

World Economic Trends

1999/2000: Recovery Following the Turbulence on Foreign Exchange Markets

In the first half of 1999 the prospects for the global economy have improved once more, following two years in which the repercussions of severe turbulence on the international capital and financial markets had retarded the growth of the world economy. Global economic trends in the coming months will depend crucially on whether the Japanese economy finally recovers from its deep recession and returns to a stable growth trajectory, and whether the US economy successfully makes another 'soft landing' following the recent rise in interest rates.

The prospects for this are currently favourable, so that a slight acceleration of global economic growth can be expected. Prices are more or less stable throughout the world economy and there are no signs of the monetary authorities adopting a severely restrictive stance (cf. tables 1 to 3). The European economy is expected to recover gradually, whereas in the USA economic growth seems set to weaken.

Japan: no signs of a lasting economic recovery

Overall economic growth in Japan was unexpectedly high in the first quarter of this year. Real GDP grew on the previous quarter at an annualised rate of 7.9% (cf. figure 1). This extremely strong expansion had not been augured by the leading indicators. At the start of the year manufacturing output had been at a low level, and retail trade turnover was actually still on the decline. It seems that the strong growth recorded by the statistics primarily reflects public spending behaviour at the end of the fiscal year (31 March). As has occurred so often in the past, a contrary reaction is to be expected in the second quarter. Overall, in spite of the massive deficit-spending programme, the Japanese economy is not expected to grow significantly in the current year. Next year, too, GDP will be only marginally higher, as the direct demand effects will have dissipated.

For several years now the central bank has sought to stimulate the economy with low interest rates – to no avail. In the spring of this year the Bank of Japan cut the

overnight rate to almost zero. However, if monetary policy is to exert a lasting expansionary impulse, low-interest rates must be accompanied by strong growth of the money supply. Money supply growth to date, at between 3 and 4%, is not sufficient for this purpose. In order to create positive price and profitability expectations and stimulate strong economic growth, money supply growth in line with that of potential output would have to be twice this rate for the foreseeable future.¹

Consumption-based upturn in the USA

The economic upturn in the USA has continued to prove extremely robust. In the first quarter of 1999 total output increased at an annual rate of 4.3% (cf. figure 2).

The driving force was strong domestic demand. In nominal terms, private household spending grew faster than disposable income. Indeed, recent consumer spending has been higher than disposable income, implying a negative savings-to-income ratio for private households. Fiscal policy acted to restrain the pace of economic expansion. The corporate propensity to invest remained high, thanks to robust consumer demand. In the first quarter of 1999 private sector gross investment grew at an annual rate of around 8½%, roughly the same pace as in the second half of 1998.

Last year, American monetary policy reacted very quickly to the increased economic risks, reducing interest rates sharply last autumn. Given the rapid recovery, it recently reversed this interest-rate cut slightly. No further rises in interest rates are expected for the moment, as price stability is not under threat and the rate of money supply growth has recently flattened out considerably.

The fact that the upturn is on the back of private consumption is typical of an economy in the advanced phase of the business cycle. Normally wage and salary income then grows strongly. This leads to rising unit labour costs, which feed on into higher inflation and, sooner or later, lead to conflict with the stability-oriented central bank.

However, there are no signs of a sustained acceleration of inflation in the USA: although labour costs per working hour (cf. figure 3) rose rather more strongly, particularly last year, unit labour cost trends have remained moderate and the inflationary climate calm.

In the light of this, it seems that the US economy has a good chance of making a soft landing. Yet there are

¹ Cf. Pohl, Reinhard, 'Japan: Can the Deflation be Averted?', *Economic Bulletin*, No. 7, Vol. 36, July 1999.

Table 1

Trends of Gross Domestic Product and of Total Domestic Demand in Western Industrial Countries

	Weight ¹ 1998 in per cent		GDP, real			Total domestic demand, real ²			Consumer prices		
			% change on the previous year								
	GDP	German exports	1998	1999	2000	1998	1999	2000	1998	1999	2000
Germany	9.9	–	2.3	1.3	2.4	2.6	1.3	1.7	1.0	0.6	0.8
France	6.7	15.1	3.2	2.1	2.4	3.5	2.7	2.8	0.7	0.7	1.2
Italy	5.4	10.0	1.4	1.2	2.1	2.7	1.3	2.0	1.7	1.5	1.3
Spain	2.5	5.5	3.8	3.2	3.4	4.5	4.1	4.0	1.8	2.1	2.1
Netherlands	1.7	9.3	3.7	2.2	2.5	3.8	2.9	2.7	2.0	1.3	1.1
Belgium	1.1	7.7	2.8	1.0	2.2	4.4	2.0	2.5	1.0	1.1	1.3
Austria	1.0	7.2	3.3	1.9	2.3	2.8	1.7	2.2	0.9	1.2	1.0
Finland	0.6	1.3	4.7	3.3	3.6	4.5	4.0	3.2	1.4	1.0	1.4
Portugal	0.5	1.5	3.5	2.9	3.1	6.0	4.0	3.8	2.8	2.4	2.3
Ireland	0.4	0.7	9.9	6.7	5.9	9.4	6.4	5.7	2.4	2.2	1.8
Luxembourg	0.1	–	4.3	2.3	3.0	3.6	3.0	3.7	0.7	1.0	1.2
EMU countries	29.9	–	2.7	1.8	2.6	3.2	2.1	2.4	1.2	1.0	1.2
EMU countries excl. Germany	20.0	–	3.0	2.1	2.6	3.6	2.6	2.8	1.4	1.3	1.4
EMU countries excl. Germany ³	–	58.3	3.1	2.0	2.5	3.7	2.5	2.7	1.3	1.2	1.3
Great Britain	6.4	11.7	2.1	0.6	1.6	3.8	1.8	1.5	3.4	2.5	2.5
Sweden	1.1	3.1	2.9	2.2	2.7	3.9	2.7	2.9	0.4	0.5	1.0
Denmark	0.8	2.4	2.9	1.5	2.0	4.8	1.7	2.2	1.8	2.0	2.2
Greece	0.5	0.9	3.0	3.0	3.0	3.0	3.3	3.2	4.8	3.0	3.0
EU	38.7	–	2.7	1.6	2.4	3.4	2.1	2.3	1.6	1.3	1.4
EU excl. Germany	28.8	–	2.8	1.7	2.3	3.7	2.4	2.5	1.9	1.6	1.7
EU excl. Germany ³	–	76.4	2.9	1.8	2.4	3.7	2.4	2.5	1.7	1.5	1.5
Switzerland	1.2	6.1	2.1	1.3	2.0	4.0	1.6	2.2	0.0	0.5	0.8
Norway	0.7	1.2	2.0	0.5	2.0	4.8	0.1	1.2	2.2	2.5	2.5
Western Europe	40.6	–	2.6	1.6	2.3	3.5	2.1	2.3	1.6	1.3	1.4
USA	39.2	12.7	3.9	3.8	2.3	5.2	5.1	2.6	1.5	2.1	2.3
Canada	2.8	1.0	3.0	3.0	2.4	2.3	2.8	2.7	1.0	1.0	1.5
Japan	17.4	2.6	–2.8	0.2	0.3	–3.5	0.5	0.0	0.6	–0.3	0.2
Non-European industrial countries	59.4	–	1.9	2.7	1.7	2.6	3.7	1.9	1.2	1.3	1.6
Non-European industrial countries ³	–	16.3	2.8	3.2	2.0	3.6	4.2	2.2	1.3	1.6	1.9
Total	100.0	–	2.2	2.3	2.0	2.9	3.0	2.0	1.4	1.3	1.6
Total excl. Germany	90.1	–	2.2	2.4	1.9	3.0	3.2	2.1	1.4	1.4	1.6
Total excl. Germany ³	–	100.0	2.8	2.0	2.3	3.7	2.6	2.4	1.5	1.4	1.6

1 On dollar basis at 1998 exchange rates (annual average).— 2 Consumption and gross investment by residents.— 3 Weighted by country's shares in German exports 1998; Luxembourg's share is included among Belgium.

Sources: OECD Economic Outlook; Eurostat; National Accounts; national statistics and DIW estimates; 1999 and 2000 DIW forecast.

risks. They result from the mode of financing private consumption expenditure and from the disequilibrium in the external position.

Private consumption has been the driving force behind the growth of the American economy since the mid-1990s (cf. figure 3). In this period private consumer spending has on average grown faster, at almost 5½%,

than disposable income (4.7%). Yet this has been accompanied by a shift in the structure of consumer spending financing. In the period from 1993 to 1997 the growth of private consumption and the decline in the savings-to-income ratio was accompanied by a substantial expansion of consumer credit (cf. figure 3). Since 1997, by contrast, private households have been taking on signifi-

Table 2

Trends in GDP Components in Western Industrial Countries

real % change on the previous year

	Private consumption			Government consumption			Gross fixed investment			Exports			Imports		
	of goods and services														
	1998	1999	2000	1998	1999	2000	1998	1999	2000	1998	1999	2000	1998	1999	2000
Germany	1.8	2.2	1.9	-0.1	0.4	0.0	1.8	2.1	2.6	6.5	1.0	5.6	8.0	1.1	3.1
France	3.8	2.3	2.9	1.1	1.2	1.2	4.0	4.4	3.6	6.3	-0.8	1.9	8.0	1.2	3.3
Italy	2.0	2.0	2.1	1.4	1.0	0.9	3.6	2.9	3.3	1.1	-3.6	2.7	5.9	-3.5	2.3
Spain	3.8	3.2	3.5	1.6	1.1	1.1	9.0	7.8	6.7	7.8	4.2	5.0	10.6	7.1	7.0
Netherlands	4.4	3.6	3.2	2.5	1.9	2.0	4.2	2.9	3.0	6.2	0.9	2.5	6.7	2.1	2.9
Belgium	3.8	1.9	2.0	1.7	1.4	1.2	4.9	6.6	5.2	3.3	0.8	2.5	5.8	2.1	2.8
Austria	1.7	2.1	2.4	1.3	1.2	1.2	5.0	3.0	3.7	8.1	4.5	6.1	7.0	4.2	6.0
Finland	4.5	4.1	3.5	0.4	0.8	0.6	8.3	6.0	5.8	8.3	3.2	6.1	8.9	5.2	5.9
Portugal	5.3	3.6	3.5	3.5	2.3	1.9	9.7	5.8	6.1	7.9	3.5	6.1	13.7	6.1	7.0
Ireland	8.1	7.6	5.7	4.0	4.3	2.5	11.5	9.4	7.3	19.6	9.8	9.1	21.5	10.3	9.6
Luxembourg	2.9	3.0	3.2	3.5	3.3	3.3	8.4	3.5	4.8	8.9	1.7	2.3	8.6	2.3	3.0
EMU countries ¹	2.9	2.5	2.5	0.8	0.9	0.8	3.8	3.5	3.7	5.9	0.7	4.3	7.8	1.7	4.1
EMU countries excl. Germany ¹	3.4	2.6	2.8	1.5	1.3	1.2	5.2	4.6	4.2	5.9	0.7	3.3	8.1	2.1	4.0
Great Britain	2.7	1.2	1.4	1.5	1.6	2.3	8.3	4.4	1.5	3.1	0.6	3.4	8.4	4.3	2.9
Sweden	2.6	2.5	2.5	1.9	1.5	1.5	9.6	4.5	5.5	7.3	3.0	5.0	11.0	4.5	6.0
Denmark	3.5	2.0	2.0	2.6	1.5	1.0	6.1	2.0	2.0	0.1	1.5	3.0	4.7	2.0	3.5
Greece	2.0	2.0	2.5	0.5	0.0	0.0	9.5	8.0	8.5	6.5	4.0	5.0	5.0	4.5	5.0
EU ¹	2.8	2.2	2.3	1.1	1.1	1.0	4.9	3.8	3.4	5.6	0.9	3.9	8.1	2.3	3.7
EU excl. Germany ¹	3.2	2.2	2.4	1.5	1.3	1.4	6.1	4.5	3.7	5.3	0.9	3.4	8.1	2.7	3.9
Switzerland	1.8	1.5	2.0	0.6	0.5	0.2	3.8	3.0	3.5	4.1	2.5	3.5	8.8	3.2	4.0
Norway	3.2	2.0	2.0	2.8	1.0	2.0	6.6	-9.0	-6.5	0.5	2.5	4.0	6.9	2.0	2.5
Western Europe ¹	2.8	2.2	2.3	1.1	1.1	1.0	4.9	3.5	3.2	5.4	1.0	3.9	8.1	2.3	3.7
USA	4.9	5.4	3.1	1.1	1.5	0.9	9.6	8.8	2.0	1.5	-1.1	0.3	10.6	7.9	2.4
Canada	2.7	3.3	2.3	0.7	2.0	2.1	4.1	3.3	4.1	8.1	7.7	5.9	6.4	7.5	6.7
Japan	-1.1	0.6	0.5	0.7	1.3	0.6	-8.8	0.7	-0.9	-2.3	-3.1	2.6	-7.5	-0.7	0.8
Non-European industrial countries ¹	3.2	4.0	2.4	1.0	1.5	0.9	2.5	5.5	1.0	1.5	-0.3	1.8	6.3	6.1	2.7
Total ¹	3.0	3.3	2.3	1.1	1.3	1.0	3.4	4.8	1.9	4.0	0.5	3.1	7.4	3.8	3.3
Total excl. Germany ¹	3.1	3.4	2.4	1.2	1.4	1.1	3.6	5.1	1.8	3.6	0.4	2.7	7.3	4.2	3.3

¹ 1998 weights on dollar basis at 1998 exchange rates (annual average); exports and imports: weighted average of the concerning countries.
Sources: OECD Economic Outlook; Eurostat; National Accounts; national statistics and DIW estimates; 1999 and 2000 DIW forecast.

cantly less debt. Yet this offers no explanation for the further decline in the already very low savings-to-income ratio.

Clearly private consumption is being financed from other sources. Realised capital gains constitute one of these potential sources of finance. If, for example, the value of share-holdings increases, and if private house-

holds sell shares to other sectors of the economy in order to purchase consumer goods, these consumer purchases are counted in the national accounts as part of consumer spending, but the revenue from the sale of shares is not listed under disposable income, but as a fall in monetary assets. This reflects the fact that the income calculations record only transactions, not increases in book values,

Table 3

Trends in Gross Incomes, Unit Profits and Labour Costs per Unit of Output in Western Industrial Countries

% change on the previous year

	Gross income from						Profit per unit of output ¹			Labour costs per unit of output ²					
	self-employment and property			employment											
	in national currencies													in SDR	
	1998	1999	2000	1998	1999	2000	1998	1999	2000	1998	1999	2000	1998	1999	
Germany	6.6	0.1	4.0	1.5	2.1	2.0	4.3	-1.2	1.6	-0.7	0.8	-0.4	-0.8	-0.1	
France	5.2	0.6	2.1	3.5	3.5	4.0	2.0	-1.4	-0.3	0.3	1.4	1.6	0.6	0.5	
Italy	5.3	2.7	4.7	3.5	2.9	3.0	3.9	1.5	2.5	2.0	1.7	0.8	1.5	0.4	
Spain	6.5	6.6	5.5	5.8	5.4	5.4	2.7	3.3	2.0	1.9	2.1	1.9	1.3	1.0	
Netherlands	6.9	-1.8	7.9	4.3	3.5	2.5	3.1	-4.0	5.3	0.6	1.3	0.0	0.4	0.4	
Belgium	6.8	1.1	5.2	3.0	2.0	2.5	3.9	0.0	2.9	0.2	1.0	0.3	0.1	0.1	
Austria	10.7	4.3	8.0	2.8	2.5	2.0	7.2	2.4	5.6	-0.4	0.6	-0.3	-0.4	-0.3	
Finland	7.9	10.8	7.4	5.1	3.5	4.0	3.0	7.3	3.7	0.3	0.2	0.4	-1.2	-0.8	
Portugal	6.7	10.2	5.6	5.6	5.2	5.3	3.1	7.1	2.4	2.0	2.3	2.2	0.7	1.2	
Ireland	12.9	11.0	9.3	7.5	6.5	6.0	2.7	4.0	3.2	-2.2	-0.2	0.1	-5.6	-0.9	
Luxembourg	18.0	1.7	3.2	5.0	3.5	3.0	13.1	-0.7	0.2	0.6	1.1	0.0	0.5	0.2	
EMU countries ³	6.3	2.1	4.5	3.1	3.0	3.1	3.6	-0.2	2.2	0.3	1.2	0.5	0.0	0.2	
EMU countries excl. Germany ³	6.1	2.9	4.7	4.0	3.5	3.7	3.3	0.3	2.4	0.7	1.4	0.9	0.3	0.3	
Great Britain	-1.5	-2.0	4.9	7.2	5.0	4.5	-3.5	-2.6	3.3	5.0	4.4	2.9	7.7	1.0	
Sweden	3.6	0.0	4.5	3.8	3.5	3.5	0.7	-2.1	1.8	0.9	1.3	0.8	-1.7	-1.1	
Denmark	-8.0	1.9	6.7	6.1	4.5	4.0	-10.6	0.4	4.6	3.1	3.0	2.0	3.2	2.2	
Greece	11.4	6.9	6.3	6.5	5.0	4.5	8.1	3.8	3.2	3.4	1.9	1.5	-3.1	1.9	
EU ³	5.2	1.7	4.6	4.0	3.5	3.4	2.3	-0.5	2.4	1.0	1.6	0.8	0.9	0.3	
EU excl. Germany ³	4.7	2.1	4.8	4.9	3.9	3.9	1.6	-0.3	2.6	1.5	1.9	1.2	1.5	0.4	
Switzerland	9.4	3.4	6.4	1.5	2.0	2.0	7.2	2.1	4.4	-0.5	0.7	0.0	1.0	1.0	
Norway	-6.9	1.9	5.8	6.0	5.0	4.0	-8.7	1.4	3.7	3.9	4.5	2.0	-1.3	1.1	
Western Europe ³	5.1	1.7	4.7	3.9	3.4	3.3	2.3	-0.4	2.4	1.0	1.7	0.8	0.9	0.3	
USA	2.8	1.8	3.4	6.3	5.2	4.7	-1.1	-1.9	1.1	2.3	1.3	2.4	3.7	-0.6	
Canada	-1.4	8.3	7.0	3.8	3.5	3.3	-4.3	5.2	4.5	0.8	0.5	0.9	-4.5	-3.3	
Japan	-3.6	2.8	3.2	-0.7	-1.0	-0.5	-0.7	2.6	2.9	2.2	-1.2	-0.8	-4.2	8.8	
Non-European industrial countries ³	1.0	2.3	3.5	4.2	3.3	3.1	-1.5	0.6	2.2	2.0	0.4	1.2	-0.0	1.8	
Total ³	2.7	2.1	4.0	4.1	3.4	3.2	0.9	0.0	2.4	1.4	1.2	0.9	0.6	0.9	
Total excl. Germany ³	2.3	2.3	4.0	4.3	3.5	3.3	0.3	0.2	2.5	1.7	1.3	1.2	0.8	1.0	

1 Gross income from self-employment and property per unit of real gross domestic product. — 2 Gross income from employment per unit of real gross domestic product. — 3 1998 weights on dollar basis at 1998 exchange rates. To 1 and 2: weighted with export shares on which the calculations of the SDR are based (with the exception of the USA); Luxembourg's share is included among Belgium.

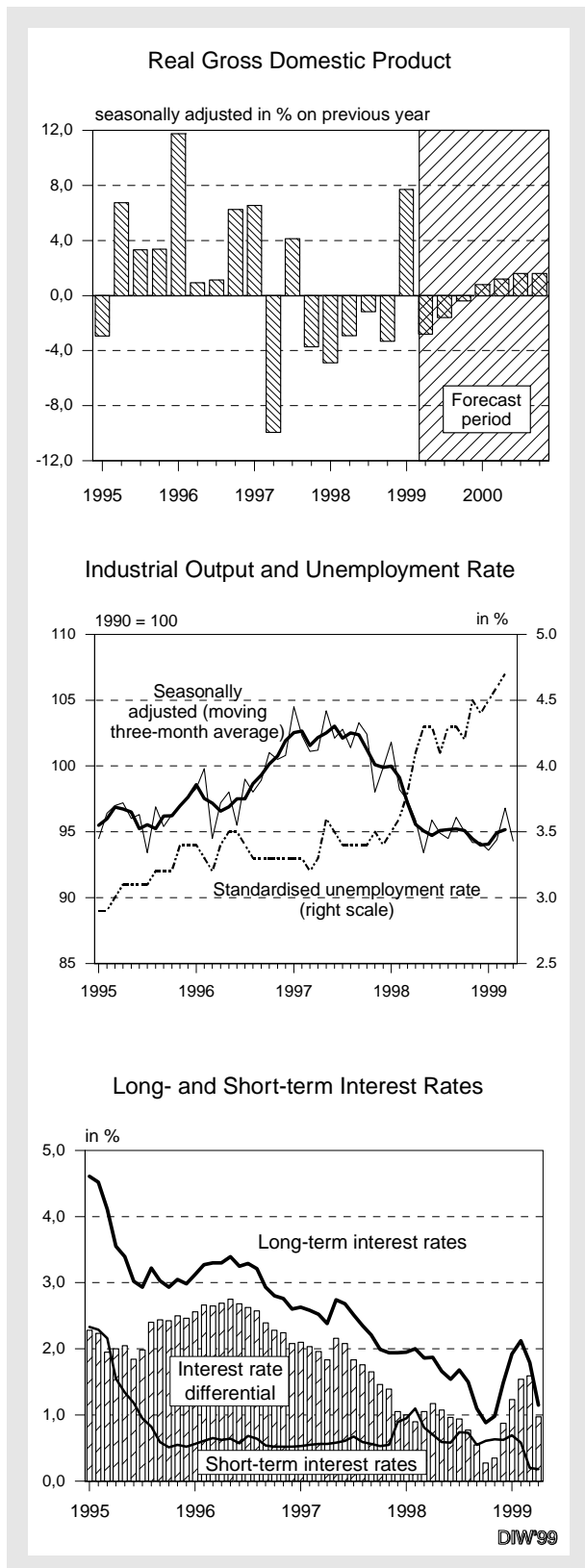
Sources: OECD Economic Outlook; Eurostat; National Accounts; national statistics and DIW estimates; 1999 and 2000 DIW forecast.

for instance, rising share prices. Private household savings, which are calculated as a statistical residual between income and expenditure flows, consequently decline, or even become negative, while savings or monetary asset formation in other sectors rise.

It seems that this is precisely what happened in the last two years in the USA. The value of shares traded on

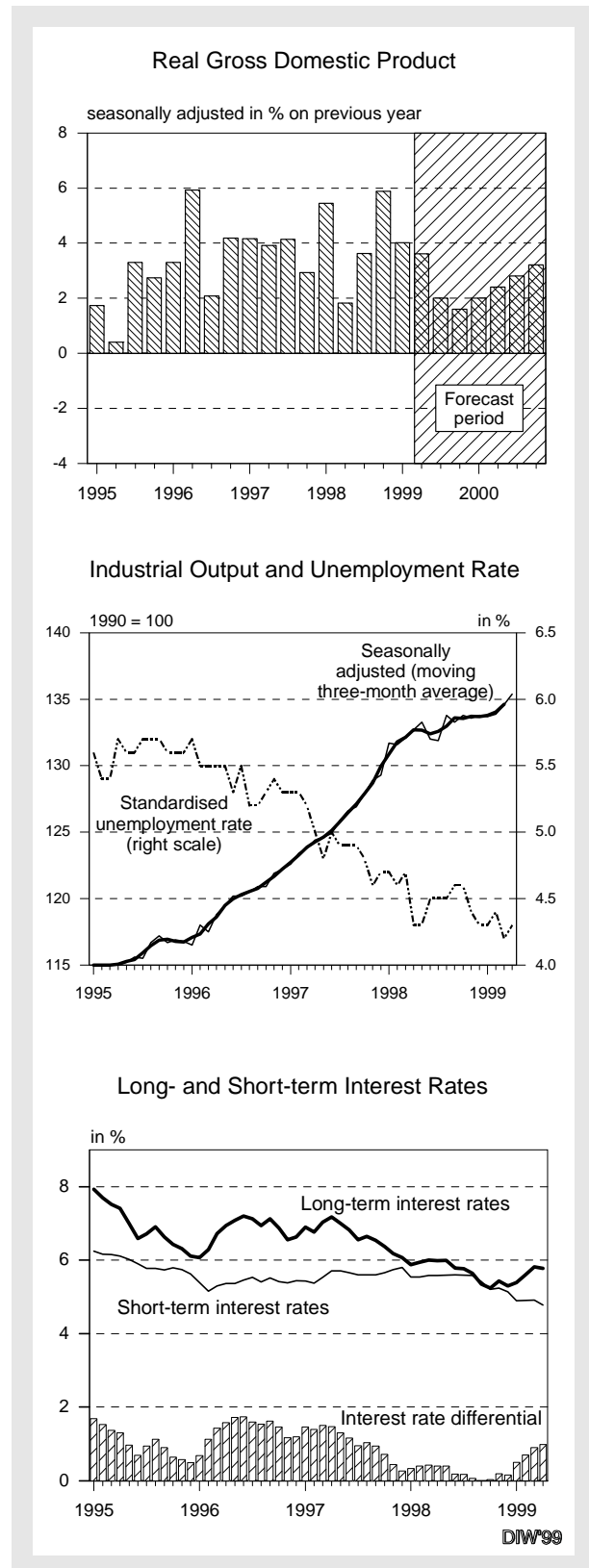
the New York Stock Exchange rose by 150% between January 1995 and April 1999 (cf. figure 3). Private households consequently feel richer. They cut their savings and realise a proportion of their gains on the stock exchange in order to increase their consumption. They were only able to realise such profits without a significant slide in share values because the shares offered by

Figure 1
Japan



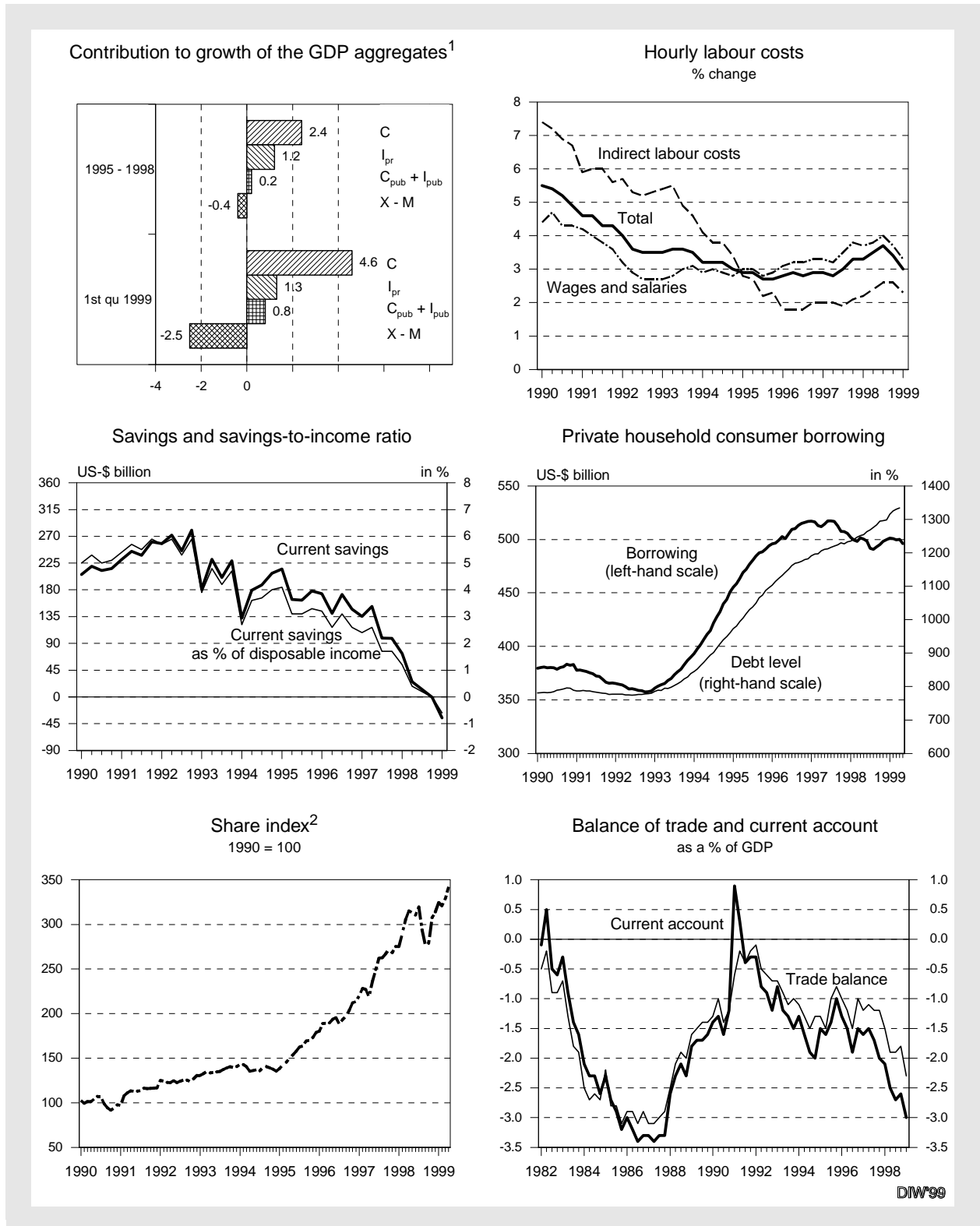
Sources: OECD, main economic indicators; DIW.

Figure 2
USA



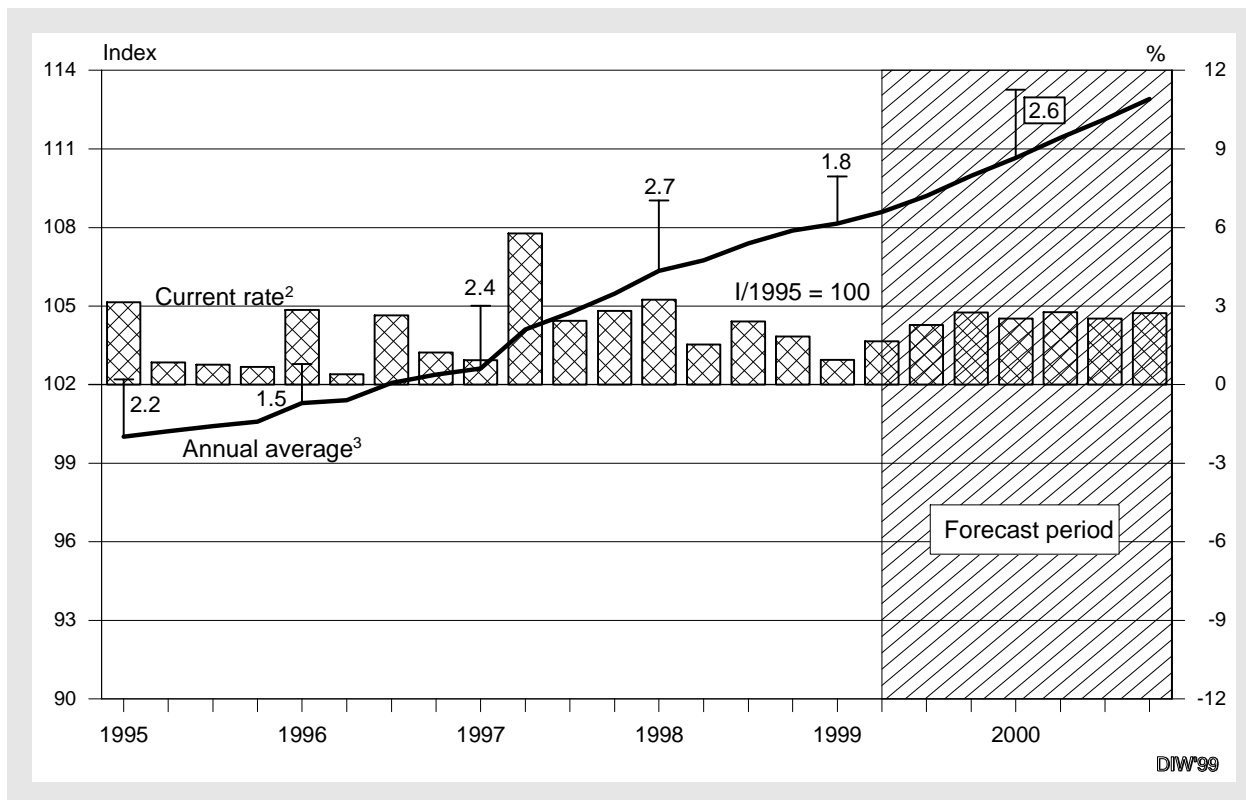
Sources: OECD, main economic indicators; DIW.

Figure 3
USA
Economic Indicators



¹ C: private consumption, I_{pr}: private gross investment, C_{pub}: public consumption, I_{pub}: public investment, X: exports, M: imports. — ² Common Stock Index of shares traded on the New York Stock Exchange.
Sources: Bureau of Economic Analysis (Survey of Current Business); Bureau of Labour Statistics; US Federal Reserve System; OECD; DIW calculations.

Figure 4
Real GDP in the EU Countries
 Seasonally adjusted¹



1 Using the Berlin Method (BV 4). — 2 Change on previous quarter in %, extrapolated to an annual rate (right-hand scale). — 3 Change on previous year in %.
 Sources: OECD; DIW calculations; from third quarter of 1998 prognosis by the DIW. The calculations and forecasts were made on the basis of the DIW's quarterly national accounts. No additional adjustment was made for the number of working days.

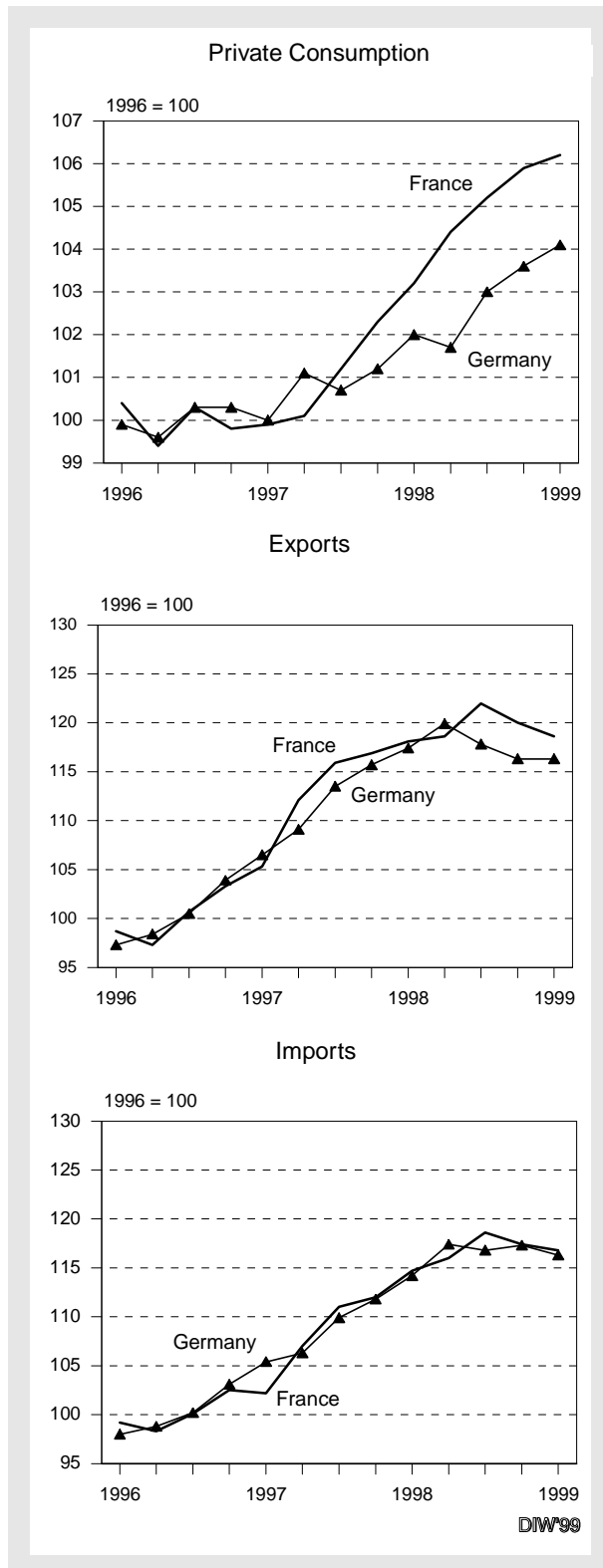
private households met with additional demand from other sectors: the most important purchaser of such shares was clearly the 'rest of the world'. In the last two years, in particular, a substantial flow of capital into the USA was observed, which recently accelerated further (cf. figure 3). This prevented the marked rise in capital market interest rates that is typical of an economy in an advanced phase of the business cycle. Recourse to potential output in the rest of the world via higher imports (cf. figure 3), moderate pay settlements, and the stronger dollar have prevented inflation picking up.

Given the volatility of international capital flows, the dependence on capital imports constitutes a significant risk. The probability of a depreciation of the dollar is increasing, particularly in the light of the widening US current account deficit. If a significant amount of capital is withdrawn, reducing the value of shares, and pushing up capital market interest rates, the economy will cool down more quickly, even without the monetary authorities tightening the reins.

The prognosis assumes that capital flows will move in this direction, although without this taking on crisis

proportions. The rise in the cost of capital will restrain corporate investment. Consumer demand, in particular, will be dampened by the fact that the rise in share prices will not continue over the longer term at the rates experienced recently. However, no collapse of private consumption is to be expected, as the disposable income of US private households will continue to rise strongly, given hourly-wage growth of more than 3% and continued employment growth. Consequently, real private consumption will continue to expand, despite the likely increase in private savings. The slight depreciation assumed for the prognosis is expected to stimulate exports over the medium-term, and restrain imports. A weakening of economic growth is not expected to begin until the second half of 1999, however, as the US economy remains dynamic; initial signs are already visible, such as slower money supply growth and stagnant corporate borrowing. All in all, the US economy is expected to grow by 3.8% in the current year, with growth falling to 2.3% in the coming year.

Figure 5
Trends of Important Components¹
of the Real GDP in Germany and France



¹ Seasonally adjusted.

Sources: Eurostat; Federal Statistical Office; DIW calculations.

Gradual recovery in the euro zone

Following a marked weakening of economic activity in the second half of last year, cyclical trends in the euro zone bottomed out at the start of 1999. This largely reflected the unfavourable global economic trends. Following the fall in euro-zone net exports of around 13% in the fourth quarter of 1998 compared with the previous quarter, they fell again in the first quarter of 1999, although only slightly. Domestic demand offset the weakness of foreign demand only partially. Under the assumptions for global economic trends made for the prognosis, the euro-zone economy is expected to pick up during the second half of this year. Towards the end of the year the impulses resulting from the cut in base rates in April 1999 will make their effects felt.

Investment in machinery and equipment, in particular, expanded significantly more weakly at the start of this year following the drop in exports. Now that exports are picking up, investment in equipment will again grow faster in the course of next year. Consumer spending by private households has continued to expand strongly. In the first quarter of 1999 it was 2.7% up on the same period the previous year. Thus private consumption is the main buttress of the business cycle in the euro zone. This reflected, alongside low-interest rates, in particular the continuous rise in real wages. In both the current and coming years, economic growth will remain largely on the back of consumer spending; at 2.5% it will grow faster than GDP.

Employment growth in the euro zone weakened, particularly in industry, although it continued unabated in the service sector. The unemployment rate has continued to fall since the end of 1998, to 10.4% in April 1999. In both the present and the coming year, the labour market situation will continue to improve only marginally. The increase will be moderate in unit labour costs.

All in all, GDP in the euro zone will grow by 1.8% this year, and by 2.6% next year (cf. figure 4).

Differences in coming to terms with currency turbulence

Of particular importance within the euro zone are the diverging trends between the major economies: Germany and Italy with slow growth, and France with higher growth. The particularly weak growth in Italy can be explained primarily in terms of the repercussions of the huge consolidation efforts made by the country to meet the criteria of the Stability and Growth Pact, and also, indeed especially, of the retarding effects of foreign demand. Yet Germany and France, too, suffered from

Table 4

Fiscal Policy Indicators in the EMU, 1996 to 2000

as a % of GDP

		1996	1997	1998	1999	2000
Total of government deficit/surplus	Forecast	-4.1	-2.5	-2.1	-1.9	-1.7
	Stability Pact requirement	-	-	-	-1.8	-1.6
Primary deficit/surplus	Forecast	-	-	2.4	2.3	2.4
	Stability Pact requirement	-	-	-	2.7	2.7
Government debt	Forecast	75.3	75.1	73.4	72.6	71.2
	Stability Pact requirement	-	-	-	72.5	71.3

Sources: European Commission, Spring 1999 Forecast; ECB, Monthly Report, June 1999.

the effects of the crises in Asia, Russia and South America. Given its close trading links with the countries affected, Germany was hit somewhat earlier and more seriously by the global economic crises (cf. figure 5). This factor alone, however, is not able to explain the divergence. The decisive factor behind the stronger economic growth in France is the private consumption trend there (cf. figure 5), which has been growing significantly more strongly than in Germany, particularly since 1997. In contrast to Germany, wage trends in France have been such that unit labour costs have not only not fallen, they have actually risen slightly. This enabled it to avoid a weakening of consumption, without the external position suffering noticeably more as a result. On top of this came the fact that the French government exploited its room for fiscal policy manoeuvre, stabilising economic trends.

Fiscal policy: deficit reduction retarded by weaker economic growth

In 1998 the deficit ratio (deficit of the overall government budget as a proportion of GDP) of the euro-zone countries declined once again on the previous year, from 2.5 to 2.1% (cf. table 4). This was primarily a consequence of the initially strong economic growth in many countries. This year, however, any further reductions in the deficit ratio will at best be marginal, given the weakening of economic growth.

The differences between the euro-zone countries in terms of deficit ratios remain substantial, however. Italy

is struggling to meet its deficit target, which was recently raised to 2.4%, following the cyclical downturn reflecting, alongside the global economic crisis, not least the knock-on effects of the huge consolidation efforts made in recent years to meet the Maastricht criteria. France has consciously eased the pace of deficit reduction in order to avoid damaging economic growth. The Scandinavian countries, Ireland and Luxembourg, by contrast, have posted – in some cases substantial – surpluses. Given the weakness of the business cycle in the euro zone, the public debate on the slight increase in the deficit target for the Italian budget appears exaggerated. After all, it is not a matter of exceeding the ceiling on the deficit set by the Maastricht Treaty, but merely of reducing slightly the pace at which the budget deficit is reduced in the light of economic trends. Given under-utilised capacity and still high unemployment, such an approach cannot be considered contrary to stability. On the contrary, by consolidating public finances more cautiously in a phase of cyclical weakness, a government stabilises economic development and thus improves the conditions for an upturn; this should then be used for a sustained reduction in the government deficit.

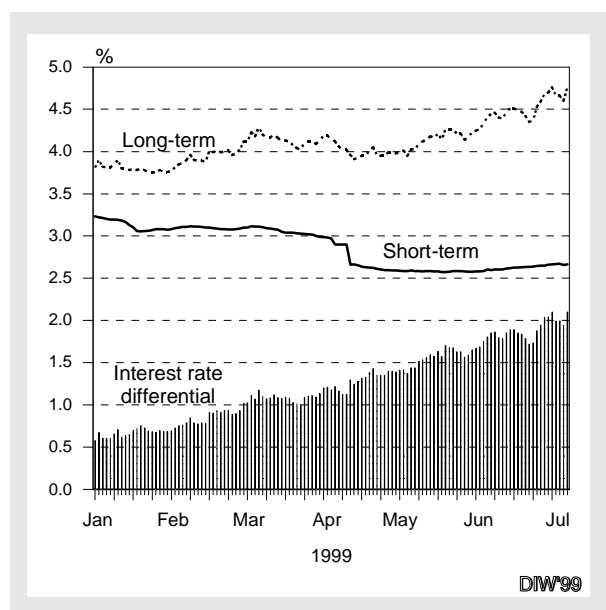
Overall, fiscal policy is likely to exert a restrictive effect in the current year. With government spending growth lagging behind that of potential output, and a more than proportional increase in government revenues, fiscal policy will exert a dampening effect on economic activity. This consolidation will continue next year as economic growth in the euro zone is expected to pick up, automatically raising revenue and reducing expenditure.

Monetary policy remains expansionary

Base rates in the euro zone were cut again in April, following the coordinated cuts in base rates to a uniform convergence level brought about by coordinated central bank action in December 1998. The ECB reduced its main refinancing rate by half a point, to 2.5%. Whereas at the start of the year short-term interest rates, as measured by the three-month Euribor, were still at around 3.2%, even prior to the cuts in base rates they had fallen below 3%, and they have since stabilised at the current level of around 2.6% (cf. figure 6). Thus short-term interest rates in the euro zone are currently at a very low level. They are around 0.6 percentage points below the level at the start of the year, and around 1.2 percentage points lower than a year ago. Short-term real interest rates, at around 1.5%, are also very low in long-term comparative terms, and have fallen still further since the start of the year.

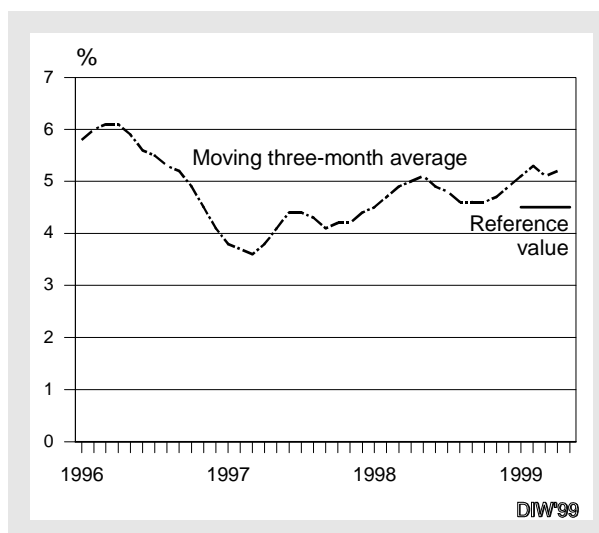
In view of the cuts in ECB base rates and the divergence between the growth dynamic and the inflationary expectations in the euro zone and the USA, capital market interest rates have to some extent become decoupled from trends in the USA. This has led to a further significant widening of the gap between capital market interest rates in the USA and those in the euro zone since the start of this year. This trend is also reflected in the depreciation of the euro.²

Figure 6
Long-term¹ and Short-term² Interest Rates in the EMU



¹ Long-term interest rates were calculated using national yields on 10-year government bonds, using weighted GDP-shares. — ² 3-month-Euribor. Source: DIW calculations.

Figure 7
Rates of M3¹ Growth in the EMU



¹ M3 is composed of cash in circulation, overnight deposits, deposits with an agreed maturity of up to 2 years, deposits redeemable at notice of up to three months, repurchase agreements, money market fund shares/units and money market paper, and debt securities up to 2 years. Moving three-month average of the changes on the previous year. Source: European Central Bank, Monthly Reports.

The three-month moving averages of the rates of money supply growth (M3) have in recent months been slightly above the reference value of 4.5% set by the ECB (cf. figure 7). The most recent three-month moving average (March to May) rose slightly to 5.2%. Even so, the overall trend of money supply growth has been downward since the start of the year.

Taking into account interest rates, money supply trends and exchange-rate trends, the monetary environment can currently be considered to be expansionary. The impact of the markedly expansionary orientation of monetary policy is being reduced somewhat, however, by the influence of international capital markets on capital market rates in the euro zone.

Inflation will remain subdued. Given that the economy is recovering only gradually, the ECB is not expected to raise interest rates during this year. Any increase in base rates will not occur until next year.

² See the section 'Does the depreciation of the euro give cause for concern?' below.