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Before EMU starts: economic policy stimulates recovery in Europe

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Before EMU Starts: Economic Policy Stimulates Recovery in Europe

by Joachim Scheide and Ralph Solveen

CONTENTS

- The decision on EMU strongly affects the course of monetary and fiscal policies in 1997 and especially in 1998. We assume that the monetary union will start in January 1, 1999 with a sizable number of participating countries. Once the decision on the members is made in the spring of 1998, any differences between short-term interest rates in the participating countries can be eliminated. Currently, money market rates in Italy, in Spain and in Portugal are substantially higher than, for example, in Germany. These high rates will be reduced quickly. Monetary policy will thus become more expansionary not only in these countries but also in Western Europe as a whole. It is not likely that the central banks in countries with relatively low interest rates will tighten their policy because such moves would be resisted in the light of the severe unemployment in Europe.
- While fiscal policy is concerned with reducing budget deficits this year in order to qualify for EMU, the course will change in 1998. Governments can afford to loosen this policy stance because the actual deficits in 1998 are not decisive for the entry into the monetary union. Also, the stability pact will become effective only from 1999 onwards, so there will not be any sanctions even if budget deficits are excessive in 1998. Therefore, further substantial cuts in expenditures or increases in revenues are not likely. In a few countries, even tax cuts were announced for 1998, for example, in France and in Germany. In summary, fiscal policy will have an expansionary effect on economic activity in 1998.
- The upswing in Western Europe will continue in 1997 and in 1998. Export conditions are favorable since the world economy will expand at a healthy pace. The increase in internal demand will accelerate because of the impulses from economic policy. In practically all countries, capacity utilization will reach or even surpass its normal level in the course of next year. As central banks will be expansionary in the fourth consecutive year, the phase of disinflation in Europe is coming to an end. Inflation will go up somewhat in 1998 and more so in the following year. Because of the deteriorating outlook for inflation, European currencies will further devalue against the US dollar and long-term interest rates will increase considerably. All these developments are a burden for the start of EMU. The future European Central Bank will have to follow a restrictive course if it wants to demonstrate its commitment to price level stability.
- The Dublin resolution for a "stability pact" is intended to limit budget deficits after EMU will have started. However, the agreement is not sufficient to reach this target for several reasons: First, the governments themselves will decide on sanctions; this raises the possibility that political factors play a major role and that opportunistic behavior will dominate. Second, the sanction mechanism has no bite because too much time goes by until sanctions are implemented. Furthermore, in order to avoid the payment of a fine it is sufficient to reduce the budget deficit to a level of 3 percent of GDP once in five years.
- A strict sanction mechanism is probably objected by several governments because they fear that it would prevent the automatic stabilizers from working appropriately, so that, e.g., fiscal policy would have to be restrictive in a recession. However, this fear is not warranted because the cyclical budget deficits in all EU countries have not been very large during the last fifteen years. In order to avoid excessive deficits in the future, it would be necessary to reduce the structural deficits considerably, in some cases even to zero. This is an ambitious target, but it is precisely what was decided upon in Dublin. So far, however, this is merely a promise because in practically no major country efforts are made to balance the budget by 1999 — a fact which reduces the credibility of the Dublin resolution even more.

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1. Economic Situation Improved in 1996

Since the spring of 1996, the European economies have expanded at a healthy pace. After having overcome the previous weakness, which had lasted almost a year, real GDP increased at an annual rate of more than 2 percent. For the year as a whole, the increase amounted to only 1.6 percent due to the weak start. The recovery was supported by the rapid growth in less developed and in newly industrialized countries. Also, the demand from North America picked up markedly in the wake of a renewed strength of the upturn mainly in the United States; furthermore, the devaluation of the European currencies vis-à-vis the US dollar raised the competitiveness of exporters on world markets. Domestic demand in Europe was stimulated by an expansionary monetary policy. Key interest rates were reduced further and have reached a very low level; money growth also accelerated in most countries. Another factor which led to an improvement of the business climate was that the decline of long-term interest rates continued after a temporary increase until the early summer of 1996.

Inflation remained moderate. On average for Western Europe, consumer prices increased by a little more than 2 percent over the past 12 months. In a few countries, the stability of the

price level was practically achieved. In contrast to this favorable development, the situation on labor markets hardly improved at all; the rate of unemployment for Western Europe stagnated at 11 percent. Some countries even experienced record highs for the level of unemployment. There are, however, exceptions from this unfavorable trend. Unemployment rates continued to decline in countries where labor markets have been deregulated, in some cases, however, this was mainly due to active labor market policies.

The development of economic activity and inflation in the near future will largely be influenced by the expectations as well as the outcome of the discussions concerning the European Monetary Union (EMU). No decisions have been made with regard to the starting date, the countries participating from the beginning, or the method of defining the conversion rates for the currencies. Therefore, assumptions have to be made for the forecast which will be explained in the following two sections on monetary and on fiscal policy. Because of the uncertainties in connection with EMU, the forecast of the economic development in Western Europe currently bears a greater risk than usual.

2. On the Road to EMU: Monetary Policy Will Become More Expansionary

In most European countries, central banks have loosened their policy since 1995. Short-term interest rates have declined considerably, and money growth has accelerated as well. This expansionary course led to the turnaround of economic activity in Europe which materialized during the first half of 1996. During 1997 and 1998, the upcoming decision on EMU will have a strong impact on monetary policy. Obviously, the governments of EU member states intend to stick to January 1, 1999 as the starting date. We therefore do not assume a postponement of

EMU. The decision on the participating countries and the conversion rates for the exchange rates will change the conditions for the course of monetary policy for individual countries but also for Europe as a whole.

It is possible that there will be a small monetary union with countries of the so-called DM bloc, i.e. Germany, France, the Netherlands, Belgium, Austria and Luxembourg. Such a decision could have negative consequences for those countries that are currently hoping they will participate as well. For example, Italy,

Spain and Portugal might then experience a negative rating on financial markets because doubts could arise concerning their stabilization policies. Their currencies, which have gained strength recently would come under pressure, and long-term interest rates, which have fallen considerably since the spring of 1995, would increase markedly. The central banks in these countries would probably raise key interest rates in order to prevent such developments and to gain credibility on international markets for their stabilization efforts. They would have to try to prevent a depreciation of their currencies and try to keep the exchange rate stable because this is a necessary condition for entering the monetary union in the not too distant future. Such restrictions of monetary policy would dampen economic activity in these countries considerably and would also — via a reduced demand for imports — have a negative impact on the other European countries.

For the present, however, we assume that EMU will start with a large number of countries. While the participation of Denmark, Greece, Sweden and the United Kingdom may be unlikely for various reasons, the other countries will most likely participate from the beginning if they wish so.¹ We believe that the decision which is due in the spring of 1998 will be made also in favor of those countries which will not have reached all the reference values of the Maastricht criteria. These criteria will probably not be strictly applied — contrary to the often-heard promise by governments and central banks. If they were, a large number of countries could already be excluded now because they will definitely miss at least one of the criteria. For example, it is currently clear that five countries do not meet the requirement of exchange rate stability because they are not participating in the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) or have joined it too late. The Maastricht Treaty is — contrary to the definition of other criteria — very precise in this respect; Italy and Finland only joined the ERM in the fall of 1996 and not, as required, two years before the decision on EMU is made, i.e. two years before the spring of 1998. As they

have not been excluded so far, it is likely that the governments leave this issue open for a mainly political decision later on. Apart from this, the development on financial markets indicates that market participants believe in a soft interpretation of the criteria. The differential between long-term interest rates in the individual countries and in Germany has come down considerably (Lapp et al. 1996); the convergence has been greater than the decline of inflation differentials.

The decision in the spring of 1998 will be the beginning of a unified monetary policy in the European Union. With the start of EMU, there will, by definition, be no differences in money market rates between the participating economies. Existing differentials can, however, already be eliminated once the group of countries is determined. This has substantial consequences for monetary policy in several countries (see the extensive analysis by Scheide and Solveen 1997). Currently, short-term interest rates in Italy are about four percentage points higher than in Germany; for Spain and Portugal, the differential amounts to some three percentage points (Table 1). Countries with relatively high rates probably have a great interest to reduce these rates immediately: First of all, they have an incentive to do so because they can expect that the positive impact on production and employment will come about quickly — and will thus be favorable for the situation in their countries —, while the inflationary effect usually takes longer to materialize and will have to be borne mainly by all the EMU countries in 1999 or thereafter. In other words: The short-term trade-off between unemployment and inflation improves. Secondly, there is no risk that such a loosening of monetary policy will put the exchange rate under pressure. Given that the decision on conversion rates will have been made in the spring of 1998 as well, there is no profit opportunity for speculators if the announcement about the method of conversion is credible.² With the substantial reduction of short-term interest rates in a fairly large number of countries, monetary policy will be more expansionary not only there but also in the European Union as a whole.

Table 1 — Three-Month Money Market Rates in the EU Countries (end of February, 1997)

Country	Interest rate (%)
Germany	3.2
France	3.3
Italy	7.3
United Kingdom	6.2
Spain	6.1
Netherlands	3.2
Belgium	3.3
Sweden	4.2
Austria	3.2
Denmark	3.6
Finland	3.1
Portugal	6.3
Greece	11.7
Ireland	5.7
Luxembourg	3.3

We do not expect that the central banks in countries with already low short-term interest rates will substantially tighten monetary policy at the same time. A slight increase of key interest rates is likely in the course of 1998; however, this would only imply that the rate of monetary expansion does not accelerate considerably. To sum up: The interest rate moves

in our forecast imply that monetary policy in the European Union will become more expansionary.³

This means that in 1998 the central banks' policy will be stimulative for the fourth year in a row. The additional loosening will give another boost to the recovery. But it also implies a risk for price level stability: There will be a slight acceleration of inflation in 1998 and a more pronounced increase in 1999. This would raise the skepticism not only in the public but also on financial markets concerning the stability of the future European currency. We therefore expect an increase of long-term interest rates which reflect inflationary expectations and a further depreciation of the European currencies, in particular against the US dollar. All these developments place a burden on the start of EMU. The European Central Bank will have to pursue a restrictive course right from the beginning if it wants to demonstrate its commitment to price level stability. There is a substantial risk, therefore, that EMU will be viewed as a new regime in which interest rates are raised and the economy slows down.

3. Fiscal Policy Will Loosen Somewhat in 1998

In 1997, governments intend to meet the reference values stated in the Maastricht Treaty. In practically each country of the European Union, measures are taken to reduce the budget deficits. In most cases, indirect taxes are raised; the same is true for social security contributions in order to limit the high deficits of those budgets. On the expenditure side, increases in social expenditures are cut and public investment projects are postponed. In 1997, fiscal policy will therefore dampen economic activity. It has to be kept in mind, however, that the reduction of the structural deficits overstates the restrictive course somewhat because it is in part also due to special circumstances which do not affect the business cycle. Among these is the

decline of interest rates which lowers the burden of servicing the debt.

In the coming year, fiscal policy will be loosened somewhat. The decision on EMU will be made on the basis of the actual data for the year 1997, so the figures for 1998 will be less important. Furthermore, the stability pact will be applied only from 1999 onwards, which means that there will not be any sanctions if budget deficits exceed the reference value in 1998. Some relief can also be expected from stronger economic activity, i.e. the cyclical component of the deficit will decline. Therefore, further substantial cuts in expenditures or increases in revenues are not likely. In some cases even tax cuts were announced for 1998,

for example, in France and in Germany. Investment projects which were postponed in order to reduce the deficits will now be realized. In

summary, therefore, fiscal policy will have an — albeit small — expansionary effect on economic activity next year.

4. Upturn Gains Momentum

For the countries of the European Union, exports were the main driving force of the recovery last year (Figure 1). But also domestic demand picked up considerably compared to the pace in 1995. The reduction of inventories came to a halt; in the latter part of 1996, there was even a positive impact of stockbuilding on overall production. But also fixed investment showed some revival; the surge during the second quarter was, however, to a large extent a reaction to the depressed first quarter when construction was hit hard by the strong winter. Private consumption stayed on a very moderate path. In some countries, tax reductions or special subsidies stimulated expenditures of private households somewhat. Throughout the year, however, the restrictive measures of fiscal policy together with the bad situation on labor markets dampened consumption considerably.

In general, the performance of business investment has not been bad in the current cycle. Compared with the recovery in the early 1980s, the development of investment in machinery and equipment has even been more favorable in a number of countries (Figure 2).⁴ In some cases, the current level of this aggregate is about 20 to 25 percent higher than in the beginning of the recovery in 1992 or in 1993. What seems remarkable, however, is the weakness in Germany; currently, the level of investment in machinery and equipment reaches roughly the level prevailing at the beginning of 1993. While this shows some parallels with the situation in Japan — and may thus reflect a structural weakness of the economy —, it must be kept in mind that there was an investment boom in the wake of German unification. In the early 1990s, investment became extremely profitable due to heavy subsidization by the government; the investment ratio reached a

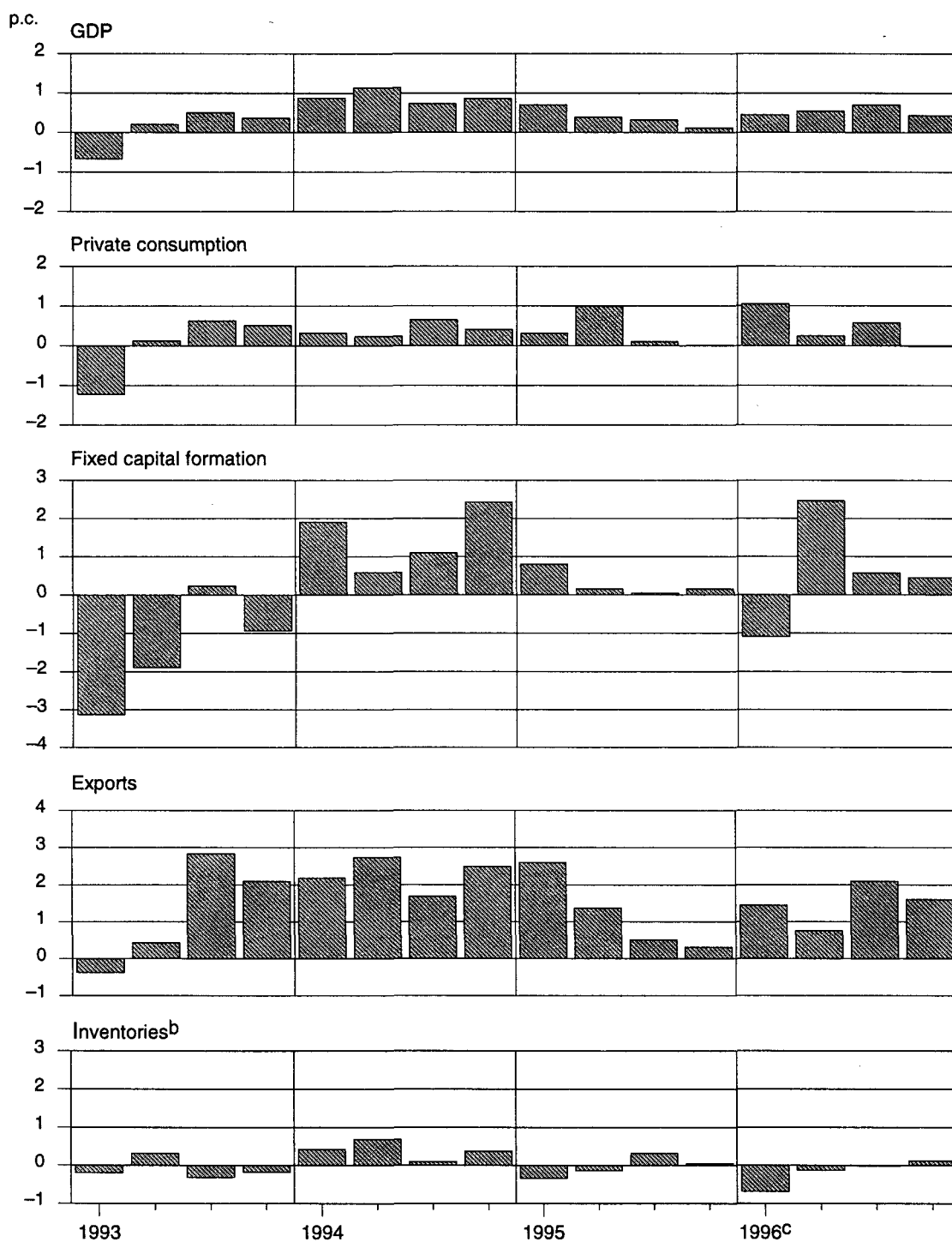
very high level and has more or less normalized since then (Boss et al. 1997).

The recovery in Europe will continue in 1997 and in 1998 (Table 2). The conditions set by economic policy are favorable: Impulses from monetary policy will remain strong throughout the forecast horizon. Fiscal policy is going to shift to a slightly expansionary course next year. The currencies will probably devalue further. Wage settlements will be particularly moderate in 1997 because of the poor labor market situation; while wages may increase a little faster next year, they will still lag behind productivity growth. This will allow for a further improvement of firms' profits and thus have a stimulative impact on investment.

During the first half of 1997, the expansion of real GDP will accelerate substantially because firms will increase their stocks in anticipation of a stronger growth of demand. While some moderation can be expected afterwards, the rate of increase will continue to be higher than the growth rate of potential output, which is roughly 2 percent for Western Europe as a whole. On average, real GDP will rise by 2.5 percent in 1997 and by about 3 percent in 1998.

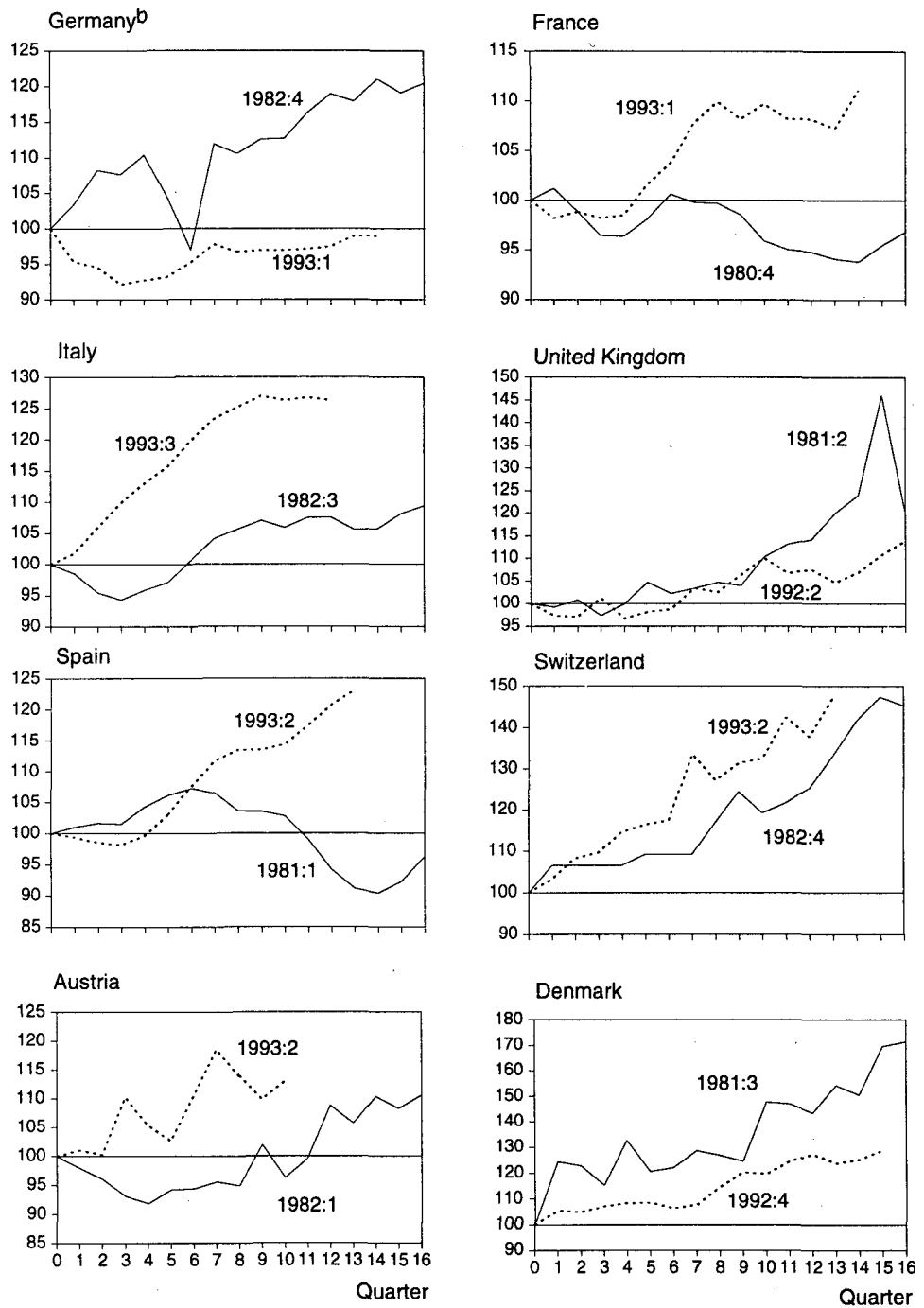
The driving force of the upswing will be private investment. The increase in capacity utilization will imply more capital widening. Furthermore, construction will benefit from the realization of public investment projects which were previously postponed.

Private consumption will expand only slowly in the near future. Employment will recover only later in 1997. This implies — together with the restrictive stance of fiscal policy and moderate wage increases — that real disposable income will rise only slowly. In the course of next year, however, private households are like-

Figure 1 — Real GDP and Its Components in the EU, 1993–1996^a

^aChange over previous quarter. — ^bContribution to GDP growth. — ^cPartly estimated.

Figure 2 — Real Investment in Machinery and Equipment in Selected European Countries in Different Cycles^a



^aIndex = 100 for the quarter when real GDP reached the trough in the cycles analyzed. The trough-quarters are used to label the curves which show the investment path in the subsequent quarters. — ^bFor the cycle 1982:4, data refer to western Germany.

Table 2 — Real Gross Domestic Product and Consumer Prices, 1995–1998 (percentage change over previous year)

	Weights (1995 GDP)	Real GDP				Consumer prices			
		1995	1996 ^a	1997 ^b	1998 ^b	1995	1996	1997 ^b	1998 ^b
Germany	27.2	1.9	1.4	2.5	3.0	1.9	1.5	1.7	2.2
France	17.2	2.2	1.3	2.6	2.9	1.8	2.0	1.9	2.2
United Kingdom	12.3	2.5	2.3	2.7	2.8	3.4	2.4	3.0	3.5
Italy	12.3	3.0	0.8	1.7	2.9	5.4	3.9	2.3	3.0
Spain	6.3	2.8	2.2	3.0	3.0	4.7	3.6	2.5	3.0
Netherlands	4.4	2.1	2.7	3.0	3.0	1.9	2.1	2.0	2.5
Belgium	3.1	1.9	2.0	2.5	3.0	1.5	2.1	2.5	2.5
Austria	2.7	1.8	1.0	2.5	2.5	2.2	1.8	2.5	2.5
Sweden	2.7	3.6	1.5	3.0	3.0	2.5	0.5	1.5	2.0
Denmark	1.9	2.7	2.5	3.5	3.0	2.1	2.1	2.5	3.0
Finland	1.5	4.5	3.2	3.0	3.0	1.0	0.6	1.5	2.5
Greece	1.2	2.0	2.5	3.0	3.0	9.3	8.5	7.0	6.0
Portugal	1.2	1.8	3.0	3.0	3.0	4.1	3.2	3.0	3.0
Ireland	0.7	7.7	6.0	5.0	5.0	2.6	1.7	2.0	3.0
Luxembourg	0.2	3.7	2.0	3.0	3.0	1.9	1.4	1.5	2.0
EU countries	94.9	2.4	1.6	2.6	3.0	2.8	2.3	2.2	2.6
Switzerland	3.4	0.1	-0.5	1.5	2.5	1.8	0.8	1.0	1.5
Norway	1.7	3.3	5.0	4.0	3.0	2.5	1.3	2.0	3.0
Western Europe	100.0	2.3	1.6	2.6	2.9	2.8	2.2	2.2	2.6

^aPartly estimated. — ^bForecast.

ly to increase expenditures a little faster. On the one hand, there will be no fiscal restraint, and on the other hand, the employment situation will improve due to the strong upswing of economic activity.

Apart from the favorable conditions for domestic demand, exports will expand strongly. The growth of the world economy continues to be high, and Western Europe will — more than other regions — benefit from the improvement in Central and Eastern Europe. Furthermore, we expect the devaluation of European currencies against the US dollar to continue, thus strengthening the competitive position in world markets. Furthermore, we do not see a risk of overheating in the United States. It is true that real wages have increased there somewhat recently but still at a lower rate than productivity. This does not suggest that cost pressure is mounting which would lead to more inflation. Most monetary indicators suggest that the Fed has been on a more or less neutral course for the past two years: Real short-term interest rates are about as high as the historical average, so is

the differential between long-term and short-term interest rates; finally, monetary aggregates have been expanding at moderate rates. Therefore, there is also no risk that the Fed will tighten its policy substantially; any interest rate hike would be just symbolic to demonstrate its anti-inflationary commitment. The recovery in Japan is also likely to continue in spite of the fiscal tightening. Experience of other countries such as Canada shows that its negative impact on economic activity can be compensated by an expansionary monetary policy. This is the stance we expect from the Bank of Japan. To sum up: Our forecast implies a fairly synchronized upswing with similar rates of GDP growth for the three major regions of industrialized countries.

Unemployment in Europe will start to fall only during the second half of this year. In the near future, there are still productivity reserves which can be exploited without raising employment. In 1998, the unemployment rate will decline to an average of about 10 percent (Table 3).

Table 3 — Indicators for the Economic Situation in Western Europe, 1995–1998 (percentage change over previous year)

	1995	1996 ^a	1997 ^b	1998 ^b
Real GDP	2.3	1.6	2.6	2.9
Private consumption	1.8	1.8	1.5	2.5
Public consumption	1.1	1.2	0.5	0.5
Fixed capital formation	3.5	1.3	3.0	4.5
Machinery and equipment	5.2	2.3	4.5	7.5
Construction	0.5	-1.1	2.0	2.5
Inventories ^c	0.2	-0.2	0.4	0.2
Net exports ^c	0.3	0.3	0.4	0.2
Domestic demand	2.2	1.4	2.0	2.8
Consumer prices	2.8	2.2	2.2	2.6
Unemployment rate ^d	10.5	10.7	10.5	10.0

^aEstimated. — ^bForecast. — ^cContribution to GDP growth. — ^dNumber of unemployed persons as a percentage of the civilian labor force.

The outlook for inflation, however, is deteriorating. The phase of disinflation, which has lasted about six years, is coming to an end. While the expected loosening of monetary policy will not lead to a dramatic increase, in-

flation rates are likely to go up somewhat in the course of 1998 and more so in the following year. A negative impact will also arise from raw material prices, which are expected to increase more strongly.

5. Upswing in Germany Continues

In the course of 1996, economic activity in Germany increased considerably.⁵ The driving factor was the performance of exports because demand had picked up strongly in trading partner countries and German firms had gained competitiveness due to the depreciation of the D-mark. In contrast, domestic demand rose only sluggishly. Private consumption was negatively affected by the rise in unemployment. While investment in machinery and equipment showed some signs of revival, the construction boom came to an end: For the first time since 1985, it declined after previous year's level. During the winter months, the employment situation continued to worsen. The unemployment rate reached a new record high of 11.3 percent at the beginning of 1997. The inflation rate picked up recently due to a considerable rise in import prices; the year-over-year increase of the CPI amounted to 1.7 percent in February.

Recent indicators suggest that the pause in the recovery near the end of 1996 will be only

short-lived. The pickup of the business climate and the new order inflow point at an acceleration of the expansion in the near future. In fact, the underlying conditions for the business cycle are extremely favorable: Interest rates are very low, and foreign demand will most likely remain strong.

The Deutsche Bundesbank has left key interest rates unchanged for the past six months. We do not expect an increase in the course of this year: Inflation continues to be below 2 percent, and capacity utilization will reach its normal level only later this year; also, the appreciation of the US dollar is viewed mainly as a correction of the previous overshooting of the D-mark. In 1998, however, the situation will change somewhat. Output will be higher than normal, and inflation will be picking up slightly. Experience shows that the Bundesbank raised interest rates considerably in periods with a comparable development. However, we expect that the Bundesbank will raise key interest rates only slightly because of the special

institutional situation in Europe before EMU starts.

Another positive factor for the upswing is that wage moderation will continue. Unit labor costs will remain roughly constant in 1997 and will even decline slightly next year.

Fiscal policy will have a moderately restrictive effect on economic activity in 1997 due to the significant rise of social security contributions. This course will change next year when parts of the currently discussed tax reform — originally planned to be effective in 1999 — will be implemented. Income taxes will proba-

bly be reduced while indirect taxes may be raised. We expect the net effect to amount to a tax relief of about DM 13 billion, equivalent to almost 0.4 percent of nominal GDP.

Real GDP will pick up again this year. The annual rate of expansion will average some 3 percent until the end of 1998. While exports will remain strong, domestic expenditures will gain considerable momentum. In particular, the outlook for investment in machinery and equipment will improve significantly due to the strong increase in profits. Unemployment will start to decline in the second half of 1997.

6. Catching-up Process in Eastern Germany Stalls

In eastern Germany, the catching-up process has practically stopped. In 1996, real GDP increased only slightly faster than in the west (2.0 percent compared to 1.3 percent). A major factor was the end of the construction boom which had boosted production in previous years. Enormous efforts were made to rebuild or modernize the capital stock in the new Länder, so that residential and non-residential investment per capita was about 80 percent higher than in the old Länder. As the level of transfers from the west is no longer increasing, such a dynamic development cannot be sustained. Nevertheless, investment will continue

to be higher because the infrastructure still needs improvements and the number of apartments is still quite low compared to western standards.

There is still no upswing driven by endogenous forces. The weak spot is the lack of competitiveness in the manufacturing but also in the services sector. A major reason for this is that unit labor costs are still more than 30 percent higher than in western Germany (Table 4). This gap is likely to even widen in 1997. All in all, real GDP will increase at a lower rate than in the old federal states in both 1997 and 1998.

Table 4 — Indicators of the Catching-up Process in Eastern Germany, 1991–1998 (western Germany = 100)

	1991	1992	1993	1994	1995	1996	1997 ^a	1998 ^a
GDP ^b	31	39	46	51	53	54	53	54
Investment in machinery and equipment ^b	64	75	100	112
Residential construction ^b	44	63	82	116	137	145	137	128
Non-residential construction ^b	89	145	195	233	245	238	230	215
Labor productivity	29	41	50	53	54	55	54	54
Unit labor costs	160	149	136	134	135	133	135	136

^aForecast. — ^bPer capita values in current prices.

7. Expansion in France Accelerates

The recovery in France gained momentum in the second half of 1996. Due to the improved situation in main trading partner countries but also to the devaluation against the US dollar, exports rose faster than during the first half of the year. Investment activity also picked up after having practically stagnated since the beginning of 1995. For construction a stabilization could be observed after the previous decline. This was mainly due to the low level of interest rates and the improved sales expectations of firms. During the second half of 1996, private consumption was quite erratic. Obviously, the subsidization of purchases of new cars, which ended in September, led to the concentration of car sales during the third quarter; in the fourth quarter, the expected backlash could be observed. For the year as a whole, private consumption increased by about 2.5 percent.

Inflation remained at a low level. In February 1997, the year-over-year increase of consumer prices amounted to around 1.5 percent. The labor market situation deteriorated further in spite of the recovery. Especially in the construction sector, employment was reduced markedly. The rate of unemployment in the French economy increased to 12.7 percent at the beginning of this year.

The Banque de France has continued to pursue an expansionary course. Until recently, short-term interest rates have been reduced in small steps, and the rate of monetary expansion (M1) has accelerated. For the rest of 1997 and for next year, we do not expect a major change in the policy stance of the central bank. Further reductions in short-term interest rates are not likely as they reached the level prevailing in Germany. In the course of 1998, key rates will probably be raised moderately more or less in line with the respective moves by the Deutsche Bundesbank. This, however, does not imply a change in the policy stance.

Fiscal policy has continued to bring the budget deficit in order to meet the Maastricht criteria. For 1997, expenditures are fixed at the level in the previous year; in real terms, this is equivalent to a reduction of about 1.5 percent. On the revenue side, marginal income tax rates were reduced; however, the effect was more or less compensated by a broadening of the tax base for the income tax and for social security contributions on the one hand and an increase of various sales taxes on the other. In the current year, the overall impact of fiscal policy will be restrictive. This will change, however, in 1998 when — as it was announced — taxes will be reduced. Therefore, fiscal policy will be moderately expansionary next year.

The recovery will gain more momentum in the course of 1997. Investment will increase markedly, especially in machinery and equipment, due to the low level of interest rates, the increase in capacity utilization and favorable profit expectations. Also, overall production will be pushed by higher stockbuilding; last year, inventories were reduced by the firms. While private consumption will rise only moderately in 1997, a stronger increase can be expected for next year due to the improvement of the employment situation and the positive effects from fiscal policy. Exports will be stimulated by the rapid expansion of economic activity abroad and the improved price competitiveness of French firms on world markets. Real GDP will increase by a little more than 2.5 percent in 1997 and by almost 3 percent next year.

Inflation will remain moderate in the near future. In the course of 1998, however, it will accelerate due to the strong recovery of the French economy; on average, however, the increase of the CPI will only be slightly higher than this year.

8. Strong Domestic Demand in the United Kingdom

The expansion of economic activity in the United Kingdom accelerated considerably in the second half of 1996. Private consumption was particularly strong for several reasons: Real disposable income increased substantially due to the good performance of employment; taxes and contributions were not raised as in previous years; and finally, mortgage rates continued to decline so that the debt burden of private households who have mortgages with variable interest rates eased further.

Investment activity also picked up strongly. This was true throughout the year for machinery and equipment. The main positive factors were the improved profit expectations and the low level of interest rates. The latter also contributed to the increase in construction, which could be observed during the second half of 1996. Also, the increase of the prices for real estate was a positive factor. Exports continued to rise at a fairly rapid pace; the expansion of the deliveries to countries in Western Europe even accelerated considerably.

The employment situation continued to improve. Early this year, the unemployment rate dropped to less than 6.5 percent while it amounted to 8 percent one year ago. Inflation has accelerated somewhat since the fall of 1996. In January, the year-over-year increase was 2.8 percent; if mortgage rates are excluded, the rate was even 3.1 percent, which is above the target of 2.5 percent set by the Bank of England.

In the light of this development, the central bank continued to push for higher key interest rates. According to the Inflation Report (Bank of England 1997), neither the rise of the short-term interest rate in 1996 nor the revaluation of the British pound is sufficient to keep inflationary dangers in check. In fact, money growth continues to be strong indicating substantial impulses for economic activity. We do not expect an interest rate hike before the coming elections, which will be held on the 1st of May

this year. Afterwards, the key interest rate will most likely be raised by more than one percentage point so that the stimulative effect of monetary policy will gradually decline over the forecast period.

Fiscal policy will most likely be more or less neutral in both 1997 and 1998. For the fiscal year 1997/98, there are plans for minor shifts from direct to indirect taxes. We do not expect major changes in fiscal policy irrespective of which party will win the election.

The upswing will continue this year and next. However, it will lose some momentum due to the expected slowdown of export growth. The strong appreciation of the pound since last fall — amounting to about 15 percent in real effective terms — implies a substantial deterioration of the competitive position of British exporters on world markets. So exports will increase only moderately in spite of the strong recovery in trading partner countries. We expect that the appreciation of the currency will continue with the discussion and the decision on EMU, although it will slow down considerably. Since the adjustment to exchange rate changes takes about one year (Lapp et al. 1995), exports will expand still a little faster in 1998 than in 1997, although they will increase by less than world trade.

Domestic expenditures will continue to expand at a healthy pace, and this applies to all components of demand. In 1997, the increase of real GDP will be a little higher than 2.5 percent to be followed by almost 3 percent in 1998. Given the excellent performance of the economy, unemployment will decline further. However, there is a risk that inflation will accelerate since the prolonged expansionary course of monetary policy will allow firms to raise their prices considerably; the strong pound will, however, dampen the increase somewhat. We expect that the retail price index will increase by a little more than 3 percent this year and by 3.5 percent in 1998.

9. Gradual Improvement of the Italian Economy

The Italian economy expanded only very slowly last year, due to the continuing restrictive course of monetary and fiscal policy. Only at the end of 1996, a slight recovery could be observed. Exports picked up after the dampening effect of the revaluation of the Italian lira — it amounted to about 20 percent in real effective terms between the spring of 1995 and the spring of 1996 — has begun to fade. Private consumption stagnated throughout the year as real disposable incomes were almost flat due to a weak performance of employment and the increases of taxes and social contributions. The firms invested less during the last year, the main reasons being the low capacity utilization and the fact that reinvested profits were not supported any more by tax law after last spring. The unemployment rate remained at a high level of about 12 percent. Inflation came down further; in February, the year-over-year increase was just 2.3 percent after a level of 4 percent in mid-1996. Apparently, the persistent monetary restrictions showed an effect, and the appreciation of the lira was also helpful.

The Italian government plans to limit the total budget deficit to 3 percent of GDP this year; last year the ratio was almost 7.5 percent. The intention is to achieve the reduction by increases in sales taxes and by a surcharge on the income tax (Euro tax). Furthermore, revenues due in the following year should already be paid in 1997. There are also several cuts on the expenditure side. Furthermore, the marked fall in interest rates implies a substantial reduction of interest payments.

Nevertheless, the measures planned will most likely not be sufficient to achieve the target of 3 percent. On the one hand, the increase in nominal GDP will be lower than in the projection of the government. On the other hand, the decision on the budget was made at a time when the deficit for 1996 was expected to be lower than it actually turned out. Therefore,

additional measures will have to be taken in a supplementary budget. All this implies that the stance of fiscal policy will be restrictive in 1997. Next year, however, there may be some relief as there will be no further increases of social contributions and the tax burden will fall because the Euro tax will expire. Also, government expenditures will not be cut by the same amount as in previous years.

Since July 1996, the Banca d'Italia has reduced key interest rates in three steps by two and one-quarter percentage points; currently, the discount rate stands at 6.75 %. Monetary policy was loosened somewhat which also shows up in an acceleration in the expansion of monetary aggregates. While this already indicates that monetary policy is becoming less restrictive, further cuts in interest rates are likely in the near future because inflation has come down considerably and the lira has regained strength on currency markets. After a positive decision on Italy's participation in EMU next year, interest rates will be cut drastically to levels prevailing in the countries with relatively low rates. The impact of this expansionary move on economic activity will, however, mainly be felt in the later course of 1998 and thereafter.

The recovery in Italy will, nevertheless, make some progress already in 1997. Exports will increase considerably because of the upswing mainly in the rest of Europe. While domestic demand will remain weak for quite some time, it will gain some strength next year when economic policy will be no longer restrictive. This will especially affect investment. Real GDP will increase by about 1.5 percent this year and by 3 percent in 1998. Inflation will not go down much further but tend to stabilize on the current level of about 2.5 percent. With private consumption picking up next year, consumer prices will probably rise a little faster.

10. The Dublin Resolution — An Efficient Stability Pact?

In December 1996, the heads of state and of government of EU countries decided upon an outline for a "stability pact." The intention of this pact is to assure fiscal discipline also for the time after EMU will have started.⁶ The respective provisions of the Maastricht Treaty are supplemented or made more precise. In particular, the following changes of the excessive deficit procedure according to the Maastricht Treaty are planned:⁷

- While the Maastricht Treaty allows, in principle, for sanctions, they are not qualified in terms of their volume. The Dublin agreement defines a deposit or a fine: It should consist of a fixed component, which is equivalent to 0.2 percent of GDP, and a variable component, which is equivalent to 10 percent of the amount by which the deficit ratio exceeds 3 percent of GDP. The total amount should, however, not be more than 0.5 percent of GDP, so that a deficit ratio of more than 6 percent would not imply higher sanctions.
- It is defined under what circumstances a deficit ratio of more than 3 percent should not be qualified as excessive. Such exceptions will be made if real GDP declines by at least 0.75 percent in a particular year.⁸
- The time frame for the excessive deficit procedure was, in part, made more definite although there seems to be a need for further clarification. Our interpretation of the sequence of decisions is given in Table 5.

In our view, the agreement is not sufficient to achieve the goal of fiscal discipline of EMU members. One weakness is that, basically, the procedure is still following Article 104c of the Maastricht Treaty. The decision on whether an excessive deficit exists will have to be made by the governments who are themselves responsible for those deficits. It will, therefore, be difficult to find majorities for sanctions; and it bears the risk that the procedure will be part of the political process and that sanctions will become a question of opportunistic behavior or of

negotiations rather than being imposed automatically.

Furthermore, a lot of time can pass by until sanctions are really decided upon. It may take up to two and a half years until a (non-interest bearing) deposit is to be paid. This long time span results from the fact that many decisions or reports by various institutions are necessary in this procedure. Also, government may prevent sanctions, or at least postpone their imposition, by deciding upon measures to reduce the budget deficit.

The sanctions lose their bite because of the long time that is needed until they are adopted. To be sure, 0.2 percent of GDP or more is a sizable fee for an excessive budget. But a deposit is only due if the deficit exceeds 3 percent for three years in a row, and the fine will only be imposed after another two years with an excessive deficit. To avoid any sanctions at all, i.e. paying a deposit or a fine, it is sufficient to reduce the deficit below 3 percent once every three years. If this is the case, the deposit will be returned. If a fine is to be avoided, it is even enough to have no excessive deficit once every five years.⁹

The stability pact in the current (preliminary) version is, therefore, not an efficient instrument for achieving fiscal discipline. The procedure would have to be fundamentally changed. The decisions on excessive deficits should not be in the hands of the European Council. Since it is difficult to set up a rule which would cover all contingencies, i.e. a discretionary behavior cannot be excluded, it would be best to establish an independent institution. Furthermore, the procedure could be significantly shortened to allow for a more rapid imposition of sanctions; for example, the time until decisions are due could be reduced markedly. It is not necessary to allow governments to prevent sanctions by announcing measures to reduce the deficits; if deficits are really pushed below the 3-percent level, the deposit would be repaid anyway. Finally, a sanction should be imposed for each year with an excessive deficit.

Table 5 — How Does the „Stability Pact“ Work? The Schedule of Decisions Following a Budget Deficit of More Than 3 Percent of GDP in 1999

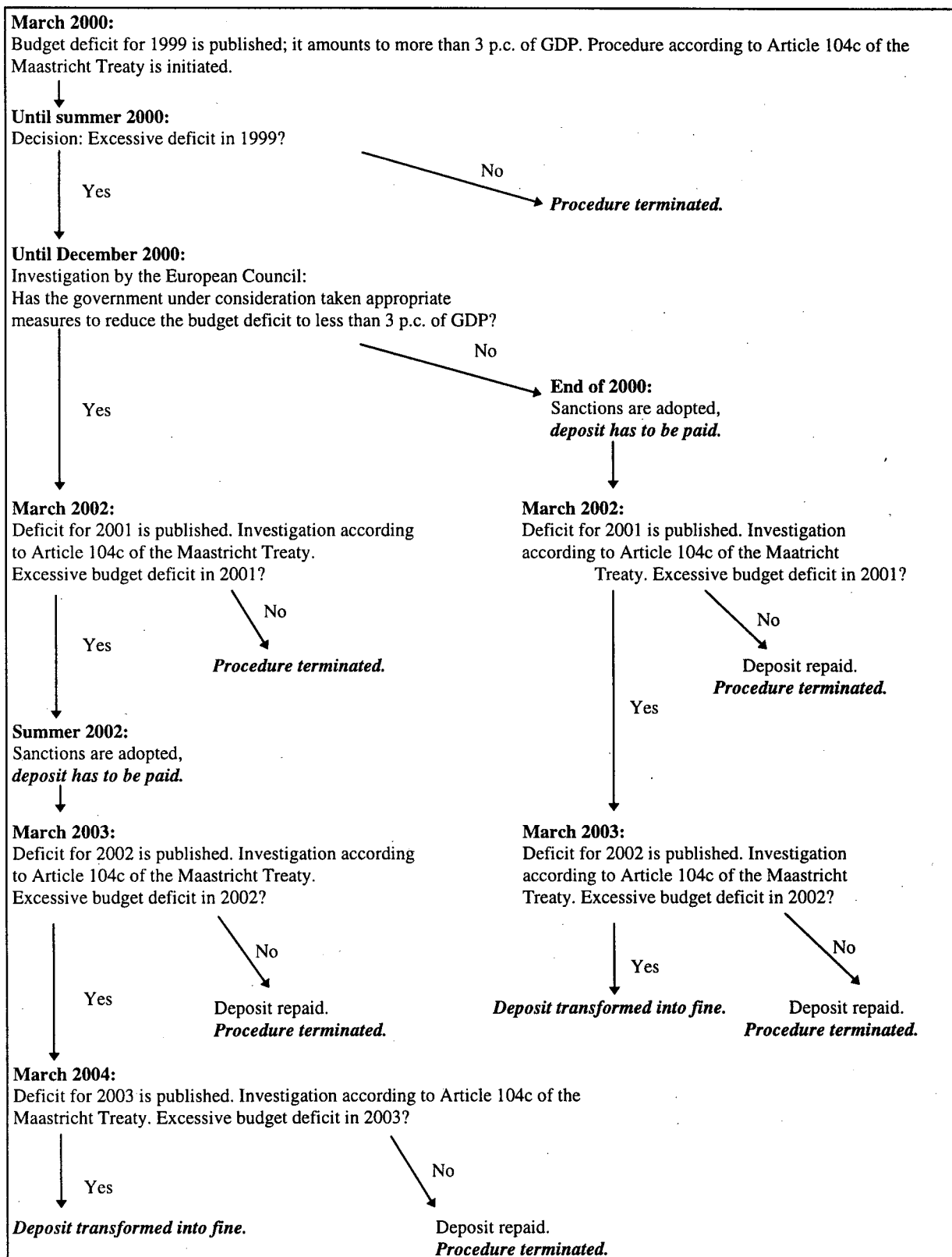


Table 6 — Cyclical and Structural Budget Deficits in the EU Countries^a

Country	Maximum cyclical deficit		Structural deficit in 1996
	all years in 1981–1996	excl. exceptional years ^b	
Germany	-1.8	-1.8	-3.5
France	-1.8	-1.6	-2.5
United Kingdom	-2.0	-2.0	-4.0
Italy	-0.7	-0.7	-6.2
Spain	-1.8	-1.8	-3.3
Netherlands	-2.0	-2.0	-2.6
Belgium	-1.7	-1.7	-1.5
Austria	-1.4	-1.4	-3.7
Sweden	-3.1	-1.8	-3.1
Denmark	-1.8	-1.8	-0.3
Finland	-5.2	-3.4	-1.5
Greece	-1.3	-1.3	-7.3
Portugal	-1.9	-1.9	-2.7
Ireland	-2.8	-2.8	-1.8

^aIn percent of nominal GDP. — ^bMaximum excluding those years in which real GDP declined by 0.75 percent or more.

Such a rigid form of the sanction mechanism, however, would probably not be accepted by many governments. While it is explicitly stated in the agreement that — under the assumption of the promised balanced budget in the medium term — fiscal policy would have enough room for an active policy, many obviously fear that a strict limit of 3 percent for the budget deficit would undermine the effectiveness of automatic stabilizers.

In order to analyze whether such fears are founded, we look at the effects of the business cycle on budget deficits. The cyclical components measure the impact of the cyclical fluctuation on revenues and expenditures.¹⁰ Table 6 shows the maximum value of this component in the EU countries (except Luxembourg) for the period 1981–1996. At first, all years are considered (column 1); in a second step, we leave out those years in which real GDP declined by at least 0.75 percent (column 2). This differentiation, however, does not alter the re-

sults very much because a decline of this size was rare during this period.¹¹

The observations reveal that — leaving aside the exceptions according to the Dublin agreement — there is only one country (Finland) in which the cyclical deficit exceeded the 3 percent level in one year. Under the assumption that business cycles will in the future not be more pronounced than in the period after 1980 one can conclude that the efficacy of automatic stabilization is not limited even under a strict stability pact. A necessary condition for not having an excessive deficit therefore is that the structural deficits are substantially reduced; in the ideal case, they should be eliminated completely. This may seem an ambitious target because in 1996, structural deficits were indeed still very high (column 3). But this target is explicitly stated in the Dublin agreement where government commit themselves to a balanced budget in the medium term.

Endnotes

- 1 It is not quite certain whether Ireland is determined to join the EMU from the start.
- 2 Scheide and Solveen (1997) discuss two alternative conversion procedures: the central rates of the EMS and an average of exchange rates over an extended period of, say, two years. Speculation against both rates cannot be profitable because the exchange rates will not fall below the values at which they will be converted in the transition to EMU. Speculative attacks are only likely if the rates of conversion are left open and market rates at the end of 1998 are taken as a reference.
- 3 A few central banks, especially the Deutsche Bundesbank, would probably like to raise interest rates considerably in order to avoid a strong upswing and the ensuing risks for price level stability. However, we do not expect that these more stability-oriented central banks will be able to pursue such a policy. The severe labor market problems will be a factor that will lead to a strong opposition by other central banks and governments. It has to be remembered that during this transition period there will be a kind of "institutional vacuum." There will not be an anchor currency as in the present system of the EMS.
- 4 The countries appearing in Figure 2 are those European economies for which quarterly data on this aggregate are available.
- 5 For a detailed analysis, cf. Boss et al. (1997).
- 6 The agreements reached in Dublin so far are only intentions of the governments. The actual pact will have to be written by the middle of June 1997. The final decision will then be made at the next European summit.
- 7 The procedure is described in Article 104c of the Maastricht Treaty.
- 8 A situation in which real GDP declines by more than 2 percent on a year will normally be called an exception. For a decline between 0.75 and 2 percent, there is room for discretion. Furthermore, a unique event can also imply an exception if it is not under the control of the country and has a dramatic impact on the deficit. A natural disaster or unique events such as German unification would be obvious incidents.
- 9 According to the schedule described in Table 5, the deficit in the year 2000 does not play a role. It can be assumed, however, that a deficit below 3 percent of GDP in that year would also be sufficient to terminate the whole procedure.
- 10 We use the OECD estimates for the components (OECD 1996). The methods are described in Giorno et al. (1995).
- 11 In addition, it can be observed that the deficit did not reach its maximum in that year in which the largest decline of real GDP occurred. This shows that the definition of a recession used in the stability pact is misleading because it is the output gap rather than the annual change of GDP which is relevant for the deficit.

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