to strong, balanced and sustainable growth is important

The *Jobs Strategy* highlighted the role of macroeconomic policy in improving labour market conditions by providing a supportive framework, based on sound public finances and price stability. These conditions are likely to affect unemployment and employment via the channel of lower real interest rates. A reduction in real interest rates will tend to reduce production costs and encourage capital accumulation and labour productivity and, if real wages do not fully adjust to the increase in productivity, this will result in lower unemployment.[17] More stable macroeconomic conditions also allow business to plan ahead with more confidence that structural reforms will not be abruptly reversed or abandoned, and give governments and monetary authorities more room for manoeuvre faced with unexpected shocks. Figure IV.7 provides some evidence of the effects of macroeconomic fluctuations on the labour market. It shows that countries that managed to contain macroeconomic fluctuations – proxied by changes in the variability of changes in actual unemployment rates – generally avoided strong increases in estimated trend unemployment. In contrast, those countries with large macroeconomic fluctuations have often experienced stronger increases in trend unemployment, especially in presence of rigid labour markets.

Figure IV.7. **Cyclical variability and trend unemployment, 1990-98**



1. Trend unemployment data are based on OECD estimates of *the non-accelerating wage rate of unemployment* (NAWRU).
2. Measured by the standard deviation of yearly changes in unemployment rates.

Shifts towards stability-oriented macroeconomic policies date back to the early to mid-1980s in most of the countries with high follow-through rates and improvements in labour market conditions. The shift in macroeconomic policy was indeed considered as an integral part of the reform strategy in Ireland and the Netherlands that was agreed with the social partners. Likewise, the shift was introduced either before or at the same time as structural reforms in the early 1980s by new governments in the United Kingdom and Denmark. However, New Zealand experienced some increase in macroeconomic fluctuations over the past decade and this may help to explain why reductions in unemployment did not materialise as early as the scope of its structural reforms would have suggested. Many other OECD countries embarked on stability-oriented macro-policy reforms in the late 1980s or 1990s. This is creating a suitable environment for implementing structural reforms more decisively. However, moves towards more stable macroeconomic conditions without also implementing structural reforms may have been costly in terms of unemployment, especially in countries with rigid labour markets (see also Ball, 1996).

17. OECD (1997) discusses in more detail the links between macroeconomic policies and labour market conditions. See also Phelps (1994) and Blanchard (1997).

Concluding remarks

The* Jobs Strategy *is a valid tool to tackle high and persistent unemployment…

Evidence in this chapter suggests that the *Jobs Strategy* represents an effective set of guidelines to tackle high and persistent unemployment and improve overall labour market conditions. Countries that have gone the furthest in implementing its recommendations have enjoyed significant falls in unemployment and reached (or maintained) high employment and participation rates. These are also the countries that started a reform process already in the 1980s, which has given sufficient time for the beneficial effects of reforms to emerge in the labour market. Countries that have made a later start, but have progressed a great deal along the lines of the *Jobs Strategy,* are beginning to experience its benefits.

… especially if it is implemented comprehensively…

The experience of the countries that have gone the furthest in implementing the *Jobs Strategy* also points to the need for a comprehensive set of structural reforms. This, combined with supportive macroeconomic policy settings, allowed them to exploit important synergies. Wide-ranging reform strategies also contributed to a perception that all workers shared the costs and benefits, including core workers, which is often not the case in piece-meal reform strategies.

... while piece-meal reforms may not deliver, even if targeted to disadvantaged groups

Several other countries have pursued targeted policy reforms to help people at the margin of the labour market, in particular youths and inexperienced people as well as low-paid workers. While sound in their own right, these policies may not produce significant results unless they are accompanied by more general actions that reduce overall unemployment. For example, measures aimed at easing the transition from education to work may prove ineffective if labour demand is constrained by very high wage floors. And fostering temporary employment while leaving in place tight regulations on regular contracts may not durably help young workers who will run the risk of being trapped in precarious jobs. Also, reforms of in-work benefits may not encourage low-skilled people to take up jobs if they are not accompanied by reductions of overly generous non-employment benefits. And targeted reductions of payroll taxes for low-paid workers may not lead to higher overall employment rates if taxes for other workers have to be increased to compensate for the revenue shortfall.

Countries that have managed to foster employment and consistently reduce unemployment exhibit a variety of economic, social and institutional settings, which inspired the implementation of their reform strategy. However, in all cases of reforms that successfully increased employment rates and reduced unemployment, the approach taken has followed the main thrusts of the *Jobs Strategy.*

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V. POLICY CHALLENGES ARISING FROM CLIMATE CHANGE

Introduction

Most OECD countries are committed to reducing their emissions of greenhouse gases

There is increasing scientific consensus that global warming is under way, linked at least in part to human economic activity. The considerable attention paid to this problem over the past ten years resulted not least from the 1992 United Nations (UN) Framework Convention on Climate Change (UNFCCC). Despite this attention, however, current indications are that emissions of greenhouse gases (GHGs) are rising faster than expected, and that the initial UNFCCC aim for emissions for the year 2000 will be substantially exceeded in almost all OECD countries. Moreover, the date by which stabilisation of world emissions (let alone the reductions necessary to stabilise atmospheric GHG concentrations) can be expected is receding into the future. The Kyoto Protocol, agreed in 1997 but yet to enter into force, adopted binding targets involving cuts in emissions, relative to the 1990 level, for the period 2008-12.

This chapter[1] first discusses the costs of meeting the Kyoto targets, the properties of international emissions trading in reducing the overall costs of abatement, and some of the domestic policies needed. The second section considers some of the work that remains to be done in clarifying important aspects of the Protocol, while the third section examines some of the arguments advanced in the ongoing discussions on whether to limit international emissions trading. The fourth section discusses the extension of binding GHG emissions limits to developing countries, and their incentives to accept such constraints, and the fifth raises some issues in evaluating the cost of climate change and the need to adapt to changes that seem likely to occur. The last section presents some concluding remarks.

Meeting the Kyoto emissions targets

Reduction targets are tighter than it seems…

The Kyoto Protocol calls for GHG emissions in the period 2008-12 to be reduced, relative to their 1990 level, by some 5 per cent for Annex 1 countries as a whole.[2] The reduction for OECD countries overall is around 7 per cent, but with variations among countries – particularly within the European Union (EU) following its (separate) burden sharing agreement (Table V.1). These targets are tighter than it seems because of

1. This chapter is derived from work undertaken as part of the OECD project on Sustainable Development (OECD, 1999*c*).
2. The Kyoto Protocol set emission targets for most OECD countries and a number of economies in transition. This group of countries is frequently referred to as “Annex 1 countries”.

Table V.1. Overview of national emission trends, Kyoto objectives and EU burden-sharing

	1990 GHG emissions *(million tonnes CO_2 equivalent)*	Percentage change 1990-1995	Kyoto target for 2008-2012 (as % of 1990)
Non-EU OECD			
Australia	406	6	8
Canada	558	10	–6
Czech Republic	188	–24	–8
Hungary	102	–24	–6
Iceland	3	5	10
Japan	1 190	8	–6
New Zealand	76	0	0
Norway	49	6	1
Poland	564	–22	–6
Switzerland	54	–2	–8
United States	5 713	5	–7
European Union			–8.0
Burden-sharing targets:			
Austria	78	1	–13.0
Belgium	139	6	–7.5
Denmark	72	10	–21.0
Finland	65	3	0.0
France	498	0	0.0
Germany	1 204	–12	–21.0
Greece	99	6	25.0
Ireland	57	4	13.0
Italy	532	2	–6.5
Luxembourg	13	–24	–28.0
Netherlands	207	8	–6.0
Portugal	68	6	27.0
Spain	301	2	15.0
Sweden	65	3	4.0
United Kingdom	715	–9	–12.5

Source: UNFCCC ‘‘official’’ national data.

the growth of emissions that would normally occur in the meantime: relative to this “Business as Usual” scenario, the targets imply reductions that may amount to some 30 per cent. Indeed, by 1995 emissions were higher than in 1990 in the majority of OECD countries. Where emissions have fallen, it is usually due to largely unrelated events or policies of a one-off nature: to collapses in output in transition countries and (eastern) Germany and, in the United Kingdom, to liberalisation of the electricity supply industry and reform of coal subsidies encouraging a switch to gas.

… and the policies to reach them are not in place

Few of the domestic policies necessary to contribute to reaching the emission targets are in place today. Such policies, to be cost-effective, will have to include market and subsidy reforms, particularly in the agriculture, transport and energy sectors. Subsidies to energy industries, especially coal, have declined considerably over the past decade, but remain substantial; OECD case studies indicate that abolition of selected energy subsidies could reduce CO_2 emissions from the energy sector by between 1 and 8 per cent (OECD, 1997).

The use of economic instruments will reduce costs…

Making use of economic instruments will also help cost effectiveness. Some steps are being taken towards the introduction of a carbon tax in a number of countries.[3] As an alternative to a CO_2 tax, a system of domestic tradable permits is in many ways equivalent, and has similar efficiency properties.[4] It has some advantages compared with a tax: it may be better suited to meeting quantitative targets, when there is uncertainty about the level of CO_2 tax that would be required; and it could be linked to international trade in emissions allowances as foreseen in the Kyoto Protocol. No such system is currently in use, though the sulphur dioxide trading system in the United States has encouraged a lot of interest.[5] However, tradable permits also have a number of drawbacks as compared with taxes – especially when introduced in small countries with few participants to trading and without linkage to international emissions trade – and it may be effective to apply both instruments.

… and exemptions should be limited and temporary

One of the challenges for cost-effective policies such as carbon taxes and emission trading is how to deal with existing heavy emitters. These emitters often ask for some exemption from a CO_2 tax, or for a sufficient amount of free allocations of emission allowances ("grandfathering"), to avoid facing a sudden large increase in costs. Industry arguments about adverse effects on competitiveness have led countries to grant tax exemptions to some emitters, even though these exemptions tend to seriously weaken the link between the tax paid and carbon emitted.[6] While preferential treatment may be warranted in an initial phase, partly to help overcome political resistance, these exemptions should be phased out rapidly to avoid reducing the overall incentive to abate. It should also be noted that "grandfathering" and tax exemptions, often lobbied for on "competitiveness" grounds, reduce government revenues and thereby potential reductions in other taxes which may have even more distortionary effects on economic performance.

Other measures may supplement economic instruments

A number of other measures have been considered in some Member countries to supplement market forces or to deal with market imperfections. Such measures include regulatory policies for materials, buildings and products, green government procurement approaches, as well as research, information and public awareness programmes. Complementing economic instruments, these measures can accelerate diffusion and development of technologies, and change consumption patterns towards goods and services produced, delivered and disposed of with lower emissions of GHGs.

Voluntary agreements to reduce emissions – between governments on one side and industrial sectors or enterprises on the other – are a response to the resistance to market-based instruments. Voluntary agreements have important drawbacks, however. Some types of voluntary agreements establish relative performance targets,

3. Germany, Italy, Austria, Norway, Sweden, Finland, Denmark and the Netherlands have some form of energy/carbon tax, though the link with the carbon content of energy is usually weak. France, New Zealand and the United Kingdom are planning or considering the introduction of such a tax.
4. In particular, that marginal abatement costs are equalised across the economy, implying that reductions in emissions are undertaken at least cost. A discussion of this and other aspects of emission trading and carbon taxes can be found in OECD (1998*a*), pp. 200-203.
5. A number of countries are exploring how to set up a CO_2 trading system including by launching pilot trading schemes (see www.oecd.org/env/cc).
6. In Germany, the burden of the energy tax is capped – if a firm's payments of the energy tax exceed savings from lower labour taxes (reduced as part of an attempt to reap a "double dividend") by more than 20 per cent, the excess is to be refunded. In Finland, a carbon tax had been introduced in the early 1990s. The electricity supply industry, facing competition from abroad, argued for tariff protection to compensate for a carbon tax on its own fossil fuel inputs. When such a tariff turned out to be forbidden by European Union (EU) rules, the Finnish Government exempted the electricity sector from carbon tax, introducing instead an electricity tax, which targets carbon emissions very poorly. The German energy tax was also shaped by concerns about competition from abroad in the absence of an EU-wide policy on carbon taxes.

which provide firms with a degree of certainty about feasibility and cost, yet the overall degree of abatement is hard to predict. Marginal abatement costs may also vary among firms and industries, losing opportunities for adjustments that would reduce overall costs. This is also a concern about regulatory approaches; where they are required, cost effective formulation is important.

Estimates of the aggregate costs of action seem moderate…

Much OECD research has gone into estimating the economic costs of implementing the Kyoto targets. The OECD's GREEN model yields results that are broadly in line with other models. GREEN simulations suggest that, if countries succeeded in meeting the Kyoto targets with only cost-effective domestic measures, *i.e.* without making use of the scope for cost reductions through mechanisms such as international emission trading, this would imply a reduction in the level of real income in the main OECD regions varying from 0.2 per cent to 0.8 per cent, about 0.5 per cent overall (Table V.2). These figures may seem small but hide much larger impacts on some sectors of the economies. Moreover, the results are based on the assumptions that policies can be fully effective in achieving domestic equalisation of marginal abatement costs and that labour-market adjustment is fully flexible. Both assumptions may imply some under-estimation of the cost of abatement policies. On the other hand, GREEN currently deals only with CO_2 from energy, and does not consider either CO_2 from forestry or other greenhouse gases. This may cause costs to be overstated, since reductions in emissions of methane and nitrous oxide, or CO_2 offsets from forestry, could probably contribute substantially to the Kyoto reduction commitments at relatively low cost, at least in Europe (Gielen and Kram, 1998). Moreover, policy reforms such as cuts in energy subsidies could further reduce costs of reaching the Kyoto targets.

… especially with international emissions trading

International trading of emission allowances allows the real income losses in OECD countries to be significantly reduced, according to GREEN simulations, to about one third of 1 per cent on average. In part, these gains are at the expense of higher overall emissions – due to "hot air" in Russia and the Ukraine, discussed below. Without "hot air" gains, trading reduces the average real income loss in OECD countries from about 0.5 per cent to about 0.4 per cent. The implied carbon tax (or price of emission allowances) would be around $90 per tonne of carbon (compared with $100 to $300 across main OECD countries and regions if they were to

Table V.2. **Costs of Kyoto in OECD regions, 2010**

	Change in GDP, per cent		Change in real income,[a] per cent		Implied carbon price, 1995 $ per tonne of carbon	
	Without trade	With trade[b]	Without trade	With trade[b]	Without trade	With trade[b]
United States	–0.27	–0.16	–0.33	–0.40	231	92
Japan	–0.03	–0.02	–0.24	–0.19	189	92
European Union	–0.17	–0.08	–0.77	–0.33	181	92
Other OECD	–0.29	–0.18	–0.68	–0.64	228	92
OECD total	–0.18	–0.10	–0.48	–0.34	..	..

a) Changes in real income differ from changes in GDP because of terms-of-trade changes. These arise mainly from *a)* changes in imported energy prices; and *b)* changes in domestic prices needed to maintain balance-of-payments equilibrium (*e.g.* to improve the balance of trade to finance emission allowance purchases). Important influences on these are, on *a)*, the initial structure of trade, in particular the degree of dependence on imported energy and, on *b)*, the price elasticities of demand for imports and exports.

b) Unrestricted trade among Annex 1 countries, *i.e.* including ''hot air'' trade.

meet their emission targets individually).[7] Trading generally allows OECD countries to meet their emission targets with higher levels of GDP than in a scenario without trading, but some of these gains are offset by the need to purchase emission allowances from abroad.

Early action may stimulate innovation…

The Kyoto targets apply to emissions a decade from now. Nevertheless, it has been argued that strong action to force emissions reduction should be taken early in order to stimulate technical progress and innovation, leading to reduced abatement costs later on. On the other hand, if technology improves independently of pressures to reduce emissions it could be beneficial to wait longer until cheaper abatement technology is available in the future.

… and reduce premature scrapping of capital

GREEN, in which progress in energy technology is exogenous, cannot assess these arguments. However, simulations suggest that a gradual phasing in of action to meet the Kyoto targets, starting as early as possible, incurs lower costs than waiting and then introducing measures more abruptly. This is mainly because it minimises the extent to which rapidly changing relative prices force premature scrapping of capital equipment. On both the technology and capital scrapping argument, early clarification of the conditions for implementing the Kyoto Protocol would be important to accelerate progress.[8]

Modalities for implementing Kyoto

Many aspects of the Kyoto Protocol remain to be clarified, including…

Negotiations on the modalities for implementing the UN Framework Convention and the Kyoto Protocol take place in the Conference of the Parties (COP) to the UNFCCC and its subsidiary bodies. The Kyoto Protocol, negotiated at the third meeting of the COP ("COP3") embodies the emissions commitments and an outline – but not the details – of how these will be defined, monitored and enforced. COP4, in Buenos Aires in November 1998, made only little progress towards defining these details, but set the aim of finalising them at COP6, currently planned for 2000.[9] Among the modalities to be settled are those related to the compliance system for the Protocol which may be considered in three parts: *i*) monitoring and reporting; *ii)* review and verification; *iii)* non-compliance responses and enforcement.[10]

… monitoring and reporting…

Monitoring and reporting is undertaken to gather information to enable assessment of compliance with the emissions targets. This process is largely the responsibility of parties to the Climate Convention themselves, who are required to produce inventories of their own emissions (and removals through sinks, such as carbon being trapped in forest growth) of greenhouse gases. Agreed guidelines have been established, but they are not yet sufficiently precise. Work is needed to improve accuracy,

7. A survey of results from a number of models suggests that results from GREEN are relatively central (OECD, 1999*a*, Table 3). Prices are expressed in 1995 dollars. For comparison, the 1995 international oil price was equivalent to about $150 per tonne of carbon.
8. GREEN does not embody any forward-looking behaviour. If agents anticipated future relative price changes – *e.g.* the introduction of a carbon tax – the advantages of targeting early emission reduction would probably be reduced. Early clarification of the Protocol would help formation of such expectations.
9. The Protocol will not enter into force until ratified by countries accounting for at least 55 per cent of Annex 1 emissions, and by at least 55 countries. Eight countries have so far ratified; no Annex 1 countries have ratified.
10. See Corfee Morlot (1998) and OECD (1998*b*) for more details.

to ensure comparability between countries and to deal with uncertainties in measurement, particularly for non-CO_2 gases and for sinks.

… review and verification…

Review and verification procedures would use the information reported to ascertain compliance, and include checks on the self-reporting procedures. Currently, an "in-depth" review process has been established, with a visit to the reporting country by a team of experts, which identify errors and irregularities (including information gaps), but they are not charged with verifying inventory data. Yet, such verification, within a stronger review procedure, may be essential for an effective non-compliance procedure under the Protocol.

… and non-compliance procedures

Non-compliance procedures are as yet unspecified. Although domestic emission limitation schemes could provide for financial penalties for non-compliance, there is little precedent for an international treaty to provide for financial penalties (OECD, 1998*b*).[11] In some cases, being publicly declared in non-compliance may act as a significant penalty, and revoking the right to participate in international permit trade may be a serious sanction. More explicit enforcement "sticks" are not readily available, although measures such as trade or economic sanctions may be explored. It has been suggested that some "carrots" should also be considered, including the possibility of making funding from international financial institutions or the financial mechanism of the Convention conditional on compliance. However, these would only affect the transition countries within the Annex 1 group.

While non-compliance measures may be necessary in any case, their importance is highlighted by discussions of the international flexibility mechanisms of the Kyoto Protocol, in particular emissions trading and joint implementation among Annex 1 countries, whose benefits are based on the assumption of strict enforcement of national targets. In the case of the so-called Clean Development Mechanism (CDM),[12] no national target is involved but emission cuts in non-Annex 1 countries will be defined with respect to a project-specific baseline that will have to be agreed. The institutional aspects of international emissions trading are likely to be complex. Important elements of the system include an accounting and registry framework for "assigned amounts" of emissions allowances; how to cope with trade between governments and between legal entities, some of which may or not be emitters themselves; and issues such as who is liable when trading itself results in non-compliance.[13]

Emission trading: should it be restricted?

Restrictions on emission trading are sometimes proposed…

Curbing emissions through market based instruments such as tradable emission rights will significantly reduce the economic costs of complying with the Kyoto targets. However, uncertainty about compliance enforcement has been suggested by

11. The EU "Stability and Growth Pact" is perhaps the only example, in a rather different domain.
12. The Kyoto Protocol defines the CDM under which Annex 1 countries can obtain credits that can count towards their emission reduction target. The idea of CDM is that the Annex 1 country may sponsor an investment project – for example the conversion of an electricity generating station from high to low carbon content fuel – in a non-Annex 1 country. The resulting emissions reductions would then count as if the sponsoring country had reduced its own emissions.
13. See Mullins (1998) for more detail on options under consideration.

some parties as a reason to restrict emissions trading. Other arguments for such restrictions include: *i*) the "supplementarity" provisions of the Protocol; *ii*) the need for domestic action to stimulate technical and social innovations; *iii)* "hot air"; *iv)* measurement problems; and *v*) demonstration effects.[14] This section considers each issue in turn.

… perhaps because the role of trading is misunderstood

First, it should be noted that buying permits is not a way for individual countries to avoid bearing the cost of action. Although some agreed emission cuts will not occur in buyer countries, those cuts will nevertheless be made somewhere and the buyer countries will pay for them. Moreover, by reducing the overall costs of cutting emissions, trading may allow more ambitious emission targets.[15]

The concept of supplementarity remains undefined and technical and social innovation does not justify caps on trade…

The need to buy emission allowances and the resulting higher cost of related goods and services should cause people and firms to economise on their use of GHG-producing products and services,[16] thereby triggering some reduction in domestic emissions in buyer countries too. This may go some way towards meeting the "supplementarity" provisions of the Kyoto Protocol, which, however, have not yet been defined.[17] While it is argued that restrictions on trade and the resulting more costly domestic action in buyer countries could further stimulate technical and social innovation in those countries, this would correspondingly reduce it in other countries, and the net result is not clear cut. Domestic ancillary benefits of reduced emissions could be enhanced by restrictions on buying emissions allowances, but again this would be at the cost of reduced ancillary benefits in seller countries. In any case, these benefits could be achieved by separate action.

… and neither does "hot air"…

Another concern arises from what has been described as "hot air". This refers to the likelihood that emissions in some countries, where the level of economic activity has fallen significantly since 1990, will be below the target level even if they take no action at all. These countries would thus be in a position to sell emission allowances that they would not otherwise use – "hot air". Hence, trade would increase overall emissions, though not above the agreed aggregate Kyoto targets. Restricting such trade, however, could be considered a retrospective renegotiating of these targets. In any case, the "banking" provisions of the Protocol allow emissions not "used" in one period to be carried forward for use in subsequent periods, though in practice future negotiations on emissions allowances might be affected by such banking.

… or measurement error

Measurement error has also been suggested by some to justify limits to trade, to ensure that only "real" emissions reductions are traded. However, measurement error is really a problem for compliance assessment rather than for trading. This is because, for any given estimate of emission levels, trading does not increase actual emissions,

14. The issue of potential use of market power in the market for emission permits is discussed in OECD (1999*a*).
15. While the Kyoto targets have already been set, the costs of achieving them may affect the targets set for future commitment periods.
16. Provided the costs of buying emission allowances are passed on. This would be automatic if individual emitting enterprises were responsible for their own emissions. Otherwise this depends on governments passing the costs of their purchases of allowances on to emitters.
17. The Kyoto Protocol includes language to the effect that allowances obtained through trading, joint implementation and the Clean Development Mechanism has to be supplemental to domestic action. Some interpret it to mean that purchases should not exceed half the required emission reductions. Even this would be ambiguous since it could be argued that this should mean reductions compared with "business as usual", which cannot be observed, but which are certainly much greater than the nominal reductions in the Protocol.

only redistributes them. Nonetheless, there may be concern that the revenue to be earned from selling allowances induces countries to understate their actual emissions.

Caps on trading may be argued on grounds of demonstration effects...

As an essentially political argument, it is sometimes argued that developing countries – without whose participation, attempts to reduce global emissions will fail over the longer term – will be willing to commit themselves to action only if they see strong domestic action by developed countries. As argued above, this position seems to reflect a misunderstanding of the role of emission trading. However, if the demonstration effect of increased (and costly) domestic action due to restrictions on emissions trading convinces developing countries of the seriousness with which developed countries take climate change, the longer-term gains from wider participation may be seen to outweigh the short-term costs of restrictions.[18]

… or as sanctions

A case is also made by some for the use of restrictions on emission trade in the context of compliance enforcement. Parties to the Protocol who do not respect the emission limits would not be allowed to sell allowances, though there is no obvious reason to prevent them buying. It may also make sense to prevent countries from trading if they do not meet requirements in respect of reporting emission trends and other technical requirements of the Protocol. However, the threat of withholding the right to trade allowances may not in itself be sufficiently strong as a mechanism for enforcing compliance with the Protocol.

After 2012

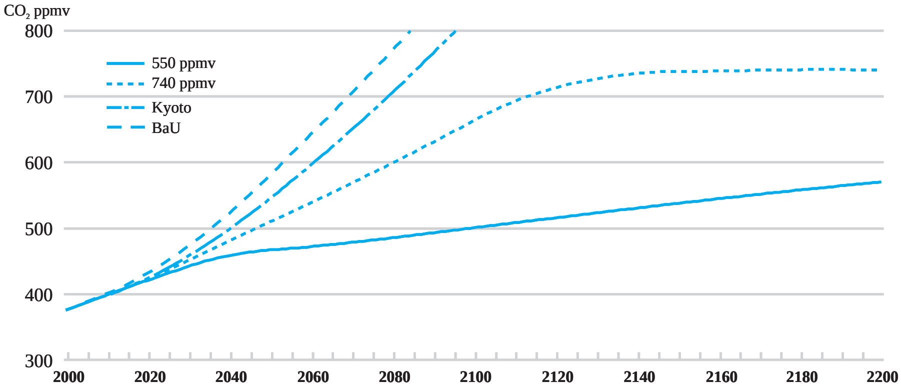
The Kyoto targets will achieve little on their own

The attainment of the Kyoto targets will only be the beginning of what needs to be an effort sustained over many decades if atmospheric concentrations of greenhouse gases are to be stabilised. Without market-based solutions over the longer term, implementation of the necessary measures seems unlikely. GREEN simulations estimate that the cost, relative to a “Business as Usual” (BaU) scenario, of maintaining emissions by Annex 1 countries constant at the levels embodied in the Kyoto Protocol will reach around 1½ per cent of the level of GDP by 2050. This cost may seem to be small, but the associated impact on atmospheric GHG concentrations would also be small: at best, this scenario would delay by one decade the time when the concentration level of 550 ppmv[19] is reached, and concentrations would continue to rise strongly thereafter (Figure V.1). In fact, there is nothing that Annex 1 countries can do on their own to stabilise concentration levels: even if they reduced their emissions to zero, expected emission growth in the rest of the world would be too high. Thus, the participation of non-Annex 1 countries is necessary.

Figure V.1 shows concentration levels in the BaU and the scenario with constant Annex 1 emissions at the Kyoto targets. Two potential global concentration scenarios

18. It is important to note that targets for developing countries need not in general require any absolute cuts in their emissions for some time, rather it might be sufficient to limit the growth in emissions below what it would be otherwise.
19. Carbon dioxide, parts per million by volume. It is estimated that the level of atmospheric concentration has increased from around 280 ppmv in pre-industrial times to some 360 ppmv today. A level of 550 ppmv thus represents an approximate doubling of the pre-industrial concentration and has often been considered as an implicit target for the end of the 21st century. The UNFCCC does not specify a target value, however.

Figure V.1. **Alternative CO_2 concentration paths**



Note: ppmv = parts per million by volume. BaU = Business as usual.
These concentration paths are derived from assumed emissions paths using the model of Wigley (1993) with coefficients from Ha-Duong *et al.* (1997). For more details, see OECD (1999*a*).

are also shown which have in common that they require significant participation by non-Annex 1 countries but which differ as to the implied degree of ambition with respect to reductions in global emissions.

The future participation of developing countries is necessary…

What incentives do non-Annex 1 countries face to accept quantitative emissions targets? Concern about climate change should be a primary motive, but – depending on the level of development – may not be a very high priority for many countries.[20] Secondly, there are ancillary benefits to reducing GHG emissions – reduced local air pollution, for example; these may be important, but are difficult to quantify. Thirdly, by signing up to emissions targets with tradable allowances, countries may find it beneficial to reduce their emissions and sell surplus allowances to other countries (the Clean Development Mechanism may be the means by which developing countries come to recognise these gains). A fourth possibility is that the richer countries may make side-payments to induce developing countries to contribute to avoiding climate change, when the other incentives are insufficient.

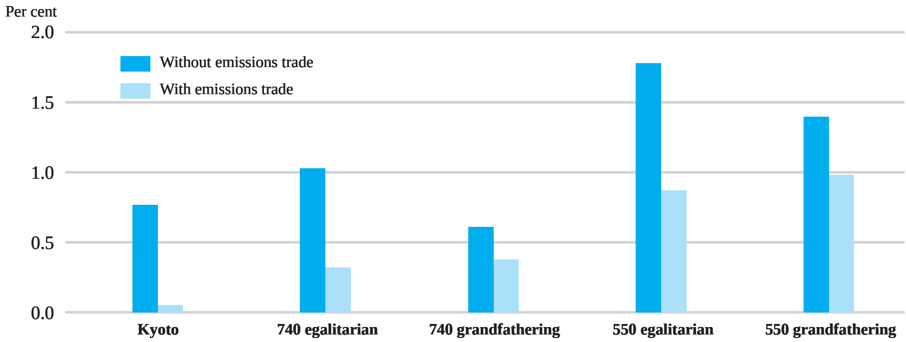
… on the basis of a – hard to define – equitable allocation of rights and responsibilities

The costs for individual countries of meeting a concentration target, as well as the gains from trade and the size of possible required side-payments, depend importantly on how emission allowances are distributed among countries. Precisely because of its influence on costs, this is a contentious issue. To induce participation of countries ranging from very rich to very poor, some notion of equity will need to be satisfied. One stylised rule for allocation of emission allowances is equal per capita emissions, corresponding to the idea that property rights in climate (change) should be held equally.[21] Imposing such an allocation in the short run would, however, be very costly for current high emitters, so one might aim for convergence through time towards equal emissions per capita, with the rate of

20. Non-Annex 1 countries are an extremely heterogeneous group. Space constraints prevent a proper reflection of this here. One generalisation assumed to hold is that avoidance of climate change is a "superior good" – the value attached to it is an increasing function of income per head, *ceteris paribus*.
21. This obviously does not take into account that for reasons of *e.g.* climate and geography countries are not equal to begin with.

Figure V.2. **Average costs of alternative scenarios, 2010-50**

World real income loss,[1] per cent



1. An average of the discounted costs over the years 2010-50, discounted at 3% per annum.

convergence being chosen so as to allow sufficiently gradual adjustment. Based on a particular convergence rule, the allocation – in the long run – of equal per capita emission rights was used when simulating the concentration scenarios in Figure V.1 (the allocation is referred to as "egalitarian").[22] To illustrate the importance of the allocation of emission allowances for overall costs and the gains from trade, an alternative stylised allocation rule was investigated, which entails freezing the share of each region in overall emission allowances at its 2010 value (referred to as "grandfathering").

Costs clearly increase with the degree of ambition of the emissions constraint (Figure V.2). In the absence of emission trading, overall (world) costs are lower when the grandfathering allocation rule is used, while full trading renders the aggregate world real income loss much less dependent on the distribution of allowances.

Table V.3. **Real income gains and losses, 2010-2050, with trading and transfers to non-Annex 1 countries**[a]

	Per cent		
	OECD	Annex 1	Non-Annex 1
Change in real income	–1.6	–1.7	1.0
of which:			
GDP	–0.4	–0.5	–0.4
Emissions trading	–0.6	–0.7	1.6
Transfers	–0.3	–0.3	0.6
Other	–0.3	–0.3	–0.8

Note: Corresponds to the 550 ppmv (parts per million by volume) scenario. Non-Annex 1 regions' emission allowances are as described in note 22. Real income change is calculated as an average of the discounted change over the years 2010-2050, discounted at 3 per cent per annum.

22. The method chosen was to allow non-Annex 1 regions' emissions to grow unconstrained until their per capita emissions reached the average level of constrained regions. At this point they are given tradable allowances which subsequently decline in per capita terms.

The role of side-payments can be considered in the context of the most ambitious of these emission scenarios (the "550 ppmv scenario") which implies a rapid and substantial reduction in emissions relative to the BaU. With egalitarian burden-sharing and no emission trade, the average annual real income loss in the period 2010-2050 is almost 2 per cent: 1.5 per cent for Annex 1 countries, over 2 per cent for the rest (on average). With emission trading, total costs are reduced by half, with non-Annex 1 regions being, on average, better off than in the BaU scenario. Even with trading, however, some non-Annex 1 regions are worse off. If Annex 1 countries make transfers to compensate these regions, they would have to transfer approximately 0.3 per cent of their GDP, with average non-Annex 1 incomes then around 1 per cent higher than in the BaU scenario (Table V.3). The average annual real income loss in OECD countries over 50 years remains under 2 per cent, however.

Climate change: prevention and adaptation

Some climate change seems likely to occur…

Preceding sections have discussed the costs of action to reduce GHG emissions and thereby to limit climate change. Unfortunately it is difficult with present knowledge to complete the cost-benefit picture by comparing these costs with their benefits (*i.e.* the costs of the climate change that would otherwise occur). The costs of climate change are largely unknown, partly because the likely climate changes themselves are not easy to predict in sufficient regional and local detail. Even for the broadest of indicators, global average temperature change, there is quite a wide range of uncertainty attached to the projections by the Intergovernmental Panel on Climate Change (IPCC): between 1.0 and 3.5° C by the second half of the 21st century if CO_2 concentrations double, itself an uncertain assumption.

… though its consequences are uncertain…

Temperature changes and, probably more importantly, changes in the quantity and distribution of precipitation will certainly have economic consequences. There are no robust estimates of the economic costs, however.[23] For most OECD regions the usually quoted estimates are for losses of between 1 and 2 per cent of GDP (Fankhauser *et al.*, 1998). Higher figures, up to 8 per cent, are obtained for some non-OECD regions.

Even if these estimates for the OECD area may not seem enormous, there are a number of reasons for continuing to work for GHG reduction policies. First, most estimates are for the costs of climate change that will probably occur anyway (if the consensus scientific forecasts are reasonably accurate), even if quite successful emission reduction policies are introduced. In the absence of such policies, changes would be larger and probably continue for several centuries, and the damage may well increase much more than proportionately. Secondly, even narrow self-interest implies that OECD countries should be concerned about severe consequences of climate change in developing countries, as these may exacerbate tensions due to migration pressures and water scarcities, for example. And self-interest was not the motivation behind the UNFCCC, which expresses explicit solidarity with countries that may be

23. See IPCC (1996) and OECD (1999*a*).

worst hit by climate change. Thirdly, the ancillary benefits of actions to reduce GHG emissions may be quite substantial, although little quantification of them is available at present.[24]

… which is an independent reason to reduce emissions

Finally, GHG reduction policies should also be motivated by precaution. The process of climate change is not sufficiently well understood. There may be discontinuities that could generate very severe outcomes,[25] and it is also possible that very little would happen to the climate. But expenditure that could reduce the risk of severe outcomes may be worthwhile, even if it did little to alter the average "expected" outcome. While this is obviously true in principle, there is at the moment little information to guide decisions on just how much weight to attach to this precautionary principle and how much mitigation effort it justifies.

Adaptation will also be necessary

Since climate change cannot be prevented entirely, it will be necessary to adapt to it. The necessary adaptation may not be very onerous – as elsewhere, research is needed to narrow the range of possibilities that needs to be considered. The likely rate of climate change may mean that it is imperceptible from year to year or even from decade to decade. Adaptation to climate change may be only a small part of the changing background to most people's lives; ensuring that adequate information is available and allowing market forces to act to reallocate resources will in many cases be sufficient. However, long-term planning will be necessary in land-use policy, particularly in low-lying coastal areas or inland flood plains. Water supply infrastructure may also need to anticipate possible climate change effects, whether changes in overall quantities of precipitation or, as seems likely, increased seasonal variation and possibly greater frequency of both storms and dry periods. This may also have implications for urban planning. Decisions on the location of new developments now can have implications many decades ahead in terms of vulnerability to water shortages or to flooding.[26]

Conclusion

OECD analysis undertaken since COP4 illustrates the challenges of complying with the Kyoto targets. Relative to a "Business as Usual" scenario, the targets may imply reductions in GHG emissions of some 30 per cent. Developments in the first half of the 1990s have implied in most countries a further increase in emissions relative to 1990 levels – the base year of the Kyoto targets. Few of the domestic measures necessary to contribute to reaching these emission targets are in place today.

International emission trading can make a big contribution to reducing overall abatement costs, and efforts need to be made to resolve the differences that exist over how it should be implemented. The considerable attention given to this subject should not, however, divert policymakers from the need to start domestic action.

24. Reducing GHG emissions may not be the only, or the most efficient, way to achieve benefits such as reduced local air pollution.
25. Two remote possibilities are: *i*) a collapse of part of the Antarctic ice-shelf, that could lead to rises in sea levels of several metres over a period of decades (central predictions are for around 0.5 metre over the next century); and *ii*) a cessation, or severe weakening, of the North Atlantic ocean circulation (the Gulf Stream) that gives western Europe its relatively mild climate.
26. Urban planning, through its impact on transport choices, can also affect GHG policy itself.

Indeed, if too many countries expect to be able to meet their target through buying emission allowances in the future market for permits, the overall abatement effort may be insufficient and they risk being faced with unexpectedly high permit prices. Continuing work on improving the timeliness of emissions data, and on modelling its links with economic activity, should improve the accuracy of forecasts of emissions to reduce this risk.

In the longer run, OECD emissions need to fall substantially and developing country emissions growth needs to be limited. Negotiating country allocations of emission allowances, which will amount to a form of wealth, will be difficult. It will likely require explicit consideration of equity, rights and responsibilities, and of the possibility of providing direct financial inducements to some countries.

Regardless of the success of measures to restrict emissions, adaptation to some degree of climate change is likely to be necessary. More attention should be paid to the long-term implications of current decisions and, in particular, to the needs of the most vulnerable countries.

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VI. THE RECENT EXPERIENCE WITH CAPITAL FLOWS TO EMERGING MARKET ECONOMIES

The excessive volatility of cross-border capital flows has imposed substantial costs on emerging market economies. Reforms of the international financial system are under consideration, aiming both at preventing crises and at dealing more effectively with them when they occur. This chapter reviews the principal causes of the recent volatility of capital flows and possible remedies that emerging market economies and the international community can take to stabilise such flows. First, by comparing key institutional features of financial markets in developed and emerging economies, the chapter examines the extent to which the domestic financial system played an important role in pushing some emerging market economies into crises in the 1990s. Second, it assesses whether the reversal of capital flows was linked to a build-up of macroeconomic imbalances, the role played by fixed exchange-rate arrangements in generating such imbalances, and strategies to exit fixed rates in an orderly fashion. Third, it reviews the role of liquidity panics, herding and contagion in amplifying and spreading investors' reaction to bad news in an individual country. Finally, the chapter discusses whether there is a role for capital controls to stabilise cross-border flows.

The domestic financial systems of emerging markets

A financial system that functions well is vital…

A financial system that functions well is vital for stable foreign capital flows in emerging and mature markets alike. Given the underdeveloped nature of capital markets in most emerging market economies, the banking system plays a critical role in intermediating cross-border financial flows. The capacity of the banking system to cope successfully with large-scale capital inflows without assuming excessive risks depends in part on the institutional environment in which the banks operate. This includes the design of the financial safety net and the extent of government directed lending, the regulatory and supervisory frameworks, and effective standards of financial disclosure. These institutional arrangements differ significantly across emerging-market economies.

… but financial systems in emerging markets have often been defective

Defective financial systems were arguably a key factor behind the highly volatile capital flows in some of the Asian countries.[1] Borrowing by Asian banks in international markets at low interest rates for lending at higher ones at home – the

1. In some Asian countries the non-bank private sector borrowed extensively in international markets. However, this might have involved borrowing abroad from a subsidiary of a domestic bank as well as borrowing from an international bank. Moreover, close ownership links between corporations and banks often meant that businesses could borrow abroad on behalf of banks, which could then use the deposited funds for relending at home.

so-called "carry trade" – proved to be highly profitable. But these profits were based on a gamble that the exchange rate would be more stable than interest-rate differentials suggested that the market expected. They were also based on the willingness of domestic corporations to increase significantly their leverage and on international banks' readiness to fund such lending. The strong domestic demand for credit was in turn related to the extraordinary growth performance that corporations had enjoyed in these countries and to the corporate strategies, sometimes explicitly or implicitly condoned by the authorities, that emphasised gains in market share rather than profitability. With financial institutions failing to counter excessive optimism or non-commercial objectives in the corporate sector, the exposure of the banking sector to credit risks rose. Demand from lower quality borrowers was increasingly accommodated and the maturity mismatch between banks' assets and liabilities widened, as long-term lending was more and more financed by short-term borrowing in the international market.

Even when commercial banks were not directly engaged in the carry trade, their lack of prudent management in the intermediation of capital inflows made the system vulnerable. Thus, while capital inflows in the run up to the Mexican crisis in 1994 were predominantly related to portfolio flows, they provided the banking system with the resources needed for strong expansion of domestic credit. During the surge in domestic credit expansion, banks appear to have paid little attention to the increased vulnerability of their customers to a peso depreciation. In the run up to the crises in Russia and Brazil, commercial banks played a relatively modest direct role in importing foreign capital and the expansion of lending to the private sector was small. However, banks in both countries invested heavily in high yielding short-term government debt. This strategy became increasingly risky as the budget positions worsened, and commercial banks, together with other domestic and international investors, arguably became over-exposed to public debt. The Russian government's effective default on its domestic debt last August had severe effects on the domestic banking system, and Brazilian banks are highly vulnerable to any rescheduling of public debt.

Banks have taken on excessive risks because of moral hazard problems…

It is uncertain to what extent moral hazard[2] problems due to the safety net for banks are more serious in emerging-market economies than in developed economies. Deposit insurance arrangements are similar, in practice, in both groups of countries: formal insurance for depositors being employed mainly in developed economies, and, at least until recently, implicit guarantees from the authorities being used in emerging markets – especially in East Asia. To prevent confidence in the financial system from being eroded, government bodies in both developed and emerging economies operate as "lender of last resort" rather than allow major financial players to fail in the event of a liquidity problem. In mature financial systems, such assistance typically implies large losses for bank shareholders and is conditional on a change in management. However, the access to the safety net in East Asia piror to the 1997 crisis has typically included injections of public funds into privately owned banks as going concerns. By alleviating both managers and shareholders of financial risk, such measures may have posed particular moral hazard problems.[3]

The role and functioning of the banking sector appear to be more closely linked to the government in emerging-market economies. This stronger involvement does not show up as greater public ownership of banks, which is not significantly different

2. Moral hazard implies that agents do not bear the full cost of their actions.
3. Corsetti, Pesenti and Roubini (1998) argue that moral hazard was the root cause of the crisis in some of the Asian countries.

in emerging and mature market economies,[4] but is more related to programmes of directed lending or funding, and to complex and distorting tax and subsidy regimes. Under these conditions, banks are not autonomous profit-maximising entities, but rather operate to some extent as quasi-fiscal bodies, providing virtual subsidies to selected parts of the economy which do not appear on the general government balance sheets. However, this may nurture a perception that banks' loans and their international liabilities are guaranteed by the government. During years of rapid economic growth, the sub-normal performance of such directed loans tends to be masked by the growth in deposits (and, on some occasions, by additional capitalisation of banks by the government); but when macroeconomic slowdowns occur, such features can be a major source of banking-sector fragility. For example, banks in Indonesia, Korea, Malaysia, the Philippines and Thailand have, at some time over the past two decades, been subject to regulatory requirements or pressures to allocate fixed proportions of their loan portfolios to particular sectors (OECD, 1998, and Folkerts-Landau *et al*., 1995)[5] and this has left their banking sectors particularly vulnerable.

… lack of enforcement of prudential regulations…

To reduce the capacity of the financial sector to exploit the insurance inherent in the safety net, both mature and emerging market economies have attempted to limit risk-taking by subjecting banks and other financial institutions to prudential regulations. Banks are typically restricted in their exposure to a single borrower to prevent them from being captured by a big debtor (Table VI.1) and their foreign currency exposure is often limited to avoid excessive exchange-rate risks (Table VI.2).[6] Moreover, banks are subject to minimum capital adequacy rules which, in principle, raise both the cost of riskier lending and the stakes for owners from engaging in risky lending. However, these rules have failed in many emerging economies to prevent excessive risk taking. Indeed, studies have found poor regulatory and supervisory frameworks to have been one of the principal causes of bank crises in emerging markets (Figure VI.1), (Dziobek and Pazarbasioglu, 1997; Lindgren *et al*., 1996).[7]

The failure of prudential rules in emerging economies in the past has been ascribed to several factors:

– By allowing banks to overstate their capital, weak loan classification and provisioning rules undermined the discipline in minimum capital adequacy ratios. Whereas best practice in mature economies considers loans to be sub-standard if they are three months in arrears, many of the Asian countries classified loans as non-performing if they had not been serviced for six months or more. And while mature economies generally require (or encourage via tax rules) prompt and full provisioning for non-performing loans, rules in many emerging economies called for only gradual and incomplete provisioning.

4. The extent of public ownership of banks differs significantly across emerging-market countries, ranging from less than 10 per cent of banks' total assets (Malaysia and Thailand) to around a half of all assets (Indonesia and Brazil). In mature countries the range is similar (*e.g.* zero in the United States to 50 per cent in Germany. See Table 2 in Blöndal and Christiansen, 1999.
5. Also, credits to the public sector from banks controlled by the general government have sometimes given rise to banking crises; for example, loan delinquencies by state governments were at the root of serious state bank insolvencies in Brazil around 1994. For a discussion, see Honohan (1997). Since the state banks were ultimately bailed out by the central bank, state authorities can be said to have indirectly obtained large credits from the central authorities.
6. Most emerging-market economies have rules on maximum currency exposure. For example, in addition to the countries listed in Table 2, the Slovak Republic requires an 80 per cent ratio between foreign exchange claims on non-residents and total foreign exchange liabilities.
7. The importance of good regulations and supervisory mechanisms was emphasised in *e.g.* OECD (1997) and G-10 (1997).

Table VI.1. **Incentives for adequate risk assessment in banking systems**

	Capital adequacy ratio (Basle definition)		Maximum lending to a single borrower	Sub-standard loans, 1996		Non-performing loans, as percentage of all loans, 1996
	Minimum ratio, 1995	Actual ratio[a]	Per cent of capital	Months of arrears	Provisioning (per cent)	
Korea	8	9.1	15	6+	20-75[b]	0.8
Mexico	8	13.1	10-30[c]	3+	Variable	12.2[e]
Hong Kong, China	8	17.5	25	None	None	2.7
Indonesia	8	11.9	10-20[e]	3-6	10	8.8
Malaysia	8	11.3	30[f]	6-12	Variable	3.9
Thailand	8	9.3	25[g]	6+	7 1/2-15[b]	7.7[e]
Chinese Taipei	8	12.2	3-5	6+	Variable	3.8
Argentina	12	18.5	15	3-6	1-25[b]	9.4
Brazil	8	12.9	30	3-6	20-100[b]	5.8
Chile	8	10.7	5[h]	1-2	20[i]	1.0
Russia	8	13.5[e]	50-100		Variable	15.1
United States	8	12.8	15	3+	Variable[k]	1.1
Japan	8[d]	9.1	20	6+[j]	None	3.4
Germany	8	10.2[e]	25	None[l]	None	

a) 1996 for OECD economies; 1995 for others.
b) Conditions depend on types of collateral and guarantees.
c) Per cent of net capital; the lower figure refers to individuals and the higher to corporations.
d) Only enforced from 1998 for international banks; from 1999 for national banks.
e) 1997.
f) Capital consists of paid-up capital, reserves and provisions.
g) Per cent of tier-one capital.
h) Per cent of capital and reserves.
i) Provisions at an estimated default risk of 5-40 per cent.
j) Changed to three months in 1998.
k) An allowance for impaired loans should be based on the present value of the expected future cash flows of the loan, or at the loan's observable market price or at the fair value of the collateral if the loan is collateral dependent.
l) Specific criteria are used to determine if a loan is sub-standard.
Source: OECD; BIS; M. Goldstein and P. Turner, 1996.

– Failure to regulate financial institutions' offshore activities has reduced the impact of rules to contain risks. Financial groups typically have offshore branches and affiliates that represent a significant part of a bank's business. Risky lending is often concentrated in such centres. Lack of consolidation for regulatory purposes has also meant that banks and other financial institutions can easily evade rules on limiting lending to connected parties, and recent research indicates that this has been an important factor behind the financial fragility in the past.[8] Moreover, rules on maximum currency exposure are not effective when banks' offshore activities are not regulated. The expansion of financial derivatives, which regulators have found difficult to control, has also seriously undermined prudential controls on currency exposure (Garber, 1998).

– Supervisory agencies have often been weak in emerging economies and penalties for non-compliance have tended to be low. This situation has reflected: the informal nature of inter-company links (especially in Asia) and unclear property rights which made it difficult to assess the degree of connected

8. A study of ten banking crises in the 1980s concluded that connected lending had been a contributing factor in all cases, see Sheng, (1996).

Table VI.2. **Prudential limits on banks' currency exposure**

	Limits on overall position (per cent of capital)	**Other comments**
Indonesia	25 (NAP)	Short-term liabilities limited to 30 per cent of own capital
Malaysia	Variable, depending on management quality	
Korea	15 (sum of long positions) 10 (sum of short positions)	Limit on spot short positions is 3 per cent of bank capital or US$ 5 million, whichever is greater.
Thailand	20 (net long positions) 15 (net short positions)	
Argentina	25 (NAP)	
Brazil		Short position ceiling is dependent upon each bank's adjusted net worth Long position ceiling is US$ 1 million (any amount above the ceiling must be deposited in the central bank)
Chile	20 (NAP)	Average overall short position is forbidden
Mexico	15	
Russia	Variable absolute amounts for different range of bank capital	
United States	None	
Germany	21 (GAP)	

Note: NAP stands for Net Aggregate Position, *i.e.* the difference between short and long positions; GAP stands for the gross aggregate position, *i.e.* the sum of short and long positions.
Source: R.K. Abrams and P. Beato (1998); IMF (1996*b*).

lending;[9] resource constraints which made on-site inspections rare and the monitoring of credit risk assessment minimal; the limited weight of supervisory agencies in the public administration compared with those charged with business sector policies; and political difficulties for supervisors to make companies provision against changes in official policy (such as, for example, a departure from announced exchange-rate policies).

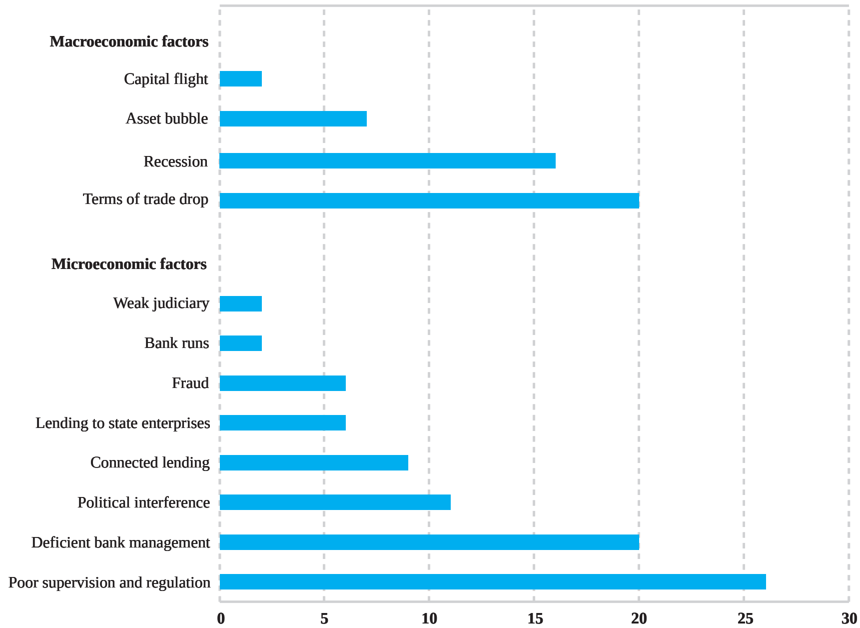
The most common supervisory problems in mature economies relate to resource constraints combined with rules lagging financial sector liberalisation (this was a factor behind the 1992-93 Nordic banking crisis) and innovation. In emerging markets there is stronger evidence of unclear corporate structures and outright forbearance hampering efficient bank supervision.

… and inadequate standards of financial disclosure of corporations

Excessive risk-taking by domestic financial institutions may in part have been based on difficulties in assessing the risks that were being assumed owing to a lack of information about the health of individual enterprises. However, though lacking the tradition for certified accounting and auditing mechanisms, an effort by many emerging market economies to adapt their national practices to international standards was widely perceived to have closed the gap between leading emerging and mature

9. This also tends to be a problem in some mature economies where corporate governance favours conglomeration.

Figure VI.1. **Factors behind twenty-nine bank insolvencies**



Note: Shows the number ot times each factor was cited in twenty-nine country cases.
Source: Caprio and Klingebiel, 1996.

economies in this area. In 1990, for example, a study by the International Finance Corporation (IFC) concluded that financial reporting in selected East Asian countries (except for Chinese Taipei and, to some extent, Thailand), was "good, of internationally acceptable quality" (IFC, 1990). Also, a cross-country survey of accounting and auditing practices done in 1995 showed a very high standard of financial disclosure in Asian countries later affected by financial crises.[10] However, while national standards have often been aligned with international ones, there is evidence that domestic companies failed to follow them in their financial reporting (Cooke and Parker, 1994), reflecting partly that a tradition of full and fair disclosure had not yet developed. For example, the recent crises in some of the Asian countries has unmasked the widespread practice of using undisclosed balance sheet items to provide guarantees or similar commitments between related companies (see *e.g*. OECD, 1998).

Corrective policy action will reduce volatile bank-driven capital flows over the long term…

The long-term policy response for dealing with bank-driven volatile capital flows in emerging market economies is to strengthen prudential regulations and supervisory mechanisms, and to improve the effective standard of financial disclosure. Indeed, recent financial support from the international community to crises-ridden economies has typically been conditional on such measures being taken. To reduce moral hazard problems, the authorities should impose sanctions on those who require access to lender-of-last-resort facilities. They should also refrain from directing bank lending. A critical part of the regulatory overhaul would involve tighter effective prudential restrictions on banks' foreign currency exposure and position

10. See Center for International Financial Analysis and Research (1995). Some of the findings of the survey are reported in Table 5 in Blöndal and Christiansen (1999).

taking. This could prevent banks and their international creditors from misusing the financial sector safety net, thus reducing their capacity to engage in carry trade with the associated capital inflows.

… but it may have little short-run gains for countries that are already facing crises due to excessive risk-taking by banks

Over the short run, financial market reform of this kind will not benefit countries that have already become over-exposed. Stemming capital outflows, once confidence has weakened, will often require very high interest rates which will undermine the economy in general and the banking system in particular. Attempts to reduce the outflows with a transaction tax on capital flows would be relatively ineffective, unless very high tax rates were employed. Imposing quantitative restrictions on outflows, or unilateral or forced rescheduling of loans could provide short-term respite, but could seriously compromise the future access of banks in emerging market economies to the international inter-bank market if such measures were seen by creditors to reduce borrowers' commitments to honour their obligations. Given these difficulties, international conditional assistance in unwinding the currency imbalances in an orderly manner would seem to be the most promising response.

Macroeconomic conditions and exchange-rate arrangements

Internal imbalances preceded crises in some emerging markets…

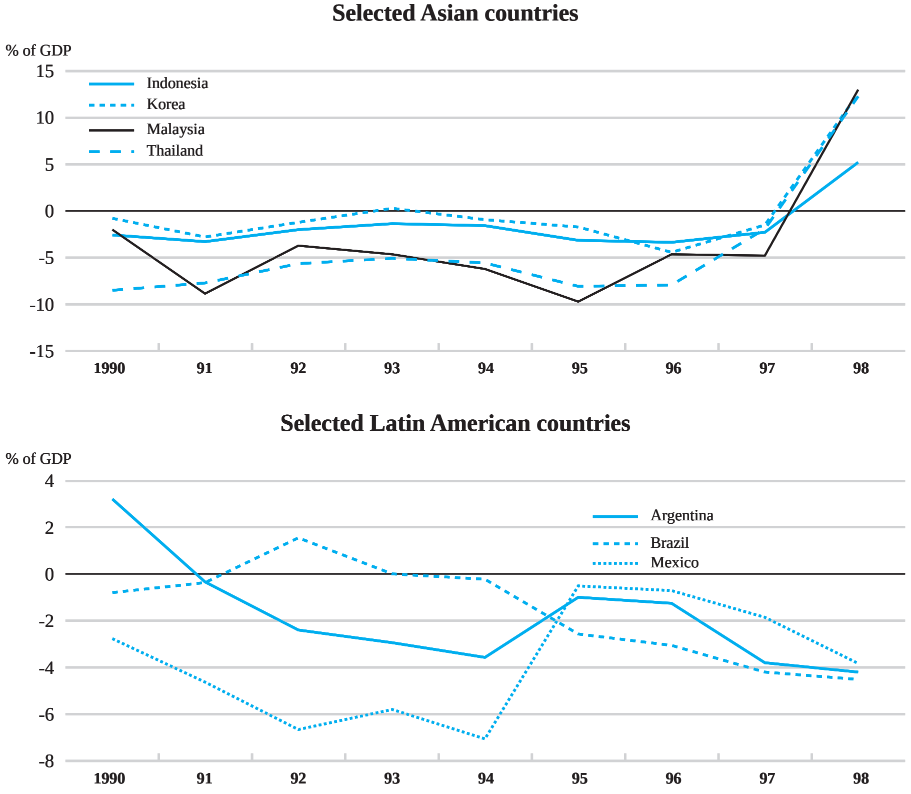
Macroeconomic conditions differed significantly across the countries that ultimately succumbed to crises in the 1990s. In the case of the Asian countries, inflation showed little sign of increasing, asset price bubbles[11] were mostly absent and the central government account was in surplus. There were also no major fiscal deficit problems in the run up to the Mexican crisis in 1994. However, the two most recent sharp reversals of capital flows took place against the background of serious fiscal imbalances. The Russian crisis in August 1998 was prompted by an unsustainable build-up of public debt, driven by a fiscal deficit amounting to 8½ per cent of GDP in 1997. The origin of the Brazilian crisis in January 1999 was also the continued widening of the fiscal deficit, the revenue shortfall in 1998 being 8 per cent of GDP.

… and the external balance came under increasing pressure…

Notwithstanding differences across the crisis countries with respect to fiscal positions and inflation developments, a common feature in most of them was that strong domestic credit expansion had weakened their external position. While domestic inflation was moderate or declining, the rate of price increases in Asia was higher than in the mature economies and in many Latin American countries it was even substantially higher. This factor did play a role in the eventual crises. The reversal of capital flows to Mexico took place against a backdrop of a large current account deficit (Figure VI.2) and a 40 per cent increase in the real effective exchange rate in the five years prior to the crisis (Figure VI.3). Prior to the depreciation of the Brazilian real last January, the real effective exchange rate had appreciated over a four year period and the current account deficit in 1998 had reached 4 per cent of GDP. The appreciation of the real effective exchange in Russia was close to 100 per cent in the four years preceding the crisis in August 1998. However, even the

11. With the notable exception of Hong Kong, China; and Singapore, commercial property prices were subdued in the main Asian cities in the period leading up to the crisis and lower in real terms than at the beginning of the decade. See the International Monetary Fund, 1998, and the Bank for International Settlements, 1997. The increase in stock prices in Asian emerging markets in the two years to mid-1997 was generally also inferior to that in many mature economies.

Figure VI.2. **Current account balances in selected emerging market countries**



Sources: IMF and OECD.

worst-affected Asian countries in the current crisis had experienced no major deterioration in their external competitiveness over extended periods until 1995, when the appreciation of the US dollar *vis-à-vis* the yen started to erode their competitive position and when the external terms-of-trade worsened (see below). The implications of deteriorating competitiveness on future prospects of export industries may have contributed to unsettling investors' confidence.

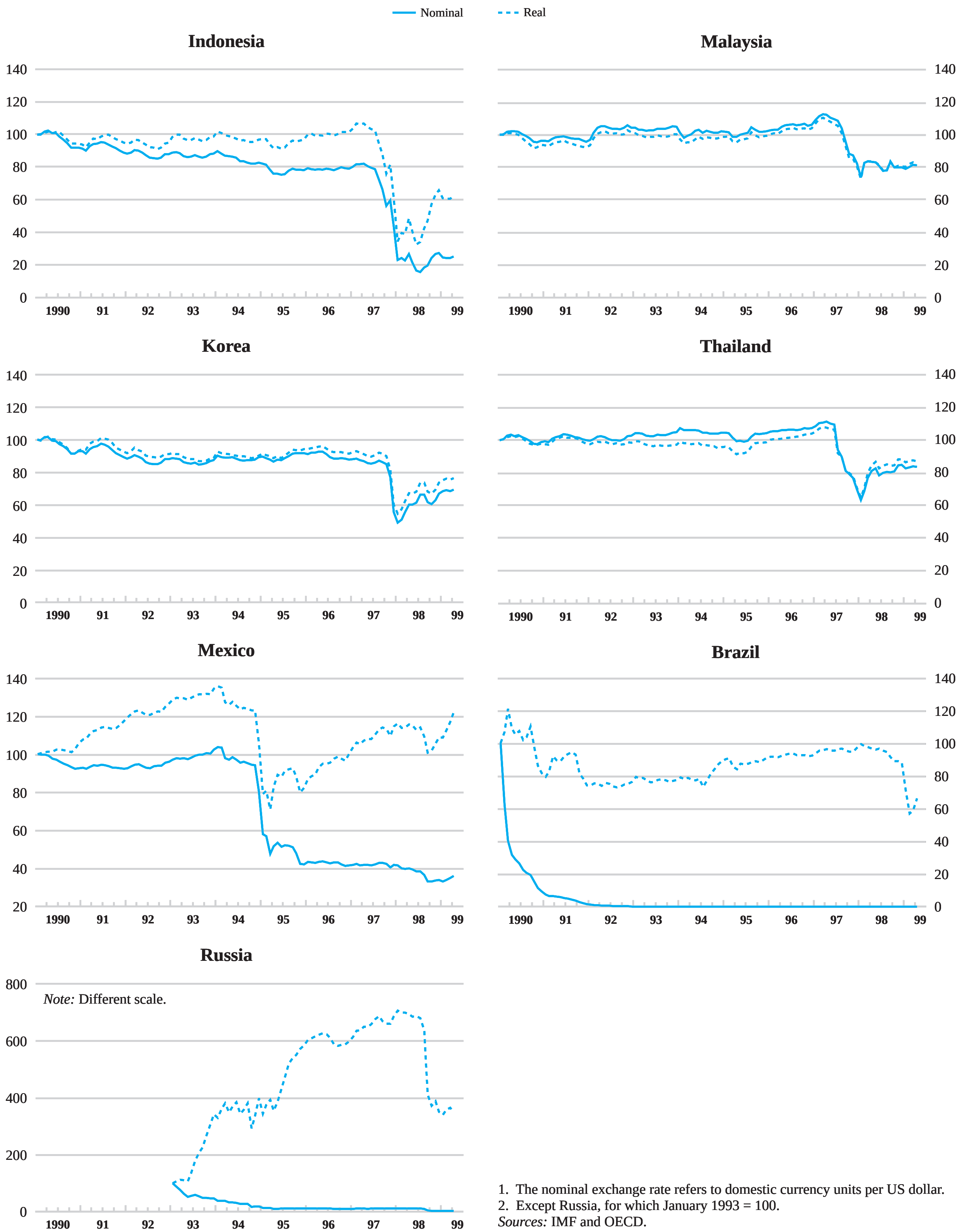
…partly reflecting fixed exchange rates

The emergence of the external imbalance was largely driven by the maintenance of fixed exchange rate arrangements[12] during a period of strong capital inflows. Indeed, fixed rates appear to have amplified capital inflows as businesses and banks in many countries became complacent about currency risks. At the same time, they made it difficult to contain the expansionary effects of capital inflows. In principle, countries can neutralise the expansionary effects of capital inflows through various means. In practice, the various methods are not without limitations and problems. For example, sterilisation via open market operations can only be undertaken if there is a

12. Even where formal exchange-rate arrangements appeared to allow for considerable flexibility, *e.g.* managed floating (Korea and Malaysia) or wide bands around a central parity (Mexico prior to December 1994), the authorities chose to keep the exchange rate within a narrow band around central parities.

Figure VI.3. **Nominal and real effective exchange rates**[1]

January 1990 = 100[2]



1. The nominal exchange rate refers to domestic currency units per US dollar.
2. Except Russia, for which January 1993 = 100.

Sources: IMF and OECD.

well-functioning securities market and such operations often turn out to be costly for the government budget and may encourage even stronger inflows of capital; higher reserve requirements may result in dis-intermediation as funds are channelled via institutions not subject to such requirements; and fiscal policy must be extremely flexible in order to cancel the effects of yearly capital inflows amounting to several per cent of GDP and such flexibility may not be feasible where the government sector is small. More flexible exchange-rate arrangements, such as floating, would have meant lower capital inflows and lower demand pressures.

Exchange-rate pegs served as nominal anchors in some countries

Emerging market economies have chosen to maintain currency pegs for a reason. An important rationale in favour of fixed exchange rates is that they provide a clear and transparent nominal anchor. This has often been used to help to establish the credibility of stabilisation programmes in countries with a history of high inflation rates, notably in Latin America, and in countries with no history of credible anti-inflation institutions, such as in Russia. In these countries, alternative nominal anchors, such as money supply targets and inflation targets, may not be adequate for technical reasons (*e.g.* unstable money demand) and are unlikely to carry the same weight as an exchange-rate peg. The experience of many of these countries demonstrates that pegged rates have often been fundamental in breaking wage-price-currency spirals.[13] However, even when a peg is the overriding objective of macro-economic policy, inflation is likely to converge only slowly to that of the countries to which the currency is fixed. During this adjustment period, the real exchange rate appreciates and can end up at levels that are unsustainable. The peg will thus ultimately lose credibility in high-but-falling-inflation countries.

In Asian countries exchange-rate pegs operated for many years to facilitate exports…

The prime objective of fixed exchange rates in many Asian countries seems to have been to help promote a stable external environment during the period of export-led growth. Together with the maintenance at times of slightly undervalued exchange rates (World Bank, 1993), this played an important part in the authorities' policies to facilitate exports. The importance attached to export promotion could explain the reluctance of the Asian countries to abandon pegs when exchange rates were under upward pressure in the mid-1990s, conditions which would seem to have been ideal for unpegging in an orderly way (Eichengreen and Masson *et al.*, 1998). With the United States being the most important export market for products from Asia, currencies were typically linked *de jure* or *de facto* to the US dollar.

… but the credibility of this policy was undermined by structural changes in the 1990s and the appreciation of the dollar after 1995

The credibility of this exchange-rate policy was arguably undermined by the extraordinary change in the export composition of the Asian emerging-market economies that took place in the 1990s (World Bank, 1998). By increasing the share of high-technology products destined for highly competitive markets where Japan was the dominant incumbent, the emerging market economies in Asia became more sensitive to fluctuations in the value of the dollar *vis-à-vis* the yen. This made the peg of their currencies to the US dollar increasingly inappropriate, and the dollar peg proved to be a source of instability when the yen began to fall *vis-à-vis* the dollar in 1995.

A peg must be abandoned before the exchange rate becomes overvalued

Though exchange-rate pegs directed at price stability or export promotion objectives tend ultimately to become unsustainable, there is no precise rule for when to give up an exchange-rate peg or to make it more flexible. It is clear that it has to be done before the exchange rate is perceived to be significantly overvalued, which

13. See for example, S. Edwards (1995). The experience with exchange-rate-based stabilisation is also reviewed in Chapter 6 in the International Monetary Fund (1996).

raises the risk of a disruptive speculative attack. In principle, the exchange rate is overvalued when it generates cyclically-adjusted current-account deficits that are larger than sustainable capital inflows. In practice, it is difficult to identify underlying equilibrium exchange rates with any precision, and therefore to use them as criteria for abandoning a peg. However, one symptom of an over-valued exchange rate is often a large external deficit. Another indication is a sustained running down of foreign exchange reserves, which could ultimately bring about a currency crisis. However, an overvalued exchange rate need not be accompanied by falling reserves for some time if capital inflows are driven by herd behaviour (see below). In the absence of clear criteria for identifying overvalued exchange rates, policy-makers must use their judgement in deciding on when to leave a peg. Past experience suggests that they have typically held on to a peg for longer than was useful.

A successful exchange-rate-based stabilisation requires that the period of a peg be used to prepare the way for alternative nominal anchors

A successful use of fixed exchange rates for stabilisation purposes must acknowledge early on that a given peg is only a temporary device. Indeed, it might be appropriate to accompany the pegging of a currency with an explicit and a coherent exit strategy, stating the exit conditions, the exchange-rate and monetary-policy regimes that would replace the peg, and transitional arrangements if any (such as gradually widening fluctuation bands around a central parity). An explicit statement of exit conditions would show that the authorities intended the peg to be a stop-gap measure only, to be replaced by different arrangements. During the period of the peg, institutional capacities would be developed to control inflation after the exchange rate became unpegged. This would typically involve making the central bank independent with an overriding aim of pursuing price stability, improving data dissemination so that the success (or otherwise) in meeting inflation objectives can be monitored on a timely basis, consolidating the government budget to reduce the risk of monetisation and introducing mechanisms that would make it easier technically to control monetary aggregates or interest rates.[14] The authorities could signal their resolve in developing these institutional capacities by fixing a timetable for the introduction of the new structures. Provided that the authorities are seen to be making progress in investing in stability-oriented post-pegged-rate institutions, the pre-announcement of the exit conditions might not diminish the impact of the peg on inflationary dynamics.

Countries can leave a peg for exchange-rate systems of various degrees of flexibility…

A pegged system could be replaced by systems with varying degrees of flexibility, ranging from a clean float to narrow bands around a (crawling) peg. An unfettered float has the advantage that it frees monetary policy from having to respond to exchange-rate developments. However, there are concerns that floating could result in excessively volatile exchange rates. The floating of the major world currencies since 1973 has been accompanied by fluctuations of an amplitude that are difficult to explain by economic fundamentals (Frankel and Rose, 1997). Indeed, exchange-rate movements over the short and medium-term may often have been driven by herd behaviour and forecasting techniques that are de-stabilising. With the market for currencies of emerging-market economies less sophisticated than that of the larger countries, the risk is that they would be more prone to such behaviour. Moreover, with exchange rates being influenced by political factors, a number of emerging market countries could experience large swings in their exchange rates under a floating regime. For all these reasons, a clean float may not be the most appropriate exchange-rate regime for all emerging-market economies.

14. It would also involve the strengthening of the banking system.

An alternative less flexible arrangement is an adjustable central rate *vis-à-vis* a trade-weighted basket of currencies but with wide fluctuation bands on either side (Williamson, 1998). This could help to anchor exchange-rate expectations and encourage stabilising speculation, but might also involve many of the disadvantages associated with fixed rates. In general, the optimal degree of flexibility in exchange-rate arrangements will differ across emerging market countries, depending on their circumstances.

… and rigid pegs may be optimal for small and very open economies

For some emerging-market economies, the most appropriate long-run exchange-rate regime may still be rigid pegs supported by currency-board arrangements. Currency boards, whereby the domestic money supply is backed by foreign reserves, would seem to be particularly attractive for small and very open economies. There are few gains for such countries from having an independent monetary policy when capital is mobile, whereas they are highly vulnerable to changes in the external value of their currency. However, a rigid peg can provide stability only if it is set at a rate that reflects economic fundamentals and if domestic wages and prices adapt flexibly to inflation developments in the country to which the home currency is tied. Moreover, since exchange-rate pressures are immediately translated into a drain on bank liquidity and high interest rates under a currency board, such an exchange-rate arrangement requires a strong and well-capitalised banking system in order to meet adverse shocks. In practice, several emerging-market economies (*e.g.* Hong Kong, China, and Argentina) have found currency boards to be useful, but such arrangements have not completely sheltered these economies from recent turmoils.

International liquidity, herding and contagion

Adverse news can trigger off a "run" when foreign exchange reserves are low…

The extent of the reversal of capital flows to some emerging market economies in the 1990s suggests that more has been involved than changing perceptions of fundamentals. Foreign reserves may be used as a gauge by international creditors of the capacity of the authorities to act as a lender of last resort for domestic entities with foreign debt.[15] As long as foreign reserves are well in excess of short-term external debt,[16] individual creditors may feel reasonably assured that their assets are protected from a "run" by other creditors. As a result, they can consequently adjust their portfolios in an orderly way to news of banking and macroeconomic problems. In the opposite case, individual creditors will be confronted with a smaller probability of recapturing their investments in the event of problems, increasing the incentive to withdraw funds as quickly as possible. These types of incentives can generate a self-fulfilling financial panic resulting in disproportionately large outflows, especially when they are accompanied by evidence of disclosure problems.

15. See notably Dooley (1997). The importance of foreign reserve cover in amplifying investors' reactions in the Mexican crisis has been emphasised in *e.g.* Sachs *et al*. (1996), and in Calvo and Mendoza (1996). Radelet and Sachs (1998) emphasise it in explaining the Asian crisis.
16. When domestic currency can be freely converted into foreign currency, the ratio of foreign reserves to money (M2) provides an alternative measure of reserve cover. Foreign reserves are typically only a fraction of the domestic money supply.

… and a low reserve cover seems to have been an important element in many of the crises in the 1990s

Liquidity problems seem to have been an important element in the sharp reversal of capital flows in both the Mexican and Asian crises. In mid-1994, foreign reserves in Mexico were only around 60 per cent of short-term foreign debt (Table VI.3), which may have triggered a run by investors. Some of the other countries seriously affected by the turbulence in the mid-1990s, such as Argentina, also had low reserve cover. This was the case for some of the Asian countries by the mid-1990s and the reserve cover continued to drop until the onset of the crises in 1997. The importance that investors attach to the reserve cover was amply demonstrated when the Korean authorities announced in late 1997 that short-term external debt was higher and "employable" foreign reserves were lower than had been earlier reported.

Table VI.3. **Foreign reserves as a per cent of short-term foreign debt**[a]

	End-1990	Mid-1994	End-1996	End-1997	Mid-1998
Indonesia	55	58	53	47	65
Korea	73	62	50	142	123
Malaysia	475	397	241	34	176
Thailand	151	101	83	67	93
China	335	228	333	422	467
Argentina	65	75	72	65	66
Brazil	34	142	136	104	131
Chile	148	198	192	164	151
Mexico	55	58	72	105	109
Russia	n.a.	n.a.	43	40	32

a) Foreign reserves equal total reserves minus gold; short-term debt is defined as claims of all BIS reporting banks *vis-à-vis* the countries, at maturities up to and including one year.
Source: Bank for International Settlements, IMF.

Herd behaviour and contagion effects may increase the volatility of capital flows

There is concern that volatile capital flows may in part be driven by herd behaviour in financial markets and contagion effects. Herding in financial markets would tend to amplify capital flows in both directions ("overshooting"), and contagion would tend to determine capital flows to one country by reference to factors in another country perceived to be similar and/or interdependent through trade and financial linkages. Herding and contagion need not be irrational in a world where information is costly. Under these circumstances it can be optimal for one investor to follow the lead of another perceived to have an information advantage. To "hide in the herd" may also be an optimal strategy for managers whose investment performance is measured against the average performance of all managers. Moreover, an environment in which international investors expect to be bailed out of problems will make it rational to follow the herd. But even if herding and contagion may be rational from an individual point of view, to the extent that they result in excessive volatility, they are unlikely to be socially optimal or desirable. In any case, the link between cross-border capital flows and the economic fundamentals of the receiving country are weakened or severed.

Contagion can be transmitted through trade and financial linkages…

It is difficult to gauge to what extent herding and contagion, unrelated to economic fundamentals, played a role in driving recent capital flows. Low risk premia on emerging market debt in the mid-1990s could suggest that these effects were operative.[17] There is also substantial evidence that a crisis in one country increases the

17. Kim and Wei (1999) show that foreign portfolio investment in Korea was influenced by herd behaviour on the part of foreign investors.

probability of a crisis in other countries (Eichengreen *et al.*, 1996). To the extent that the transmission is related to trade linkages, and there is evidence that suggests that this transmission channel has been important in the past, such contagion is based on economic fundamentals. An alternative transmission channel can occur through "demonstration" or "wake-up call" effects (Goldstein, 1998): an event in one country alerting investors to risks in "similar" countries that had not been properly taken into account previously, thus leading to a re-adjustment of balance sheets. Such contagion could bring exposure more into line with economic fundamentals, provided that the re-assessment is based on a country-by-country basis. It cannot be determined to what extent such revisions of perceived risks have been based on an assessment of fundamentals rather than being driven by herd mentality.

While the contagion across the Asian countries could arguably be explained by trade and "wake-up" linkages, that from Asia to Latin America and Russia in 1997 seems to have operated *via* financial linkages: Asian banks suffering losses on lending at home selling their holdings of Russian and Brazilian high-yielding bonds to improve their liquidity position. The ensuing drop in bond prices in these countries was then transmitted to other key emerging markets via widely-employed modern risk management systems, whereby market volatility in one country automatically increases estimated credit and market risk in another country with similar past volatility.

… and leveraged positions can amplify contagion effects

The extraordinary impact of the Russian crisis on global financial markets appears to have been transmitted through highly leveraged positions of some financial institutions (including hedge funds). The small weight of Russia in international trade indicates that trade links cannot account for the contagion that took place in August 1998. Direct financial linkages were also too small to propagate the shock throughout the international financial system. However, although firm data do not exist, anecdotal evidence suggests that holdings of high-yielding Russian securities had been financed partly by borrowing on margin and also that they served as collateral for further borrowing. Under these conditions, the drop in the price on Russian securities would have given rise to margin calls, forcing investors to raise liquidity by selling Russian and other assets. Together with increased risk aversion, this in turn would have depressed prices on these assets further, reducing their value as collateral and prompting additional margin calls. The result may have been a broad-based sell-off of emerging market securities and high yielding instruments issued in mature markets. The small response in international financial markets to the Brazilian crisis last January could reflect that financial institutions had substantially reduced their leveraged positions in the wake of the Russian crises.

Emerging market countries can take measures to reduce their vulnerability to international liquidity problems and to adverse herding and contagion effects…

Countries can reduce their vulnerability to liquidity-driven disturbances by maintaining sufficiently high reserve cover and by establishing credit lines that can be drawn on in a crisis situation. Moreover, to minimise the risk of falling victim to herd behaviour and contagion, the most appropriate policy in the long run is to make it easier and less costly for foreign investors to acquire information about the economy, and to take measures to reduce the perception that investors will be bailed out if they make mistakes.[18] However, countries on the verge of financial panics have even fewer options to modify capital flight than when outflows are driven by changing perceptions of fundamentals only. In such circumstances

18. Investors have little incentives to engage in credit risk assessment when they expect to be bailed out, thereby increasing the likelihood that they will simply follow the lead of the herd.

interest rate hikes and the imposition of a transaction tax on capital flows are likely to prove ineffective. Quantitative restrictions on outflows may not even prove to be very effective, as there would be very strong incentives to find measures to circumvent such regulations.

… and changes to the international financial architecture are being proposed to contain and minimise the likelihood of crises

Recent measures and proposals to reform the international financial architecture have been motivated by a perceived need to help countries facing a potential crisis. Such help is not necessarily altruistic insofar as it acts as a "circuit-breaker" to contagion or herding effects. Thus, the recently established contingent credit line facility in the International Monetary Fund (IMF) for countries facing adverse contagion effects despite sound fundamentals could make liquidity-driven panics less slikely. Increased private sector involvement in the resolution of crises (*e.g.* automatic extension of loans under certain circumstances) could also reduce the risk of sudden withdrawal of credit lines, but might also unduly reduce the availability of funds in the longer term. Moreover, an international lender of last resort and an international bankruptcy court could help to prevent financial panics altogether. In order for the international community to create effective institutions of this kind,[19] it is necessary to address adequately the moral hazard inherent in such arrangements (Giannini, 1999). At the domestic level, this is done by giving the lender of last resort and bankruptcy courts vast powers to impose conditions unilaterally on those seeking their services. Wielding such powers with supra-national institutions may not be compatible with national sovereignty.

On the efficacy of capital controls

Capital controls remain common in emerging market countries…

The volatility of foreign capital flows has raised questions about the desirability of free capital movements, and the possible use of controls to shelter countries from the disruptions associated with such instability. However, notwithstanding substantial liberalisation of capital-account transactions,[20] legal and administrative restrictions remained common in several emerging economies in the mid-1990s,[21] including those that later succumbed to crises. In addition to controls directly targeted at cross-border movements of capital, most countries have prudential regulations on banks' foreign currency exposure (discussed above) which can indirectly influence capital flows. Direct restrictions typically take two different forms:

- Quantitative restrictions that prohibit outflows or inflows of funds. Such restrictions are often used to prevent excessive exchange rate volatility due to sudden capital outflows. Malaysia's controls announced last September fall under this category.
- "Tax-based" controls that make it more costly to move capital across borders. The Chilean capital control system, in effect since 1991, imposes a transaction tax on all inflows, except for foreign direct investment, through unremunerated reserve requirements and withholding periods.

19. Fischer (1999) argues that the IMF, generally acting in concert with other official organisations, has undertaken certain important lender of last resort functions in the past.
20. The average capital controls index for 17 emerging countries, constructed by Bartolini and Drazen (1997) to gauge the restrictiveness of capital controls, fell by one-third from 1987 to 1995. This is reported in Bacchetta and van Wincoop (1998).
21. See Table 1 in Blöndal and Christiansen (1999).

… and aim at stabilising cross-border flows…

The objective of these restrictions has been to gain greater independence in macroeconomic policy making and to shelter countries from capital flows perceived to be excessively volatile. Some countries have also aimed at reducing volatility through systematic discretionary changes: tightening controls on inflows when the availability of foreign capital is abundant, and tightening restrictions on outflows when foreign capital becomes scarce.

… but their long-term effectiveness is open to doubt

Proposals to limit capital movements implicitly assume that such flows can be controlled by legal means. There is, however, evidence that they are difficult to restrict (Dooley, 1997; Eichengreen and Mussa *et al.*, 1998). The private sector can develop various means to circumvent such restrictions: mis-invoicing in trade, leads and lags, substituting exempted flows for flows subject to restrictions, and resorting to illegal methods, including bribery. The ability to avoid selective capital controls has also increased substantially with the proliferation of financial derivative instruments, which facilitate the transformation of one financial instrument into another (Garber, 1998). Indeed, a common finding of studies in this area is that the effectiveness of control programmes diminishes over time as the private sector invests in avoidance techniques. And there may be serious difficulties in enforcing a reimposition of capital controls once the private sector has become accustomed to a liberalised system.

When effective, controls may have short-term benefits but can also have long-term costs

If the reimposition of capital controls could be made effective as an emergency measure, they would have short-term benefits but could also have long-term costs. The short-term benefits would come from greater independence in setting interest rates with the aim of supporting economic activity (Edwards, 1998). The costs relate to the risk that temporary controls might become permanent and be used to perpetuate inappropriate policies rather than foster policy reforms. Transitory restrictions on financial flows could also reduce trade in goods and services if they would imply that trade-related currency exposure could not be hedged. Temporary controls may also entail longer-lasting burdens in terms of higher borrowing costs, if the risk of losses related to possible future controls is factored into financial asset prices, and lower foreign direct investment, especially if the controls affect the ability of investors to repatriate their profits and assets.

Emerging market countries should aim at progressive liberalisation of capital flows over time, based on sound financial systems and macroeconomic stability

Given the potential benefits of international integration,[22] emerging market economies should aim at progressive liberalisation of capital account transactions over time. As the experience of the crises in emerging markets in the recent and the more distant past demonstrates, it is essential to precede and/or match capital-account liberalisation with measures to strengthen the financial system and to establish macroeconomic stability. This should not serve as an excuse to unduly postpone liberalisation and to continue to pursue inappropriate structural and macroeconomic policies.

22. Empirical studies provide only weak evidence that capital account liberalisation improves economic growth, but this may be related to methodological problems in detecting the benefits. See Eichengreen and Mussa *et al.* (1998).

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VII. CAUSES OF THE RECENT WIDENING OF OECD CURRENT ACCOUNT IMBALANCES

Introduction

OECD current account imbalances have recently widened raising concerns about sustainability and protectionism

Over the past two years a number of countries in South East Asia have experienced massive swings in current account positions, world trade growth has slowed substantially and current account imbalances for some of the major OECD countries have widened sharply. The current account deficit for the United States is expected to increase from 1¾ per cent of GDP in 1996 to 3½ per cent of GDP this year, whereas the surplus for Japan is projected to widen from 1½ to 3 per cent of GDP; the current account surplus of the European Union (EU) remains relatively stable (at just over 1 per cent of GDP). These movements reflect a number of partly inter-related factors: the counterpart to the adjustment of the financial crisis in South East Asia, differences in economic growth and cyclical positions, changes in competitiveness as well as underlying structural factors. Although as a percentage of GDP these current account positions are not as extreme as those reached in the mid-1980s, they have begun to raise policy concerns in some quarters about sustainability and pressures for increased protectionism. Concern may be underlined by the analysis presented previously in this *Outlook* and discussed further in this chapter which suggests that, at unchanged real exchange rates, these imbalances are likely to persist over the medium term.

This chapter addresses some of the issues involved by analysing the main factors underlying recent changes in trade and current account positions to show to what extent the imbalances are due to cyclical or other temporary factors, in particular those associated with the crisis in South East Asia, rather than more deep-rooted trends or structural factors. The issue of protectionist pressures is addressed in the next chapter.

The main points to emerge from the analysis are:

Import contraction in the Asia-5 economies had a major impact on OECD exports

– The brunt of the current account adjustment of the Asian crisis countries has so far come about through import contraction with the corollary that the main impact on the OECD regions has been through a fall in exports; the largest adverse impact has been on Japan given its greater exposure to the markets of the Asian-crisis countries.

Widening external imbalances are largely due to relative demand and cyclical positions...

– Recent increases in the current account imbalances of both the United States and Japan can be largely explained by movements in their relative growth and cyclical positions. OECD Secretariat calculations, comparing the change in exports which can be attributed to export market growth and the change in imports attributed to the growth in total final expenditures, suggest that this can more than account for the change in the trade balances of both the United States and Japan since 1996. The greater stability of the EU current account position is a reflection of its more central relative cyclical position.

... and in United States and Japan, they reflect private sector saving – investment imbalances

– The widening of current account balances in both the United States and Japan is a reflection of private sector saving-investment imbalances, offset only partially by the change in the public-sector position. Conversely, for the European Union any modest improvement in the current-account surplus is to be explained by an improvement in government sector saving-investment balances.

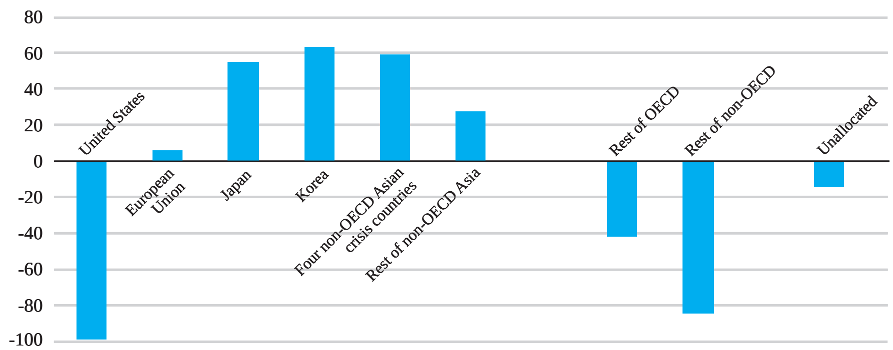
Recent trends in selected current accounts

A growing current account surplus in Asia has been offset by a widening deficits for the American continents and major oil producers

Between 1996 and 1998 the combined current account balance of Korea and the four non-OECD Asian crisis countries – Indonesia, Malaysia, the Philippines and Thailand – (hereafter referred to as the "Asia-5") increased by more than $ 125 billion, rising from a combined deficit of $ 60 billion to a combined surplus of $ 65 billion.[1] With the surplus in Japan increasing by about $ 55 billion over the same period and that in the European Union remaining broadly stable, the main offsetting change was a further widening of the current-account deficit in the United States by about $ 100 billion (Figure VII.1**)**. Offsets are also found among major oil-producing countries (reflecting weakening oil prices) as well as other members of North America Free Trade Agreement (NAFTA) and countries in Latin America.

Figure VII.1. **Change in current account balances, 1996-98**

Billions $



Most of the increase in the trade balance of the Asia-5 has been through import contraction

Looking at trade balances, that of the Asia-5 increased by $ 120 billion between 1996 and 1998 and is expected to decline only marginally this year. Over $ 80 billion of the increase can be accounted for by a deterioration in the bilateral trade balances of OECD countries, and about $ 70 billion by those of the three main OECD regions (Table VII.1, top panel).[2] Up until now, the adjustment to Asia-5 trade

1. Such changes are massive in relation to GDP in the zone, for example in the case of Korea the swing in the current balance over this period amounted to about 17 per cent of GDP.
2. Outside the three main OECD regions, Australia and New Zealand are the OECD countries with which the bilateral trade balance with Asia-5 has most severely worsened: between 1996 and 1998 the combined trade balance of Australia and New Zealand worsened by $ 7 billion, equivalent to about 1½ per cent of combined GDP.

Table VII.1. Trade adjustment of the major OECD regions with the Asia-5[a]

Trade balance:	with:	$ billion 1996	$ billion 1997	$ billion 1998	Absolute change 1996-98 $ billion	Absolute change 1996-98 % of GDP
OECD[b]	Asia-5	14.7	2.8	–69.6	–84.3	–0.4
United States	Asia-5	–15.8	–18.3	–37.9	–22.1	–0.2
	World	–168.8	–183.0	–233.8	–65.1	–0.5
	World as % of GDP	*–2.2*	*–2.3*	*–2.7*		
Japan	Asia-5	22.8	18.9	1.4	–21.4	–0.5
	World	61.6	82.2	107.3	45.7	1.5
	World as % of GDP	*1.3*	*2.0*	*2.8*		
European Union[c]	Asia-5	1.0	–0.9	–26.4	–27.3	–0.3
	World	25.3	29.5	–6.6	–31.9	–0.4
	World as % of GDP	*0.3*	*0.4*	*–0.1*		
Exports of:	**to:**	**$ billion 1996**	**$ billion 1997**	**$ billion 1998**	**Change 1996-98 Absolute**	**Change 1996-98 Percentage**
OECD[b]	Asia-5	203.8	198.2	126.6	–77.2	–37.9
United States	Asia-5	52.4	55.2	39.8	–12.6	–24.1
	World	622.9	687.9	680.6	57.7	9.3
	Asia-5 as % of World	*8.4*	*8.0*	*5.8*	*–2.6*	
Japan	Asia-5	80.4	74.1	45.6	–34.8	–43.2
	World	410.9	421.2	387.9	–22.9	–5.6
	Asia-5 as % of World	*19.6*	*17.6*	*11.8*	*–7.8*	
European Union[c]	Asia-5	49.7	48.4	28.1	–21.6	–43.4
	World	752.9	780.9	777.6	24.7	3.3
	Asia-5 as % of World	*6.6*	*6.2*	*3.6*	*–3.0*	
Imports of:	**from:**	**$ billion 1996**	**$ billion 1997**	**$ billion 1998**	**Change 1996-98 Absolute**	**Change 1996-98 Percentage**
OECD[b]	Asia-5	189.1	195.4	196.2	7.1	3.8
United States	Asia-5	68.2	73.5	77.7	9.5	13.9
	World	791.7	870.9	914.4	122.8	15.5
	Asia-5 as % of World	*8.6*	*8.4*	*8.5*	*–0.1*	
Japan	Asia-5	57.6	55.2	44.3	–13.4	–23.2
	World	349.3	339.0	280.6	–68.6	–19.6
	Asia-5 as % of World	*16.5*	*16.3*	*15.8*	*–0.7*	
European Union[c]	Asia-5	48.7	49.3	54.5	5.8	11.9
	World	727.6	751.4	784.2	56.6	7.8
	Asia-5 as % of World	*6.7*	*6.6*	*6.9*	*0.3*	

a) Asia-5 refers to Indonesia, Korea, Malaysia, the Philippines and Thailand. Figures refer to trade in merchandise goods only. For Italy and Ireland, data for December 1998 are unavailable and so are assumed to be equal to November 1998.
b) OECD excluding Austria, Greece, Korea, Mexico and Turkey.
c) European Union excluding Austria and Greece. Intra-trade is excluded.
Source: OECD, *Monthly Statistics of Foreign Trade.*

balances has come about almost entirely from a massive reduction in the dollar value of imports, mostly occurring in 1998.[3] Indeed, the decline in Asia-5 imports directly accounts for a fall in world trade growth of 1½ percentage points in 1998. Although the evidence is patchy, available official data and other estimates suggest that there has been strong growth in export volumes from the Asia-5, despite supply constraints

3. Of the estimated $ 120 billion increase in the trade balance of the Asia-5 between 1996 and 1998, $ 110 billion is accounted for by a fall in the value of imports.

arising from difficulties in obtaining export credits or imported inputs for certain export categories.[4] However, there have also been substantial declines in dollar export prices to the extent that there has been little positive effect on overall Asia-5 export values in dollar terms.

Large percentage falls in OECD exports to Asia-5, have been particularly severe for Japan

Reflecting import contraction in Asia-5, there have been large falls in the value of OECD exports to the region between 1996 and 1998: the dollar value of exports from Japan and the European Union fell by about 43 per cent and from the United States by 24 per cent (Table VII.1, middle panel). For Japan, this represents a reduction in total exports of nearly 8 per cent reflecting the importance of the Asia-5 as an export market, compared with only 3 per cent and 2½ per cent for the European Union and the United States, respectively. The quarterly pattern of exports to the Asia-5 from all the main OECD regions would suggest that a trough was reached in the third quarter of 1998.

Imports coming from the Asia-5 have remained a stable share of total imports for the main OECD regions

Changes in imports by the main OECD regions from the Asia-5 were less significant, with a fall in the value of imports by Japan roughly equal to the combined increase by the United States and European Union. These changes mainly reflect movements in aggregate imports. Thus, imports coming from the Asia-5 remained relatively stable as a share of total imports for both the United States and European Union, and to a lesser extent Japan (Table VII.1, lower panel).

A limitation of the preceding analysis of bilateral trade balances is that it does not account for the multilateral nature of the adjustments taking place (for example, potential exports to the Asia-5 may have been diverted to other markets), nor is the effect on trade volumes and prices clearly distinguished. The following assessment provides a broader macroeconomic – and multilateral – perspective on recent changes in current account balances in the three major OECD regions, including the impact of turmoil in South East Asia.

Rapid import volume growth underlies the deterioration in the US trade balance…

The widening of the US current account deficit between 1996 and 1998 occurred mainly because of rapid growth in import volumes and despite strong export performance and terms-of-trade gains (Table VII.2). This rapid import growth reflects both strong growth in total final expenditures, as well as a relatively high import elasticity with respect to demand.[5] Low relative import prices, reflecting the strong dollar, may also have contributed to a rise in import penetration.

… reflecting the strength of demand and an extreme relative cyclical position…

The much stronger effect of market growth on import than on export volumes is indicative of the relative strength of US demand and that the US cycle is not at all synchronised with those of its major trading partners. Calculating the difference between the change in exports which can be attributed to export market growth and the change in imports attributed to the growth in total final expenditures (see Table VII.2), suggests that the "net demand component" of the deterioration in the trade balance between 1996 and 1998 is equivalent to more than 1 per cent of GDP.[6]

4. Official estimates suggest that export volumes in Korea and Thailand rose 17 per cent and 8 per cent in 1998, respectively. IMF estimates suggest that export volumes in Indonesia increased 18 per cent in 1998.
5. The estimated elasticity of imports with respect to total final expenditure from the OECD INTERLINK model (used in the analysis presented in Table VII.2), is significantly higher for the United States (at about 2¼) than that for an average of European Union countries and Japan (about 1½ to 1¾).
6. The calculated "net demand" component, combines both differences in potential growth rates and differences in cyclical positions, as measured by short-term deviations from potential. As indicated in the later section of this chapter, both components are important in explaining current and prospective developments in the imbalances.

Table VII.2. **Trade based decomposition of changes in currrent account balances, 1996-98**

$ billion

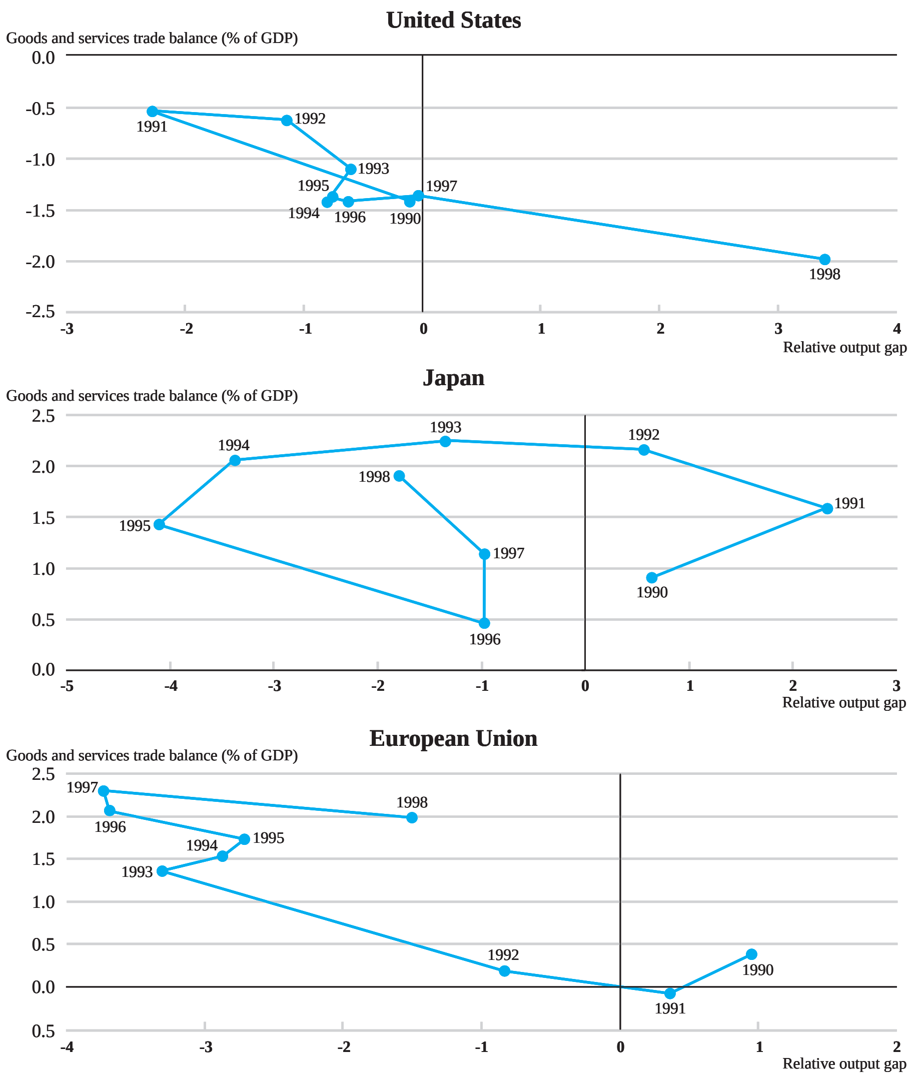
	United States	Japan	European Union[a]
Change in current account balance	**–98.5**	**54.9**	**5.7**
Change in trade balance	**–56.6**	**38.5**	**–12.9**
of which:			
Export volumes	120.8	39.3	144.2
Export market growth[b]	98.8	46.6	145.3
Other factors[c]	22.0	–7.3	–1.2
Import volumes	256.3	–9.2	173.6
Total final expenditure growth[d]	218.5	–12.4	110.2
Other factors[e]	37.8	3.2	63.4
Net demand component[f]	**–119.7**	**59.0**	**35.1**
Terms of trade effect	29.1	6.1	9.1
Residual[g]	49.7	–16.1	7.4
Balance on non-factor services	**–3.9**	**13.0**	**1.6**
Balance on investment income	**–36.7**	**3.1**	**16.5**
Balance on transfers	**–1.3**	**0.2**	**0.5**
Memorandum items (percentage changes):[h]			
Export volume	18.0	10.5	15.6
Export market	14.7	12.5	15.7
Import volume	27.9	–3.7	22.4
Total final expenditure	10.8	–2.2	7.9
Terms of trade	3.5	2.4	1.3
Effective exchange rate	18.7	–1.3	..
Real exchange rate (CPI-based)[i]	14.2	–5.0	0.9

a) For the European Union intra-EU trade is excluded.
b) On the assumption that export volumes grow at the same rate as export markets.
c) Growth in export volumes not explained by growth in export markets.
d) On the assumption that import volumes grow at the rate of total final expenditure multiplied by the respective INTERLINK demand elasticity.
e) Growth in import volumes not explained by growth in total final expenditure.
f) The net demand component is calculated as the difference between the change in exports that can be attributed to growth in exports markets and the change in imports which can be explained by growth in total final expenditure. It therefore combines changes attributable to potential and cyclical demand factors.
g) Residual includes customs/balance-of-payments adjustments effects and effects arising from initial imbalances and from cross-product terms in the analysis.
h) Cumulative growth over the period 1996-98.
i) See Durand M., C. Madaschi and F. Terribile ''Trends in OECD Countries' International Competitiveness: the influence of emerging-market economies'', *OECD Economics Department Working Paper* No. 195 for a description of the measures of competitiveness.

For the United States an inverse relationship is clearly discernible over the 1990s between the balance of trade in goods and services and the relative output gap, defined as the difference between the US output gap and a trade-weighted average of the output gaps in competitor countries **(**Figure VII.2).[7] The United States moved from a near-zero relative (and domestic) output gap in 1996 to a situation where the relative output gap, at plus 3½ percentage points, is at its most extreme in two decades. The main factors behind this change were an increase in US output above potential and the downturn in Asia-5 and Japan.

7. For these purposes the output gaps for OECD countries are taken to be those described elsewhere in this publication (and detailed in the Annex tables). For those (mainly non-OECD) countries/regions for which an output gap is not published, a measure is constructed as the difference between actual and projected GDP and its trend, based on a Hodrick-Prescott filter estimate.

Figure VII.2. **Relative output gaps and trade balances on goods and services in the main OECD regions, 1990-98**[1]



1. The relative output gap is calculated as the difference between output gap and a trade-weighted measure of competitors' output gaps (see main text for details of calculation).

… a deterioration in net investment income…

A further factor contributing to the widening US current account deficit is the balance on investment income, which has deteriorated from a surplus of about ½ per cent of GDP in 1990 to a deficit of ¼ per cent of GDP in 1998 and is expected to worsen further in 1999. This trend is mainly the consequence of a steadily deteriorating net external indebtedness position; reaching about 16 per cent of GDP in 1997. The United States became a net debtor in the late 1980s but, because of the higher rate of return earned on its assets relative to its liabilities, ran a surplus on investment income until as recently as 1997.

… and overall, a growing imbalance in private sector saving and investment

Overall, the deteriorating US current account balance reflects a growing difference between private sector saving and investment that has been apparent from the early 1990s.[8] Thus, private sector fixed capital investment, driven by business investment, has been rising as a proportion of GDP since the early 1990s, and the household saving rate has fallen further from an already low level in the early 1990s. A number of factors might explain the decline in household savings, including the strong performance of the US equity market, the effect of low unemployment on consumer confidence and continued low inflation.[9] The growing private sector imbalance has outweighed the trend improvement in the savings of general government, which has shifted from a position of dissavings in the early 1990s to positive gross saving of nearly 4½ per cent of GDP in 1998.

The rise in Japan's current account surplus, has followed an absolute decline in import volumes…

The rise in Japan's current account surplus between 1996 and 1998, occurred despite the severe impact of Asia-5 on export market growth as well as losses in export market share. It was mainly due to the absolute decline in import volumes (see Table VII.2**)**, which is mostly explained by the fall in total final expenditure growth associated with the sharply weakening cyclical position of the Japanese economy.

Japan experienced a slight loss of export market share which cannot be easily attributed to price competitiveness, even allowing for the currency devaluations in the Asia-5 countries – because of the reversal of the previous strength of the yen against other OECD currencies most aggregate measures suggest that competitiveness has been improving in recent years. Aggregate measures may, however, understate the effect of large swings in the exchange rates of the Asia-5 on Japan's competitiveness, particularly given the close overlap in product segments between the exports of Japan and some Asia-5 countries (especially Korea, Thailand and Malaysia).

… reflecting a worsening in demand and the relative cyclical position…

The relative output gap of Japan, estimated to be minus 1¾ percentage points in 1998, became more negative between 1996 and 1998, despite the severity of the downturn in many Asian competitors, because output in Japan fell 4 percentage points relative to potential. It is not easy to discern a stable relationship between the relative output gap and the balance of trade in goods and services during the 1990s (Figure VII.2), perhaps because it may be partly obscured by large changes in the exchange rate. The "net demand component" of the change in the trade balance, calculated as the difference between the change in exports attributed to export market growth and the change in imports attributed to the growth in total final expenditures (see Table VII.2), explains all of the increase in the surplus since 1996.

Japan's stock of net external assets has grown steadily from about 10 per cent of GDP in 1990 to over 25 per cent of GDP in 1997, with a rise in the surplus on

8. Although the saving-investment balance is conceptually identical to the current account there is a statistical discrepancy. Moreover, in the case of the United States, as shown in Table VII.3, this discrepancy has recently been increasing, making it more difficult to isolate the causes of the change in the current account.
9. Recent empirical research, including that by the OECD (see Boone, L., C. Giorno and P. Richardson, "Stock Market Fluctuations and Consumption Behaviour; Some Recent Evidence", *OECD Economics Department Working Paper* No. 208) suggests that every 10 per cent increase in the value of stock market wealth (relative to disposable income) might reduce the personal sector savings rate by ½ a percentage point. Given the rise in stock market wealth of about 40 per cent from the beginning of 1996 to the end of 1998, these findings might explain a large part of recent falls in household saving. Moreover, (positive) effects of the rise in the valuation of equities on fixed investment, although more difficult to quantify, might be equally important. One researcher has estimated that the effect on investment (as a share of GDP) is about similar to that on consumption, see Meredith G., "Effect of Equity Prices on Aggregate Demand", unpublished IMF Office memorandum, (1997).

investment income over this period from ¾ to 1¼ per cent of GDP. However, since 1996 the investment-income balance has remained relatively flat in dollar terms and so has not contributed to the widening current account surplus.

… and an increasing private sector saving-investment imbalance

Overall, for Japan there has been a trend fall in both gross savings and fixed capital formation as a proportion of GDP since the early 1990s. The increase in the current account surplus between 1996 and 1998 reflects a widening of the imbalance between private-sector savings and investment which has only been partially offset by the general government sector (Table VII.3). Thus, between 1996 and 1998, with output falling substantially below potential, business and housing fixed investment have declined as a share of GDP. The effect on the current account has been exacerbated by a rise in household savings. The severity of the current downturn, with falling employment and incomes unprecedented in recent times, has led to sharp declines in consumer confidence, which may be a major cause of the rise in household savings.[10]

Table VII.3. **Saving-investment based decomposition of changes in current account balances, 1996-98**

Change expressed as a percentage of GDP

	United States	Japan	European Union
Current account balance	–1.0	1.8	0.1
Gross savings	0.5	–1.9	0.9
General government	2.5	–2.6	2.4
Private sector	–2.0	0.6	–1.6
Gross capital formation	1.2	–3.7	0.9
General government	–0.1	–0.9	–0.1
Private sector	1.3	–2.7	1.0
Statistical discrepancy	–0.3	0.0	0.1

Note: Components may not add due to rounding.
Source: OECD *Annual National Accounts* and OECD estimates.

The current account of the European Union has remained relatively stable…

The current account position of the European Union has remained relatively stable over recent years, reflecting more stable demand and cyclical position, lesser exposure to the Asia-5 and the absence of any major changes in the terms of trade or price competitiveness (Table VII.2). Growth in export volumes (excluding estimates of intra-EU trade) has been in line with growth in export markets.

… reflecting more stable demand and cyclical position and…

Since 1996 the output gap and relative output gap of the European Union have closed somewhat, in marked contrast to the position in both the United States and Japan. In 1998 the estimated relative output gap is about minus 1½ percentage points, mainly reflecting that output in the European Union is about 1 percentage point below potential. As for the United States there has been a clearly discernible inverse

10. Recent econometric evidence suggests that the fall in consumer confidence between the end of 1996 and the end of 1997 may have increased the household savings rate by about ¾ of a percentage point (see Economic Planing Agency "Economic Survey of Japan 1997-98", July 1998, No. 315, pp. 45-47). The Bank of Japan's "Monthly Research Report", June 1998, pp. 132-4, provides similar econometric evidence of a link between saving rates and consumer confidence.

relationship between the relative output gap and the trade balance over much of the 1990s (Figure VII.2), although there was little reduction in the trade balance in 1998 despite a significant closing of the relative output gap. Looking at the change in exports which can be attributed to export market growth and the change in imports attributed to the growth in total final expenditures (see Table VII.2), suggests that the "net demand component" of the trade balance has only changed by some ½ per cent of GDP since 1996 – much less than for either Japan or the United States.

… greater stability in the saving-investment balance

The stability in the current balance of the European Union in recent years reflects a trend improvement in the government saving-investment balance, which has offset the increase in the excess of private sector capital formation over private saving since 1996 (Table VII.3). The former is consistent with the fiscal consolidation measures which have been undertaken to meet the Maastricht criteria.

Medium-term prospects for current account imbalances

Current account imbalances may persist over the medium term because of differences in potential growth

As argued above, relative demand and cyclical positions can explain much of the recent increase in current account imbalances. However, over the medium term as output gaps are closed, current account imbalances may persist because of marked differences in potential output growth across regions, even if they are eventually resolved over a longer time horizon. The OECD current estimates of potential output, incorporated in the short-term projections and the medium-term reference scenario, suggest an average annual rate of growth of 2¾ per cent for the United States which is significantly higher than that for Japan at 1 per cent per annum or the European Union countries at 2¼ per cent per annum.

Important regional differences in potential growth rates over the medium term reflect divergent demographic trends

Divergent demographic trends are an important factor underlying these differences. Working age population in the United States is (abstracting from immigration flows) likely to increase on average by over 1 per cent per annum over the next five years, compared to a rise of less than ¼ per cent per annum in Europe and a fall of over ¼ per cent per annum in Japan. This implies that over the next five years almost two-thirds of the difference in the potential growth rates of Japan and the United States might be explained by divergent demographic trends.

Without changes in real exchange rates or trade openness further adjustment may be slight…

These differences in potential output growth are one of the main factors explaining why the current account imbalances between regions experienced in the most recent period might – in the absence of major changes in real exchange rates or the degree of openness of the economies – persist over the medium term even if the current differences in cyclical positions disappear. Thus, in the OECD's most recent medium-term projections (as described in the appendix to Chapter I "General Assessment of the Macroeconomic Situation"), the US current account deficit is expected to remain at or around 3½ per cent of GDP over the next five years, while the current account surpluses for Japan and the European Union are projected to remain at or around 3½ and 1½ per cent of GDP, respectively.

… and imbalances could be larger if US growth potential were higher…

These external imbalances could be even larger if, as suggested by some analysts, the growth of US potential has increased more strongly over the recent period than indicated by OECD estimates. As an illustration of the quantitative importance of the link between differentials in potential output growth rates and the size of the current account imbalances, a simulation has been carried out using the INTERLINK model. This is based on the alternative assumption that the US economy converges over the next five years towards an average growth rate of potential of 3¼ per cent, *i.e.* ½ percentage point higher than in the current reference scenario. The combination of assumptions which might plausibly support such an alternative comprise: a lower trend unemployment rate (at 4¾ per cent), a higher rate of trend factor productivity growth (an additional ¼ per cent per annum) and higher capital investment – all of which might, for example, be associated with the wider impact of innovations in the computer and telecommunications sectors on US supply performance. On this basis, the projected level of GDP for the United States would be about 2½ per cent higher than baseline after five years. Assuming unchanged trade elasticities and real exchange rates, this would, over the same period raise US imports by about 6 per cent and GDP in the rest of the OECD that is by about ¼ per cent. As a result, the US current account deficit would be a further ½ per cent of GDP larger than in the reference scenario (at around 4 per cent of GDP) by 2004. The current balance surpluses for Japan and the European Union would then be ½ and ¼ per cent larger (at 4 and 1¾ per cent of GDP).

… although supply-side improvements could also enhance US trade performance…

Such estimates may exaggerate the impact of divergences in potential output growth on the size of current-account imbalances because they focus on the implications for trade from a demand perspective, assuming that estimated trade elasticities are unchanged. If supply-side improvements, reflected in higher total factor productivity, underlie an increase in potential growth, then there might also be favourable effects on the (non-price) competitiveness of traded goods, leading to an enhanced trade performance.[11] In relation to the previous illustrative simulation of higher US potential growth, an accompanying decline in the US income elasticity for imports from 2.0 to 1.5 would be sufficient to limit the decline in the current-account balance to ¼, rather than ½, per cent of GDP.

… and exchange-rate movements may also mitigate further growth in regional imbalances

The medium-term projections may also overstate the extent of current account imbalances because the real exchange rate is held fixed as a technical assumption, even though current exchange rates may in part reflect cyclical differences and would also be likely to shift if current account imbalances were perceived by financial markets to be unsustainable. Macroeconometric model simulations generally suggest that exchange rate movements might play a role in mitigating such imbalances, although typically very large exchange rate changes would be required to eliminate them completely. INTERLINK model simulations suggest that exchange rate depreciation (appreciation) does lead to an increase (decrease) in the current account balance, although the extent depends on the country/region concerned according to the size of estimated price elasticities as well as initial conditions. Thus, for the United States (which is estimated to have a relatively low export price elasticity) a 10 per cent depreciation leads to an increase in the current account equivalent to about ¼ per cent of GDP after 3 years, but for Japan (which has a much higher export price elasticity) the increase is nearly ¾ per cent of GDP, with the response from the Euro area between these extremes.[12]

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11. The US economist Paul Krugman has noted an empirical relationship between income elasticities of trade and growth rates which he has called a “45-degree rule”, under which fast-growing countries appear to face high income elasticities of demand for their exports, while having low income elasticities of import demand. He suggests a supply-side explanation in terms of increasing product returns and product differentiation. See Krugman, P., “Differences in income elasticities and trends in real exchange rates”, *European Economic Review* No. 33, pp. 1031-54, 1989.
12. These estimates are based on model simulations where real interest rates and real government expenditures are assumed unchanged and domestic demand is endogenous. The corresponding current account effects would be significantly greater on the alternative assumption of unchanged GDPs, at around ½ per cent of GDP for the United States and 1 per cent of GDP for both Japan and the Euro area.

VIII. TRENDS IN MARKET OPENNESS

Introduction and summary

Current account imbalances have raised concerns about related increases in protectionist sentiments

Widening imbalances in current account positions across some of the major OECD economic areas[1] have raised concerns about related increases in protectionist sentiments. So far trade disputes have been confined to a few, highly visible areas covering a very small fraction of global commerce, but concerns have been expressed that tensions in trade relationships could spread to other sectors if external imbalances persist. According to the OECD's Medium-Term Reference Scenario (see Appendix to Chapter I) present current account imbalances are unlikely to narrow much, at current real exchange rate levels, even if differences in cyclical conditions are eliminated. This implies a risk that protectionist sentiments may strengthen over the coming years.

Trade policies do not have a significant impact on current account adjustment, but can impact on growth prospects

If protectionist measures are implemented, prospects for sustained growth would be damaged and the adjustment process taking place in emerging markets adversely affected. Moreover, the effects on current account adjustments would be small, as ultimately restoring more balanced positions depends on securing changes in saving and investment behaviour.[2] Protectionist policies cannot directly influence these at an aggregate level and tend over time to result in lower levels of both imports and exports, leaving the trade balance broadly unchanged.

Nonetheless, it is still sometimes argued that protectionism and lack of market openness are contributing to current account imbalances. This chapter reviews whether barriers to international trade and investment have risen and assesses trends in market openness indicators. The main findings are:

- Tariff levels on industrial goods have fallen considerably up until the late 1980s in most OECD countries and since then have been broadly constant.
- Up to 1996, the frequency of use of non-tariff barriers to trade also declined, but their importance may have escalated recently following the financial turmoil in emerging market economies.
- Anti-dumping cases have typically been initiated by OECD countries, especially the United States, the European Union, Canada and Australia. But there has been a marked increase recently in resort to them by non-OECD countries.
- The countries most affected by anti-dumping actions are mainly China, the United States, Korea and Japan. The five Asian countries mainly affected by

1. In the United States the current account deficit increased from 1.8 per cent to an estimated 2.7 per cent of GDP (the change being worth $ 99 billion) between 1996 and 1998, whereas the surplus for Japan widened from 1.4 per cent to an estimated 3.2 per cent of GDP (the change being worth $ 55 billion). In contrast, the current account surplus of the European Union has remained relatively stable at around 1 per cent of GDP. Movements in the balance on goods and services account for most of the change in the current account positions.
2. See the previous chapter for an analysis of the causes behind the recent widening of current account imbalances.

turmoil in financial markets since mid-1997 have not been disproportionately hit by the rise in anti-dumping actions by OECD countries.

– Over a longer time period, recourse to anti-dumping actions appears, to some extent, to be related to cyclical economic conditions, tending to increase during periods of high spare capacity and falling when capacity is tight. There is also evidence of this pattern in prices: filing of anti-dumping investigations follows drops in the world price of the affected product.

– Aggregate measures of trade openness over the past 30 years show that it has increased, but changes have been uneven across sectors and countries, with Japan still displaying a lower degree of openness than either the United States or the European Union (EU).

– Restrictions on direct foreign investment have declined in the manufacturing sector over the past decade and inflows have increased, except in Japan. A number of barriers remain in the service sector in most countries. Scattered evidence suggests that barriers to competition seem to restrict market access more in Japan than elsewhere.

Is protectionism creeping back?

Border protection has fallen in all major OECD areas

A large number of commercial policy instruments exist to directly restrict foreign trade flows. Such instruments include import tariffs and quotas, foreign trade licensing and export taxes. Recourse to these border measures has fallen considerably in most OECD economies. By the end of the 1980s, average tariff rates on industrial goods had dropped by almost a factor of three since the 1960s to below 5 per cent in Japan, to around that level in the United States and slightly above that in the European Union (Table VIII.1). For some products, however, notably textiles and apparel, tariffs still remain high and in others, such as food, beverages and tobacco, the "tariffication" (see below) of certain quantitative border measures in the mid-1990s has meant a rise in the production-weighted tariff rate, especially in the United States, Canada, Norway, and Mexico.

The dispersion of tariffs has risen due largely to the tariffication of quantitative controls on imports of agricultural products

Tariffs, from an economic welfare perspective, are generally preferred to other trade inhibiting commercial policies due to their transparency and readily quantifiable efficiency costs. In broad terms, the distortionary impact of a tariff depends on the price elasticity of demand of the product on which the tariff is levied and rises disproportionately with the level of the tariff. A low average tariff rate could thus disguise significant efficiency losses if the dispersion of tariff rates were high. Widely used dispersion measures, such as the standard deviation, and trade policy specific measures such as the number of tariff "spikes"[3] have risen or remained constant over the past decade in those OECD countries for which data are available (Table VIII.1). In part, this reflects the gradual replacement and ultimately the abolition of virtually all quantitative restrictions on imports of agricultural products, with their estimated tariff equivalent as agreed in the context of the Uruguay Round Agreement on

3. Domestic tariff "spikes" are defined as those tariff rates that exceed a certain threshold value usually taken to be three times the overall simple bound rate, or above 15 per cent.

Table VIII.1. Production-weighted average tariff rates[a]

Per cent

(ISIC)[b]	Agriculture, forestry, fishing (1)	Mining and quarrying (2)	Manufacturing (3)	Food, beverages and tobacco (31)	Total, all products	Domestic tariff spikes[c]	Standard deviation
United States							
1989	3.8	0.2	4.7	7.6	4.4	4.5	7.7
1993	4.1	0.2	5.0	8.2	4.7	4.0	8.6
1996	7.9	0.2	5.4	15.9	5.2	3.8	14.2
European Union							
1988	6.4	0.5	8.4	27.4	8.2	2.2	6.1
1993	6.1	0.3	8.6	27.1	8.4	2.3	6.1
1996	10.7	0.6	7.7	32.5	7.7	4.8	20.7
Japan							
1988	5.1	0.5	4.1	15.6	4.2	5.3	8.9
1993	5.1	0.3	3.5	17.5	3.6	5.7	12.7
1996	5.0	0.3	3.3	18.9	3.4	6.8	11.8
Canada							
1988	4.1	3.4	10.0	16.8	8.7	0.5	8.8
1993	4.0	3.4	9.7	15.6	8.4	0.3	8.4
1996	5.5	1.9	14.4	57.4	12.1	1.4	27.5
Norway							
1988	1.9	6.6	4.8	7.9	5.3	12.2	6.9
1993	1.5	3.8	4.9	8.1	4.0	12.3	6.9
1996	60.3	3.0	33.4	135.1	22.3	7.6	91.1
Switzerland							
1988	2.9	0.7	5.0	23.4	4.8	6.4	13.0
1993	2.7	0.5	4.6	18.7	4.5	6.3	11.6
1996	2.6	0.8	3.2	11.7	3.2	4.9	7.4
Australia							
1988	1.7	2.2	12.8	6.2	11.2	3.1	14.3
1993	0.7	0.7	7.7	3.2	6.6	7.9	12.1
1996	0.5	0.5	4.8	3.3	4.2	10.8	9.1
New Zealand							
1988	2.9	2.2	13.7	8.9	10.6	2.4	15.7
1993	1.8	1.5	7.3	5.6	5.7	6.2	10.4
1996	1.7	1.2	6.4	5.2	5.1	8.3	15.5
Mexico							
1988	10.6	3.4	11.8	14.0	11.0	0.0	7.0
1993	12.2	12.2	13.5	15.2	12.9	0.0	5.2
1996	14.7	14.7	19.9	43.6	18.0	0.7	13.7

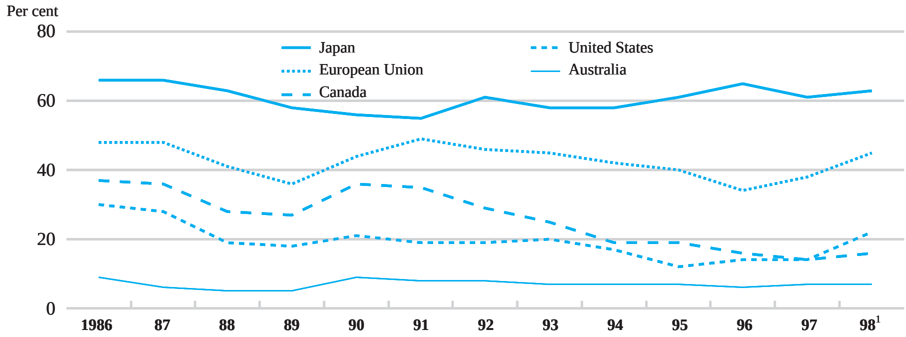
a) Calculations are based on each country's own value-added.
b) International Standard of Industrial Classification.
c) Domestic tariff ''spikes'' are defined as those tariff rates exceeding three times the overall simple average most favoured nation rate.
Source: OECD (1997*c*).

Agriculture (URAA).[4] This process, known as "tariffication" was one of the major commitments accomplished at the last round of global trade talks – the Uruguay round. Thus, the rise in tariff dispersion measures and the corresponding small increase in the average tariff level between 1993 and 1996 is unlikely to have been associated with an overall increase in distortionary costs.

4. See OECD (1995) for an assessment of the impact of the Uruguay Round Agreement on Agriculture in OECD countries.

Figure VIII.1. **Protection in the agriculture sector**

Producer support estimates



1. Data for 1998 are provisional estimates.
Source: OECD, PSE/CSE Database.

Protection remains very high in the agricultural sector in most OECD countries

While much progress has been achieved in lowering protection on industrial goods, barriers to trade in agriculture remain pervasive in most OECD countries. Protection in the agricultural sector, as measured by producer support estimates (PSEs), has remained broadly constant at a very high level in Japan at around 60 per cent and at about 40 per cent in the European Union and 20 per cent in the United States over the past decade (Figure VIII.1). In Canada over the same period, PSEs have fallen by some 10 percentage points to around 15 per cent, but still remain above the levels in those OECD countries with low assistance to agriculture, such as Australia and New Zealand. Up until the Uruguay Round, agriculture had been largely excluded from the agenda of multilateral trade talks. Some progress began to be made with the URAA and its disciplines on market access, export subsidies and domestic support.[5] Furthermore, it was agreed to resume multilateral trade negotiations on agricultural products towards the end of 1999 as part of the Uruguay Round's "built-in" Agenda (see Box VIII.1). Efficiency gains from the dismantling of market access barriers in the agriculture sector are likely to be substantial. For example, empirical work by the OECD (Goldin *et al*, 1993) suggests that full multilateral trade reform in agriculture could yield over $ 450 billion per year in net welfare gains.

Non-tariff barriers to trade may be gaining greater importance as a means of impeding access to markets

While the level of tariffs and certain quantitative import controls have declined and are programmed to fall further, there are concerns that non-tariff barriers to trade in general (NTBs) may be gaining greater importance as a means of protecting domestic producers of goods and services and impeding access to international markets. A basic problem in analysing NTBs is the lack of a clear definition of what they are: NTBs consist of all barriers to trade that are not tariffs. Examples of these NTBs thus include countervailing[6] and anti-dumping duties, "voluntary" export restraints,[7] subsidies

5. For further details, see Josling (1998).
6. Countervailing duties (CVD) are intended to counteract foreign government subsidies for exports or domestic duties.
7. Voluntary Export Restraints (VERs) and orderly marketing arrangements are banned under Article 11 of the WTO Agreement on Safeguards, but some prominent examples have yet to expire, such as the 1991 EU "consensus" on imported Japanese cars, which is expected to be abolished by December 1999.

Box VIII.1. **A millennium trade round?**

The next World Trade Organisation (WTO) Ministerial Conference, to be held in late 1999 will consider whether to launch a new round of multilateral trade negotiations – called by some "the Millennium Round". Most OECD countries broadly support a new round of trade negotiations to further relax impediments to movements of goods and services across countries and as a stimulus to global economic activity. Some developing countries, however, are more hesitant and others are even critical of the idea of a new round. They claim that most suggested agenda topics for negotiation would disproportionately benefit the developed OECD countries. Other countries are concerned that a new round is premature, given the current accession process to the WTO of some 30 countries, including China and Russia, and would divert attention from the gradual implementation of commitments agreed during the last Round. These include the expected elimination by 2005 of quotas on imports of textiles and clothing, the implementation of guidelines in the areas of trade-related investment measures (TRIMs), trade-related aspects of intellectual property rights (TRIPs) and agriculture. Furthermore, under the Uruguay Round a range of selective negotiations, in the areas of trade in agriculture, trade in services and aspects of intellectual property were scheduled – the so-called "built-in" Agenda – regardless of whether the WTO Ministerial Conference results in an agreement to launch a new round of multilateral trade negotiations.

An agenda for a new round of negotiations has yet to be agreed, but many suggestions have been put forward. These include additional cuts in industrial tariffs and a host of trade facilitation issues covering agriculture, electronic commerce, competition, investment and government procurement policies. It remains an open question whether the "built-in" agenda would follow its own course or whether it would be merged into the new round's agenda. The least developed countries are also expected to link negotiations with assistance for other initiatives such as "capacity-building", while some OECD countries would like to establish links between trade and labour standards and with environment standards. These proposals are strongly resisted by developing countries who fear that such links would ultimately be used as disguised protectionism and would effectively deny their comparative advantages. While negotiations are still proceeding on the timing and agenda of a new round, wide support already exists for a negotiation process that favours a short round; some have suggested a three-year period. Suggestions have also been made to conclude, when possible, negotiations in specific areas before the set deadline for the whole round – the concept of an "early harvest".

which sustain in operation loss making enterprises, technical barriers to trade,[8] and obstacles to the establishment and provision of services. Moreover, the term is often used to include certain domestic measures, such as restraints on distribution and non-competitive practices that can also distort trade in the same way as border measures do.

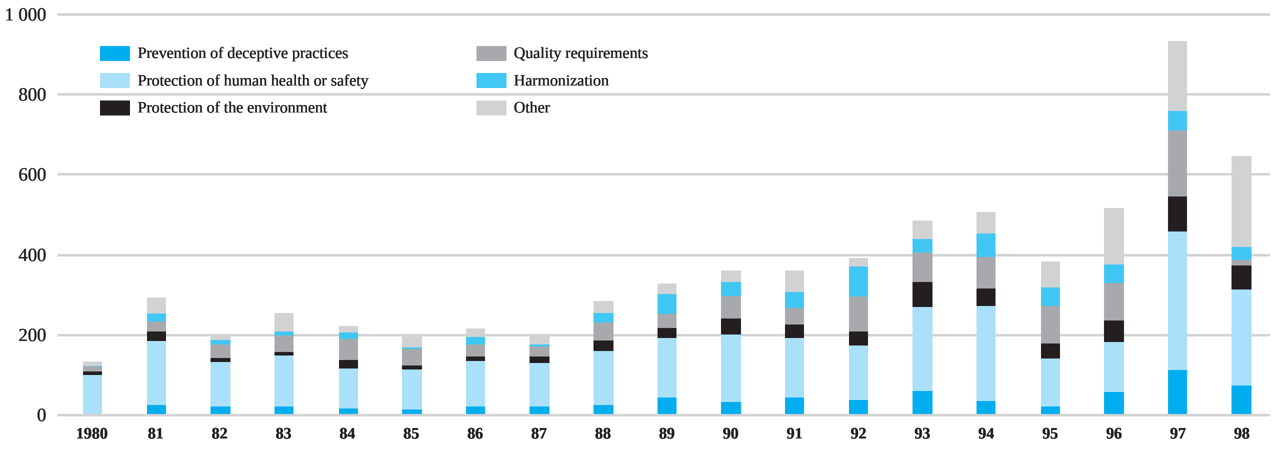
A rising proportion of trade disputes concern technical barriers to trade

Some of these instruments – in particular, technical regulations, minimum standards and certification systems regarding health and consumer safety – do not, *ipso facto*, constitute barriers to trade, as they are generally employed to meet legitimate policy goals. However, there is a perception that, in some circumstances, these sorts of policy instruments are being mis-used.[9] A rising proportion of trade disputes concern technical barriers to trade (TBTs) in the human health and safety area. Two recent examples which have received considerable attention concern bans on imports into Europe of hormone-fed beef and genetically modified organisms on the basis of possible health risks. Exporters of these

8. Technical regulations, minimum standards and certification systems, which are used by all OECD governments for health, safety and environmental protection and to enhance the availability of information about products, may result in the erection of technical barriers to trade (TBTs). TBTs are mainly caused by the differential application of technical regulations, standards and certification systems between domestic and foreign suppliers, although the fact that such regulations, standards and certification systems differ across countries may in itself be a barrier to trade. In practice it is difficult to evaluate the extent to which standards are applied or enforced differentially. See Hoekman and Kostecki (1995) for a detailed discussion of TBTs.
9. To the extent that they are abused, they are contrary to the World Trade Organisation's (WTO) most-favoured nation principle. As it is difficult to distinguish between the use of trade policy instruments, such as anti-dumping and countervailing duty actions which are legitimate and those which are not, recourse to these instruments are treated as NTBs for the purposes of this study.

products argue that there is no conclusive scientific evidence to suggest a health risk and feel either that stated policy objectives dissemble protectionist measures or that the original (legitimate) objectives have been distorted for protection purposes. Trade disputes of this complex kind, which also involve issues such as environment standards and animal rights, are likely to rise, given the recent sharp increase in the number of notifications to the World Trade Organisation (WTO) of TBTs, especially for the protection of human health and safety (Figure VIII.2). It is thus important that newly created dispute settlement procedures are promptly adhered to by all parties and the judgements which are handed down respected.

Figure VIII.2. **Number of notifications of technical barriers to trade**[1]



1. For certain years, several notifications indicated more than one objective. As a result, the total number of objectives may not correspond to the total number of notifications received.
Source: WTO Secretariat.

NTBs are less transparent than tariffs and their efficiency costs are harder to estimate

Trends in the use of NTBs are difficult to monitor because these instruments of trade policy are generally less transparent than tariffs.[10] Most indicators focus on the incidence or frequency of use of NTBs (Table VIII.2) and do not capture the restrictiveness of such measures. As a consequence, it is difficult to measure the distortionary impact of NTBs, as this requires information which is intrinsically hard to measure and presupposes an ability to correctly identify the purpose of the NTB measure as a genuine obstacle to trade. To complicate matters further, the mere threat of certain NTBs, for instance an anti-dumping investigation, even if it never materialises, can be sufficient to change behaviour and thereby generate welfare losses (see Messerlin, 1991).

10. For a discussion of these issues, see Deardorff and Stern (1997).

Table VIII.2. **Pervasiveness of non-tariff barriers**

Per cent

	Frequency ratio [a]			Import coverage ratio [b]		
	1988	1993	1996	1988	1993	1996
United States	25.5	22.9	16.8	16.7	17.0	7.7
European Union	26.6	23.7	19.1	13.2	11.1	6.7
Japan	13.1	12.2	10.7	8.6	8.1	7.4
Canada	11.1	11.0	10.4	5.7	4.5	4.0
Norway	26.6	23.7	4.3	13.8	11.1	3.0
Switzerland	12.9	13.5	7.6	13.2	13.2	9.8
Australia	3.4	0.7	0.7	8.9	0.4	0.6
New Zealand	14.1	0.4	0.8	11.5	0.2	0.2
Mexico	2.0	2.0	14.6	18.6	17.4	6.9

a) The frequency ratio is the proportion of national tariff lines that are affected by a particular non-tariff barrier (NTB). or by a specified group of NTBs, irrespective of whether the products affected are actually imported.
b) The import coverage ratio is the share of a country's own imports that is subject to a particular NTB or any one of a specified group of NTBs.
Source: OECD (1997*c*).

Anti-dumping actions have proliferated during the past few years to levels reached at the beginning of the decade and are used by a growing number of countries

Indeed, one trade policy instrument which has received much attention, is anti-dumping actions, since their use as disguised protection is feared.[11] Anti-dumping initiations have proliferated during the past few years to levels reached at the beginning of the decade and are used by a growing number of countries. In the late 1980s fewer than 10 countries (treating the EU as a bloc) – which were all OECD members – launched anti-dumping procedures. Now more than 20 countries, most of which are non-OECD members, regularly use them. Nonetheless, the majority of cases are still filed by the United States, the European Union, Australia and Canada (Table VIII.3); indeed these countries account for over three-quarters of the anti-dumping measures currently in force. Anti-dumping cases filed by OECD countries are concentrated among a small number of products including base metals (primarily steel), chemicals, machinery and electrical equipment and plastics.

Investigations span a much wider spectrum of countries. Over the past decade some 100 countries have been concerned by such measures, of which OECD countries account for roughly 40 per cent of the total. The most affected countries include China, the United States, Korea and Japan. The five Asian countries[12] struck by the turmoil in financial markets over the past 18 months and where current account adjustments have been most marked have not, however, been disproportionately hit by the rise in anti-dumping actions by OECD countries.

11. Anti-dumping and countervailing duties are permitted under the trade remedy laws of the WTO provided "material" injury from dumping can be established. Their purpose is twofold: *i)* to help local producers adjust to intensified competition from foreign trade and *ii)* to remove "unfair" competition by foreign producers. About one quarter of actions brought to the WTO result in the imposition of duties or price undertakings. Initiations of anti-dumping procedures, or intentions to start them, have frequently led to other arrangements outside the WTO, with foreign governments or firms, on "grey" area measures such as voluntary export restraints, exporter's consent to respect price minima, which replace final WTO determinations like definitive anti-dumping duties or price undertakings. Care, therefore, should be used in interpreting trends, levels and the composition of anti-dumping statistics.
12. These countries are Indonesia, Korea, Malaysia, the Philippines and Thailand.

Table VIII.3. **Use of anti-dumping actions**

Actions reported for the year ending 30 June

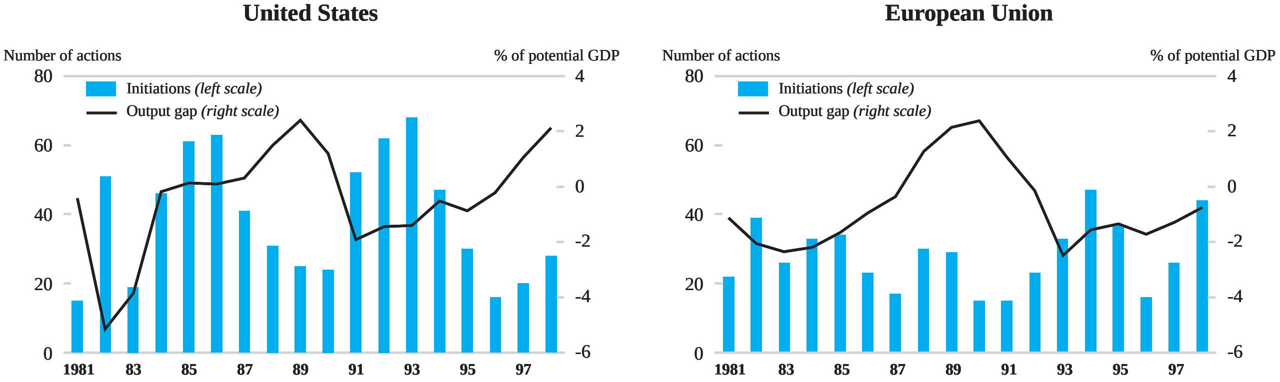
	1993	1996	1997	1998
European Union[a]	81	70	67	117
United States	178	46	57	60
Canada	83	24	19	25
Australia	106	11	30	65
Other OECD[b]	88	48	73	47
OECD Total[b]	536	199	246	314
of which: Against Asia-5[c]	71	38	34	46
Total Non-OECD[b]	21	145	196	212
of which: Against Asia-5[c]	2	13	24	31

a) Before 1995, Austria, Sweden and Finland were not members of the European Union, but are included in the EU calculations for 1993 to maintain consistency over time.
b) Of those countries reporting.
c) Asia-5 comprises Korea, Indonesia, Thailand, Malaysia and the Philippines.
Source: WTO, *Report of the Committee on Anti-dumping Practices*, various years.

In the major OECD areas anti-dumping actions appear to be related to cyclical economic conditions and movements in world prices

Over a longer time period, recourse to anti-dumping actions, to some extent, appears to be related to cyclical economic conditions. The number of anti-dumping investigations initiated by the European Union and the United States has tended to increase during periods of high spare capacity – proxied by the output gap – and fall when capacity is tight (Figure VIII.3). Such a relationship, however, is difficult to reconcile with activity developments in the US economy over the past four years or so. While the output gap for the United States is estimated to have closed in 1996 and excess demand to have risen above 2 per cent by 1998, the number of anti-dumping initiations almost doubled over the same period from 16 to 28 actions. This increase, however, is almost entirely associated with a greater number of actions brought against steel products, an area where considerable spare capacity in the United States remains. There is also fragmented evidence of an inverse pattern between world prices – which themselves are related to capacity developments – and anti-dumping actions. In the first quarter of 1999, the World Bank's steel product price index was 20 per cent below its year earlier level and reached its lowest point in over 20 years. This drop has coincided

Figure VIII.3. **Anti-dumping initiations and economic slack**[1]



1. Anti-dumping initiations over 12 months to mid-year.

with renewed allegations of dumping, and in the United States, where 40 per cent of all anti-dumping measures are imposed on steel products, legislation for the introduction of steel quotas has been proposed, and the Administration is discussing "voluntary" export restraints with Russia and Korea. Prices of other commodities on which anti-dumping measures are frequent, such as woodpulp and urea (fertiliser) have also dropped, and by similar magnitudes over the past year.

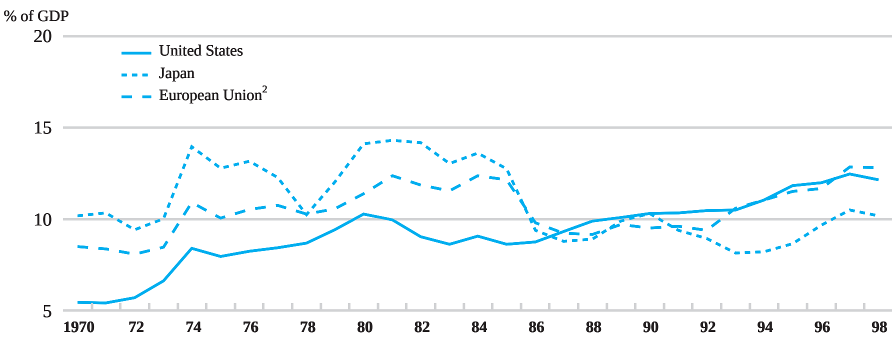
In summary, levels of assistance afforded to domestic industries through protectionist trade policies have gradually fallen over the past 40 years. The average level of tariffs and the incidence of use of NTBs in most OECD countries for which data is available reached relatively low levels by the mid-1990s. There are concerns, however that recourse to some trade policy instruments are being mis-used and that these instances are on the rise. But it is difficult to advance conclusive evidence.

Evidence on external openness to trade

Trade liberalisation has led to an increase in the share of trade in OECD GDP, although not in each major region

Against the background of a general decline in direct trade restrictions, market openness has increased significantly over the past five decades. The volume of world merchandise trade is today about sixteen times what it was in 1950 and has almost tripled as a share of global GDP. Services trade has also grown at a rapid pace, becoming one of the fastest growing components of world trade since the mid-1980s. However, the evolution of openness – calculated as the average share of imports and exports of goods and services in GDP – has differed visibly across the major OECD economic areas (Figure VIII.4). Since 1970, trade openness has increased in the European Union and especially in the United States. In Japan, after rising in the 1970s and early 1980s, it fell back to its 1970 level in the mid-1980s and has been quite stable since then.[13]

Figure VIII.4. **Trade openness**[1]



1. Average share of imports and exports of goods and services as a per cent of nominal GDP.
2. Net of intra-EU trade.

13. In Japan, and to a lesser extent the European Union, movements in this measure of trade openness are influenced by changes in world commodity prices. For example, the threefold rise in the price of oil in the early 1970s and Japan's high dependency on imported energy was a major factor behind the increase in trade openness for Japan. The indicator is also influenced by the magnitude of an economy, with an inverse relationship between the size of the domestic economy and the level of trade openness.

Table VIII.4. **Import penetration rates for manufacturing industries**[a]

Per cent

	1970	1975	1980	1985	1990	1995	1996
United States	5.3	6.7	8.9	12.3	14.5	17.9	18.2
Japan	4.0	4.2	5.5	5.4	6.8	7.7	9.1
European Union[b]	7.2	8.9	10.3	11.3	10.7	12.7	12.9
Canada	25.2	28.1	30.6	35.7	37.3	49.7	49.4
Australia	16.2	17.9	21.5	26.4	24.2	31.9	31.4
Iceland	..	64.1	53.8	52.7	55.2	56.7	..
Korea	..	..	..	..	..	27.0	26.3
Mexico	..	..	..	..	15.7	39.1	40.2
New Zealand	32.4	32.0	35.5	37.8	36.2	39.9	..
Norway	39.8	39.6	38.7	42.6	43.4	43.8	45.8

a) Import penetration is defined as the ratio of manufacturing imports to apparent consumption of manufactured goods (domestic production minus exports plus imports). A low penetration rate does not necessarily imply import barriers. It may reflect greater productivity or price competitiveness on the part of national firms.
b) Net of intra-EU trade. Excludes Austria, Belgium, Ireland and Luxembourg.
Source: OECD, STAN Database.

Other indicators of market openness also vary across countries, sectors and by the technology content of traded manufactured goods

The share of trade in output, however, is but one indicator of the extent to which OECD markets have become more open. Other measures, such as the import penetration rate and the intensity of exposure to foreign competition for manufacturing industries provide additional information (Tables VIII.4 and VIII.5). They show wide variations across countries, sectors and by the technology content of traded manufactured goods. Since 1970, the import penetration rate in all three major OECD regions has doubled, or more than doubled, although in Japan the level is about half the size of what it is in the other two major regions. Exposure to foreign competition is also lower in Japan than elsewhere, albeit less strikingly so. Based on disaggregated import penetration rates, the following industries: motor vehicles, computers, office machinery and communication equipment and semiconductors are more exposed to import competition than for example, food, beverages and tobacco, non-metallic mineral products and

Table VIII.5. **Exposure to foreign competition for manufacturing industries**[a]

Per cent

	1970	1975	1980	1985	1990	1995	1996
United States	10.6	14.2	17.5	18.9	24.2	29.2	29.7
Japan	12.1	15.1	16.7	19.0	18.0	19.4	21.2
European Union[b]	15.9	20.2	22.0	24.6	20.9	26.6	27.6
Canada	45.1	44.7	51.4	58.4	59.8	74.9	74.8
Australia	25.9	29.0	34.2	37.2	34.8	45.5	45.1
Iceland	..	78.4	77.4	75.0	77.7	81.0	..
Korea	..	..	..	..	..	48.0	46.1
Mexico	..	..	..	..	24.2	63.3	63.7
New Zealand	53.7	48.3	58.4	59.2	57.3	61.5	..
Norway	58.5	58.9	57.1	61.4	63.4	64.0	66.2

a) The exposure to foreign competition indicator (E) is a synthetic measure which takes into account both the export orientation of an industry and its import penetration. The indicator is based on the notion that the share of output exported (export ratio) is fully exposed and that the exposure of the share sold on the domestic market is proportional to the import penetration rate on that market. It is defined as $E = X/Y + (1 - X/Y) * M/D$, where Y is output, M imports, X exports and D domestic demand.
b) Net of intra-EU trade. Excludes Austria, Belgium, Ireland and Luxembourg.
Source: OECD, STAN Database.

basic metals. Indeed, import penetration appears to have increased most in the high and medium technology sectors. This may reflect the trend towards increased intra-firm and intra-industry trade,[14] and given Japan's low share of intra-industry trade it may at least partly explain its low import penetration rate.

The role of internal measures on market openness

A country's overall openness to trade also depends on policies that restrict market entry by foreign firms

While there has been a general trend towards opening markets to international trade, it is most likely that future progress in this field will be achieved through other means than changes in trade policy regimes. The degree of a country's overall openness also depends on domestic policies that restrict entry into national markets. Such policies include competition policies and investment barriers which favour local national producers or limit the ability of foreign firms to establish local production or distribution facilities, discriminatory industrial subsidies, tax concessions, government procurement practices and restrictions on land ownership or use. In many countries, policy reforms in certain of these areas could most certainly contribute to increased market openness.

Restrictions on foreign direct investment have declined and inflows have increased in manufacturing in all countries, except Japan

In nearly all OECD countries restrictions on outward and inward direct investment in manufacturing have been substantially reduced over the past decade. Bureaucratic prior authorisation arrangements have mostly been replaced with simple notification procedures required for administrative and statistical purposes. The easier regulatory framework governing foreign direct investment (FDI) in manufacturing has favoured increased FDI flows and contributed to the globalisation of production systems.[15] As in the case of trade, however, the realised degree of openness to foreign investment varies significantly across countries. While for manufacturing, the stock of foreign investment abroad by US and Japanese firms is broadly similar as a per cent of GDP, at about 3½ per cent, and some 8 per cent for companies based in the European Union,[16] the stock of inward investment is much lower in Japan than in the other two regions, at just under ½ per cent. This compares with 3½ per cent and 4 per cent in the United States and the European Union, respectively. This disparity in FDI inflows is also evidenced in the share of foreign affiliates in Japanese manufacturing production which is between six to ten times lower than in any other major seven country and has declined since the early 1980s (Table VIII.6).

14. The share of trade by multinational companies in the OECD countries for which data are available, is about 50 per cent, of which intra-firm trade accounts for about 40 per cent. For an analysis on the role of multinationals in trade patterns see OECD (1996*a*). This is a factor behind the high share of intra-industry trade in the OECD total which is around 60 per cent in the EU and the United States. The proportion in Japan is lower at 40 per cent, albeit on a rising trend since imports and exports are more diversified between investment, intermediate and consumer goods.

15. Increasing FDI by multinational companies has influenced international trade patterns, though in ways that are not always straightforward. Empirical evidence on the impact of foreign investment on exports and imports remains largely inconclusive, the effects varying significantly between countries and the time period under consideration. For more details, see Barrell and Pain (1997), Barry and Bradley (1997) and Blomström *et al.* (1997). In the case of Japan, a MITI study on the impact of Japanese overseas activities in manufacturing on the balance of trade finds a positive, but declining, impact of foreign affiliates on Japan's trade surplus.

16. Includes intra-EU area stocks of foreign direct investment. Belgium, Denmark, Greece, Ireland, Luxembourg, Portugal and Spain are not included due to lack of data.

Table VIII.6. **Share of foreign affiliates in manufacturing production** [a]

Per cent

Host country	1981	1988	1995
United States [b]	7.0	10.6	15.7
Japan [b, c, d, e]	4.7	2.4	2.5
Germany [b]	16.7	13.1	12.8
France [b, d]	29.4	28.4	31.0
Italy [b, d, f]	16.9	21.3	24.6
United Kingdom	19.3	20.2	30.5
Canada [g]	..	27.3	31.2
Finland [h]	2.6	3.3	10.1
Ireland [i]	46.1	55.1	65.2
Mexico [d]	..	18.9	..
Netherlands [d, h, i]	42.5	40.7	42.8
Norway	10.5	10.9	19.5
Sweden [b]	8.3	14.9	21.6
Turkey [i]	..	6.3	12.1

a) The criterion used for the collection of data on foreign affiliates is the effective exercise of control over company decisions. For statistical purposes, this is defined as an equity holding of over 50 per cent in a company.
b) Turnover instead of production
c) Data for 1980 instead of 1981.
d) Data for 1989 instead of 1988.
e) Data for 1992 instead of 1995.
f) Data for 1993 instead of 1995.
g) Data for total industry are used instead of manufacturing industry.
h) Turnover instead of production in 1995.
i) Data for 1983 instead of 1981.
Source: OECD, Activities of Foreign Affiliates and STAN Databases.

In most countries many restrictions remain on FDI inflows in the service sector

An increasing proportion of FDI flows now goes to services and about half the stock of outward FDI by OECD countries is in services. These investments are mostly concentrated in the finance, insurance and non-financial business sectors. Many OECD countries have filed reservations on the liberalisation of foreign investment under the OECD Codes of Liberalisation of Capital Movements. These are concentrated in the services area, especially in transportation, banking and financial intermediation, communications and professional and business related services. The actual importance of these reservations is hard to evaluate, given that they may cover a wide range of situations which are likely to differ across countries. Nevertheless, this points to potentially important barriers to market access by foreign companies, and hence some scope for further liberalisation of foreign investment regimes.

Based on synthetic indicators of market access, the United States and the EU appear more open than Japan

Synthetic indicators of barriers to international trade and investment have been constructed by the OECD in the context of its work on Regulatory Reform.[17] As expected from the analysis presented in the first half of this chapter, Japan displays the largest degree of openness on explicit barriers, but an overall summary indicator, which also takes into account implicit barriers, such as national discrimination implied by regulatory and administrative procedures, indicates that, when implicit barriers are also considered, the United States and most EU countries are more open than Japan.[18]

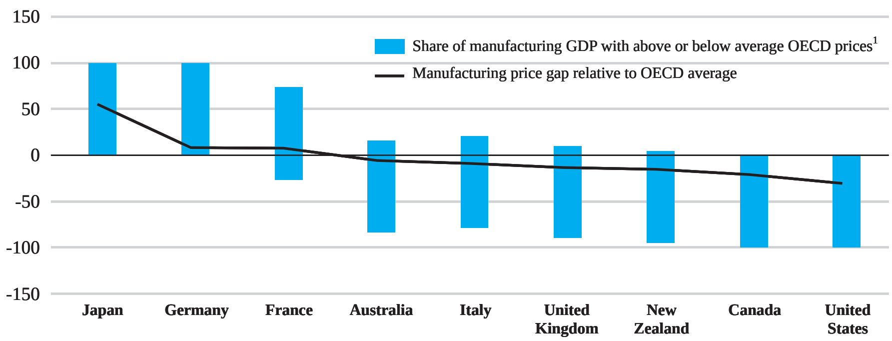
17. A summary indicator has been derived by conducting factor analysis on five first-level indicators: *i)* legal and administrative barriers to foreign ownership of businesses, *ii)* the existence of explicit provisions discriminating against business activity on the basis of nationality, *iii)* nationality discrimination implied by regulatory and administrative procedures, *iv)* average trade tariffs and *v)* the incidence of NTBs. For more details, see Nicoletti and Scarpetta (forthcoming).

Price levels are much lower in the United States and much higher in Japan than the OECD average

To some extent, cross-country comparisons of price levels for traded goods may also provide some insight as to whether domestic competition policies limit market access. Countries where prices appear to be consistently lower than in trading partners may be considered as being more open than countries with relatively higher prices. Figure VIII.5 compares price performance in the manufacturing sector for the major seven countries. This comparison is based on levels of PPPs for nine industries. The United States and Canada stand out as having particularly low manufacturing prices, while Japan has particularly high prices in all manufacturing sub-sectors. Conducting the same comparison on prices of three service industries most exposed to foreign competition (distribution, transportation and communication and business services) shows the same hierarchy in price levels.

Figure VIII.5. **Comparative price performance in manufacturing**

1993 sectoral PPPs, OECD = 100



1. Contribution of industries with above or below average OECD prices.

Another indicator of potential barriers to competition is the level of mark-ups earned by firms in the traded goods sector. Work carried out by the OECD suggests that mark-up ratios in the manufacturing sector estimated up to the early 1990s were highest for Japan, Germany, the Netherlands and Finland, and lowest for the United States and the United Kingdom (see Oliveira Martins and Scarpetta, 1999). Tentative estimates for selected service industries (wholesale and retail trade and transport and communication) display wider cross-country variation than for manufacturing and show that mark-ups are highest in most of the EU countries and lowest in the United States, Canada and Japan.

18. In Japan, private practices, such as cultural differences in the way business is done may also play a role, limiting the size of FDI inflows. For further details see Lawrence (1993).

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