The World Economy in the Spring of 1997

An abridged version of the Evaluation of the Economic Situation by the following members of the working party of the German Economic Research Institutes, Berlin, Germany

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Following the slight slowdown in 1995, global economic activity has been expanding rapidly since the start of last year. The rate of economic growth in the developing and newly industrialising countries has remained above the global average. The economic dynamic in the central European reform countries has declined somewhat, but remains nonetheless strong. The contraction of output in the CIS countries has continued. The growth of demand and output in the western industrialised countries has picked up. Economic expansion in the USA has remained strong, with a further increase in capacity utilisation. The underlying trend of economic activity in Japan marks a sharp improvement. In western Europe the economic upturn has begun to gather steam; exports, in particular, have expanded strongly, a trend favoured by the depreciation of European currencies against the dollar; investment in machinery and equipment has also expanded markedly.

Unemployment in the USA remains unchanged at its previous low level, with labour market tensions building up in certain sectors. There has been a slight fall in unemployment in Japan. In western Europe, however, unemployment remains entrenched at a high level. Given the only slight increase in capacity utilisation and the continued moderate pace of wage growth in the western industrialised countries, inflation remains subdued. On global commodity markets the price of industrial raw materials has risen further, although only moderately. The price of crude oil, on the other hand, has declined perceptibly since the start of this year.

The brisk expansion in the industrialised countries was in most cases due to a further improvement of monetary conditions: the marked decline in long-term interest rates have exerted a substantial expansionary impact on the level of economic activity. In addition, the international competitiveness of firms in western Europe and Japan has improved vis à vis those from the dollar area due to the appreciation of the US currency. Moreover, last year central bank base rates were again cut in almost all western European countries, while in Japan they have remained at the extremely low level reached back in the summer of 1995. Only in the USA has the monetary policy stance – in the light of the high level of capacity and labour utilisation – been broadly neutral.

European Monetary Union likely to include most EU countries

The decisions on participation in European Monetary Union (EMU) are to be taken in the spring of next year. They have major implications for economic policy and consequently also for economic trends in Europe. It is assumed here that a large-scale monetary union will be established on schedule in 1999: Great Britain and Denmark may opt out, Sweden still has to take a political decision and Greece is a long way from meeting all the criteria.

For a number of reasons a monetary union encompassing most of the EU Member States is far more likely than a postponement or a small-scale union. In terms of both inflation rates and capital market interest rates Europe has achieved a high degree of convergence in recent years (cf. table 1).[1] In virtually all countries the rate of consumer price inflation is likely to be between 2 and 2½% in 1997, and thus below the one and a half percentage points above the average in the three countries with the lowest inflation rates stipulated by the Maastricht Treaty. Long-term interest rates will not be more than two percentage points above those in the three countries with the lowest inflation rates. Thus there is scarcely any problem in meeting the corresponding criteria. The situation is less clear with respect to the fiscal policy criteria. Despite considerable efforts at consolidation, most countries will exceed, albeit only marginally, the reference value for the government deficit of 3% of GDP. Some countries are a long way from meeting the government debt criteria of 60% of GDP. Yet

[1] The figures given in table 1 need to be interpreted with caution. For instance, the precise definitions of the price index and the capital market rates to be used in applying the Maastricht Treaty to decide on participation in EMU are not yet known. Moreover, discretionary measures, in particular so-called creative accounting, have been implemented in order to reduce the deficit and debt quotas.

Table 1

Indicators for the Reference Values of the Maastricht Treaty*

Country	Consumer prices		Long-term interest rates[1)]		Public sector's fiscal deficit				Public debt[2)]			
	% change on the previous year		in %		in % of nominal GDP							
	1996	1997	1996	1997	1994	1995	1996	1997	1994	1995	1996	1997
Germany	1.5	1.5	6.2	6.0	2.4	3.6	3.8	3 to 3½[3)]	50.4	58.1	60.6	62
France	2.0	1.75	6.5	6.0	5.6	4.8	4.1	3 to 3½	48.4	52.8	56.5	58
Great Britain	2.4	3.0	7.8	7.5	6.8	5.5	4.8	3 to 3½	50.3	53.9	55.0	55
Italy	3.9	2.5	9.2	7.0	9.3	6.9	6.8	3½ to 4	125.5	124.9	124.5	124
Spain	3.6	2.5	8.7	7.0	6.3	6.6	4.4	3 to 3½	63.0	65.8	69.0	68
Netherlands	2.1	2.5	6.2	6.0	3.4	4.1	2.4	2 to 2½	77.6	80.0	79.0	76
Belgium	2.1	2.0	6.3	6.0	5.1	4.1	3.4	3 to 3½	135.0	133.7	130.0	127
Austria	1.9	2.0	6.3	6.0	4.4	5.9	4.5	3 to 3½	65.1	69.0	72.0	73
Sweden	0.7	1.5	8.0	6.5	10.3	7.7	3.6	2 to 2½	79.0	79.4	79.0	78
Denmark	2.1	2.5	7.1	6.5	3.4	1.9	1.5	½ to 1	76.0	71.9	71.0	68
Finland	0.6	1.5	6.0	6.0	6.2	5.1	2.6	1½ to 2	59.5	59.2	60.0	59
Greece	8.5	6.0	14.0	11.0	12.1	9.2	7.5	6 to 6½	110.4	111.8	110.0	109
Portugal	3.2	3.0	8.6	6.5	5.7	5.0	4.0	3 to 3½	69.6	71.7	71.0	69
Ireland	1.6	2.0	7.5	6.5	2.0	2.3	1.0	1 to 1½	87.9	81.6	75.0	70
Luxembourg	1.4	1.5	6.3	6.0	–2.6	–1.5	–0.9	0 to –½	5.7	6.1	8.0	8

* For the interpretation of the data see footnote 1) on page 3 of this article.
1) For the year 1997 rounded to half percentage points. — 2) For the year 1997 rounded to full percentage points. — 3) Not rounded: 3.2 %.
Sources: International organisations; 1997: prognosis of the Institutes.

clearly, national governments still differ in their interpretation of the fiscal criteria, leading, along with other factors, to uncertainty concerning the participating countries and even as to whether the union will be realised. Moreover, the currently prevailing interpretation of the exchange rate criterion, under which participation in the exchange rate mechanism of the European Monetary System two years before the planned start of monetary union – and not, as stipulated by the Treaty, immediately prior to the decision on participation – suggests that a large group of countries are to be considered. An interpretation based on exact conformity to the fiscal reference values is unlikely to prevail.[2]

Countries participating in EMU face a fundamental change in the conditions for monetary policy because the exchange rates of their national currencies are irrevocably fixed. In reality this requires a harmonisation of monetary policy, which in turn gives rise to a convergence in short-term interest rates. Thus the central banks of those countries whose money market rates are currently still high – i.e. in particular Italy, Spain and Portugal – are expected to reduce their base rates sharply in the run-up to EMU.

Many commentators perceive a danger that the common European currency will be less stable than Europe's hard currencies have been to date. Consequently, it is argued, the European currencies could depreciate against other leading currencies – and particularly against the US dollar – prior to the decision on participation; capital market rates would also be expected to rise. The extent of these two effects will depend decisively on whether governments can credibly show that the European Central Bank will orientate its policies primarily to price stability – as promised in the Maastricht Treaty – even in the case of a large-scale union. It is assumed here that this is by and large achieved in practice and that the rise in both the value of the dollar and in long-term interest rates remains moderate. Thus the decision

2 For example in Article 104c of the Maastricht Treaty it is stated that "... in particular it (the Commission) shall examine compliance with budgetary discipline on the basis of the following two criteria:

a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value,

b) whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace."

for a large-scale union will not pose a threat to economic expansion in western Europe in the coming year.

Monetary conditions remain favourable

The cyclical recovery in the western industrialised countries has been promoted by favourable monetary conditions. The Japanese central bank has maintained its decidedly expansionary stance in order to continue providing positive impulses to the still fragile economy. The US Federal Reserve, which since the start of 1996 had taken a wait-and-see approach, raised its base rates marginally in the spring of this year. Given the accelerated growth of the US economy, its action served as a signal to the markets that it would take steps at an early date to prevent the growth of inflationary expectations. On top of this came a perceived need to guard against the danger of speculative excesses on the stock markets. In Europe, most central banks cut their base rates further in 1996 against the background of the still restrained economic dynamic and low inflation rates, leading to strong growth of the money supply in most countries. Capital market rates, too, declined from the summer of 1996 until into the current year, following a prior rise. The fall in long-term interest rates was particularly pronounced in those countries whose participation in EMU has recently been seen as increasingly probable. Most European currencies have depreciated significantly against the US-dollar.

Interest rates in the USA have passed their lowest point. In the course of this year base rates are almost certain to be increased further, albeit only marginally. However, this slight tightening is unlikely to lead to a restrictive monetary policy stance, making a sharp restriction on the level of economic activity unlikely. Given the still precarious nature of the economic recovery in Japan, the need for consolidation in the banking sector and the start of efforts to reduce the extent of the fiscal deficit, the Japanese central bank will, for the time being, allow interest rates to remain at their current low level. No increase in base rates is to be expected in western Europe until the start of next year given the prevailing under utilisation of productive capacity and moderate inflation. Capital market rates, too, will begin to rise only gradually. Indeed, for those countries whose participation in monetary union is becoming increasingly likely – i.e. for Italy, Portugal and Spain – a decline in both short- and long-term interest rates is to be expected. All in all monetary conditions are favourable a continuation of the economic recovery in Europe.

Consolidation remains the prime aim of fiscal policy

In the USA the consolidation-oriented fiscal policy stance is likely to be maintained more or less unchanged with a view to the target of achieving a balanced budget by the year 2002. In Japan the government has begun to make efforts to reduce the budget deficit. In part this is being done by imposing significant cuts in public capital spending, but more importantly by raising taxes. West European governments have maintained their policy of reducing budget deficits. The overall impact of fiscal policy is substantially restrictive. Indeed, in the course of this year consolidation efforts may be stepped up because in some countries the approximation to the criteria stipulated in the Maastricht Treaty is seen as inadequate. In the coming year, on the other hand, deficits as a proportion of output will decline slightly and the impact of fiscal policy on the level of economic activity will be more or less neutral, particularly given the tax cuts to be implemented in certain countries.

Moderate growth in the industrialised countries

For the purposes of the prognosis it is assumed that the widening interest-rate differential between the USA and Europe will continue to exert upward pressure on the dollar. Exchange rate parities between those countries seeking membership of EMU will remain virtually stable. The price of crude oil will be around US-$ 19 per barrel in the current and coming years, compared with US-$ 20.5 in 1996. The prices of industrial primary goods will continue to rise, although the annual average for this year will still be somewhat lower than that for the previous year due to a base effect; the 1998 average is expected to be around 4% higher than that for 1997.

In the USA the growth of domestic demand will weaken somewhat following the slight tightening of monetary policy. Overall, economic growth will move over to a path in line with that of productive potential. Consequently, economic growth will by and large proceed without overheating. The recovery in Japan will gain in strength. Initially this will be largely due to export growth, a trend favoured by the sharp depreciation of the yen since mid-1995. In western Europe economic expansion will continue at a pace in line with that observed in recent months. The still significantly expansionary effects of low central bank interest rates will be offset by the retarding effects of a fiscal policy whose prime target is consolidation; in the coming year, though, monetary policy will be less expansionary and

Table 2

Real GDP, Consumer Prices and Unemployment in Middle and Eastern Europe

	Weight in %	GDP				Consumer prices				Unemployment rates			
		% change on the previous year											
		1995	1996	1997	1998	1995	1996	1997	1998	1995	1996	1997	1998
Germany	11.2	1.9	1.4	2¼	2¾	1.9	1.5	1½	1¾	9.4	10.3	11.25[1)]	11.0[1)]
France	7.1	2.2	1.3	2½	2¾	1.8	2.0	1¾	2.0	11.7	12.4	12.75	12.5
Great Britain	5.1	2.5	2.4	2¾	2½	3.4	2.4	3.0	3¼	8.2	7.6	6.0	5.5
Italy	5.1	2.9	0.7	1¼	2½	5.4	3.9	2½	3.0	12.0	12.2	12.5	12.5
Spain	2.6	2.8	2.2	3.0	3.0	4.7	3.6	2½	3.0	23.3	22.7	21.5	20.5
Netherlands	1.8	2.1	2.8	3.0	3.0	1.9	2.1	2½	2½	7.1	6.6	6.0	5.5
Belgium	1.3	1.9	1.4	2½	2½	1.5	2.1	2.0	2½	13.0	12.9	12.5	12.0
Austria	1.1	1.8	1.0	2.0	2½	2.2	1.9	2.0	2.0	5.9	6.2	6.5	6.5
Sweden	1.1	3.6	1.1	2.0	2½	2.5	0.7	1½	2.0	7.7	8.0	8.0	7.5
Denmark	0.8	2.6	2.4	3.0	3.0	2.1	2.1	2½	3.0	10.3	8.9	8.0	7.5
Finland	0.6	4.5	3.2	3½	3.0	1.0	0.6	1½	2.0	17.2	16.3	15.0	14.0
Greece	0.5	2.0	2.6	3.0	3.0	9.3	8.5	6.0	5½	10.0	10.0	10.0	10.0
Portugal	0.5	1.8	2.5	3.0	3.0	4.1	3.2	3.0	3.0	7.2	7.3	7.0	6.5
Ireland	0.3	10.7	6.3	7.0	6½	2.6	1.6	2.0	2½	12.2	12.0	11.0	10.0
Luxembourg	0.1	3.7	2.4	3.0	3.0	1.9	1.4	1½	2.0	3.0	3.0	3.0	3.0
European Union	39.2	2.4	1.6	2.4	2.7	2.8	2.3	2.1	2.4	–	–	–	–
Switzerland	1.4	0.1	–0.7	1.0	2.0	1.8	0.8	1½	1.0	4.2	4.7	5.5	5.5
Norway	0.7	3.3	4.8	3½	3.0	2.5	1.3	3.0	3½	4.9	4.9	4.5	4.5
Western Europe[2)]	41.3	2.3	1.6	2.4	2.7	2.8	2.2	2.1	2.4	–	–	–	–
United States	32.3	2.0	2.4	2¾	2.0	2.8	2.9	3.0	3.0	5.6	5.4	5.25	5.5
Japan	23.8	1.4	3.6	2.0	2½	–0.1	0.1	1½	1.0	3.2	3.4	3.25	3.0
Canada	2.6	2.3	1.5	3.0	2¾	2.1	1.6	2.0	2.0	9.5	9.7	9.25	9.0
Total[2)]	100.0	2.0	2.3	2.4	2.4	2.1	1.9	2.2	2.2	–	–	–	–
Memo item: Total[3)]		2.2	1.7	2.4	2.6	2.7	2.3	2.3	2.5	–	–	–	–

1) Rounded to one digit: 11.2 % (1997) and 10.9 % (1998) respectively. — 2) Total of countries listed. — 3) Weighted with 1995 GDP. — 3) Total of countries listed. Weighted with countries' shares in 1995 German exports.
Sources: OECD, national data. 1997 and 1998 forecast by the participating Institutes; figures rounded.

fiscal policy will exert only slight restrictive effects. There will be a slight rise in capacity utilisation and a gradual expansion of employment. Against this background inflation will be marginally higher (cf. table 2).

In the industrialised countries as a whole GDP growth will be of the order of 2½ % in both the current and the coming year. In the Asian developing and newly industrialising countries economic growth will be slightly weaker than to date, and in the oil-exporting countries of the Middle East the economic dynamic is expected to ease due to the lower price of oil. The central European reform countries will once again experience substantial GDP growth. Demand and output in the Latin American economies will grow rapidly. Against this background the growth of world trade, following an increase of 6% in 1996, will on annual averages be slightly higher in the current year (around 7%) and somewhat higher still in the coming year.