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SHORT-TERM PROSPECTS FOR THE INTERNATIONAL ECONOMY - Spring 1996

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CONTENTS Page

Preface

Twice a year, the conjunctural institutes united in the Association of European Conjuncture Institutes AIECE discuss short-term developments of the international economy. The discussion is supported by a General Report made in turn by one of the Member institutes. This spring, the report has been prepared by the International Department of CPB. We gratefully acknowledge the assistance of almost all colleague institutes by answering a special questionnaire. The responses have facilitated the preparation of the report and have permitted to include a near full coverage of country notes. Of course, the general analysis and conclusions remain CPB's responsibility.

Henk Don
managing director

I Overview

Last year the industrial countries posted disappointing growth. The OECD economies expanded by only 2%, compared to 3% in the previous year. The envisaged soft landing of the US economy brought American GDP growth close to zero in the first half of 1995. This was followed by a brief, vigorous recovery, but there was another downswing in the last quarter, partly as a result of one-off factors. GDP growth for the whole year thus turned out at 2%. The US economy is expected to continue at this rate (which is close to potential) in the coming years. The Japanese economy again showed only flickers of life last year, but in the final quarter the recovery indeed started taking shape. The cyclical upturn in Europe slowed down badly, especially in the second half of 1995. But there are good hopes that the economy will rebound in the near future. The conditions for an upswing, the so-called 'fundamentals', are still encouraging despite the disappointing recent performance. It is difficult to pinpoint the start of the upswing to the quarter, however. This year's growth forecasts for Europe must therefore be treated with some caution. In the course of this year the European and Japanese economies may achieve annual growth rates of 2½ to 3%. That the full-year 1996 growth rates for both regions will be much lower is due to the very low level of activity in the early part of the year.

Alongside the efforts to reduce unemployment, deficit reduction is a high priority in nearly all industrial countries. Japan is the main exception. Most countries have already taken significant measures in recent years to strengthen their public finances. But much more has to be done to achieve a balanced, or at least more balanced situation in due course, especially since the economic climate is now less promising. In this regard the EU countries are taking the EMU criteria as their guideline. Consequently, the public sector will have a braking effect on demand in the coming years as well. Deficit-cutting measures may well have a beneficial effect on inflation and hence an easing effect on international long-term interest rates, also in real terms. They should also have confidence-building effects, especially in those countries with a large government debt. In these ways the negative demand impulses from the public sector which deficit cutting entails can be significantly softened.

Table I.1 Economic key data now and a half-year ago (AIECE forecasts)

	Spring 1996			Autumn 1995	
	1995	1996	1997	1995	1996
	annual percentage changes				
GDP volume[a]					
United States	2	2	2¼	3	2¼
Japan	1	2½	3	½	2
Western Europe	2½	1¾	2½	3	2¾
Industrial countries	2	2	2½	2½	2½
Private consumption deflator					
United States	2¾	2½	2½	3¼	3½
Japan	−½	0	¾	−¼	0
Western Europe	2¾	2½	2½	3¼	3¼
Industrial countries	2½	2¼	2¼	4	3¾
	levels in percentages				
Unemployment[b]					
United States	5½	5¾	5¾	5¾	5½
Japan	3¼	3½	3½	3	3¼
Western Europe	11	10¾	10½	10½	10
Industrial countries	7½	7½	7½	7½	7½
General government financial balance[c]					
United States	−1	−1	−1	−1¾	−2
Japan	−4	−4¾	−4	−4	−4¼
Western Europe	−5	−4	−3½	−4½	−3¾
Industrial countries	−3¼	−3¼	−2¾	−3½	−3¼
World trade volume	8½	6½	7½	8½	7½

[a] Aggregates on the basis of purchasing power parities; industrial countries include all OECD members except Mexico, Turkey and the Czech Republic.
[b] As a percentage of the labour force.
[c] As a percentage of GDP.

The non-OECD economies as a group continue to steam ahead. As in previous years, China and the so-called 'Dynamic Asian Economies' (DAEs) will lead the way, posting real growth rates of 7% a year or more. The boom is driven by exports and domestic demand, above all investment. Last year growth in the Central European countries was up on previous years, while the GDP contraction in Russia levelled off considerably. The Transition countries will probably experience a temporary loss of momentum as a result of weaker demand in western Europe, their main export market. But as the western European economies revive, the eastern ones should be able to achieve growth rates of 4 to 5% over the coming years, although doubts remain over the outlook for the Russian economy. Latin America suffered a sharp growth dip last year, due above all to the fallout from the Mexican crisis. This hit also the Argentine economy particularly hard. But the region as a whole is already over the worst.

The economic slowdown in the industrial countries has also held back the expansion of world trade. This is true especially for the internal trade among the western European countries. International commodity prices settled in the course of last year, and given the projected development of world demand this is unlikely to change over the coming years. Measured in national currencies, world trade prices will rise only a few percentage points this year and next. In dollar terms prices will rise even less, because the dollar is expected to appreciate slightly during this period.

II Developments outside Europe

II.1 United States

The 'soft landing' of the US economy in 1995 turned out to be somewhat harder, with growth declining closer to zero than expected. Domestic demand for interest-rate-sensitive consumer goods reacted more strongly to the rate hikes of 1994 than anticipated. Moreover, exports and output were hit by the financial crisis in Mexico, which also threw other countries' financial markets into turmoil. Weaker final demand and demand expectations prompted a major reduction in stock levels (especially in the car sector), which nevertheless remained too high. Housing construction, another interest-rate-sensitive sector, also fell back sharply. The high capacity utilization rates of US industry came down appreciably, and the tight labour market also slackened. Halfway through the year the inflation threat had receded sufficiently for the Federal Reserve to relax monetary policy several times. Long-term rates eased to such an extent over this period that the surge of early 1994 was almost undone. Share prices rallied spectacularly. Interest rates eased more than in Europe, which put the dollar under pressure. The dollar's effective depreciation was rather limited, however, because many of the United States' trading partners use to link their currencies to the dollar.

In the second half of the year the US economy bounced back. Housing construction and household consumption (especially of durable goods, including cars) reacted positively to the interest-rate cuts, and the soaring share prices created positive wealth effects. Towards the year-end extremely bad weather and the partial shut-down of federal government services depressed economic activity. Exports performed well, owing to their competitiveness and the gradual recovery of the Mexican market. This reduced the negative contribution of the external sector to GDP. The year 1995 could thus be closed with a real GDP growth of 2%, according to the new US definition (equivalent to 3% on the old definition, see box).

The economy and statistics

A revision of statistical series often produces remarkable changes to the conjunctural picture. Last year there were two salient examples of this.

The first concerns the German inflation. By shifting the statistical baseline for the consumer price index from 1985 to 1991 the official inflation rate for West Germany dropped by nearly ½%-point overnight. This brought price inflation well within the range the monetary authorities had set themselves, and it was thus much easier for the Bundesbank to trim official interest rates.

The second example concerns the US national accounts. From the start of this year these are calculated, economicly more relevantly, on the basis of moving prices rather than fixed prices. This means that goods which tend to rise little in price or even become cheaper, such as computers, in the new system gradually receive less weight. These are precisely in the sectors which have been among the fastest-growing in recent years. Under the new calculation method, GDP growth in 1993 and 1994 turns our more than ½% per year lower, and for 1995 and the following years the difference will be close to 1%. This change also yields lower figures for labour productivity gains. According to the old definition, US economic growth could reach 2½ to 3% in the coming years, but according to the new official registration it will turn out at only 2%.

Of course the new calculation methods have not changed the economic situation in Germany and the United States, and insiders will have been aware of the consequences of such revisions for some time. But for the public at large the situation does change suddenly, especially when performances are compared with those of other countries.

Table II.1 Key data United States and Japan, 1995-1997 (CPB forecasts)

	United States 1995	1996	1997	Japan 1995	1996	1997
	annual percentage volume changes					
Private consumption	2½	2¼	2	1½	2½	2
Government consumption	½	0	0	2	2	2
Gross fixed investment	6	3½	4	¾	3	4
Domestic demand	2¼	1¾	2¼	1½	2½	3
Exports	8	8½	8½	5	6	7½
Imports	8½	6½	6½	13½	8	8
GDP	2	2	2¼	1	2	2¾
	annual percentage price changes					
GDP	2½	2½	2½	−½	−½	¼
Private consumption	2¾	2½	2½	−½	0	¾
	levels in %					
Unemployment[a]	5½	5¾	5¾	3¼	3½	3½
General government financial balance[b]	−1	−1	−1	−4	−4¾	−4

[a] As a percentage of the labour force.
[b] As a percentage of GDP.

With unemployment a little above the `natural' rate of unemployment (NAWRU) and wage and price increases very modest, the US economy appears to be on a steady course at the moment. GDP volume should continue to grow at around 2% per year, which is around or just below capacity growth. Stocks are gradually coming down to levels reflecting sales, so that this constraint on output will disappear. Growth will rely less on capital expenditure, and the external sector's contribution is expected to turn positive. The moderate growth rate will be accompanied by some slackening of the labour market. Inflation should stay around 2½%, because prices of raw materials and semimanufactures are rising moderately, and unit labour costs are not exerting significant upward price pressures. One blot on this rosy picture is the 'double deficit': the current-account deficit (last year $ 153 bln) is not shrinking very fast, while the federal budget deficit will still amount to around 2½% of GDP next year.

In 1994 and 1995 the United States scored some successes in reducing its financing deficit. The deficit for the public sector as a whole fell from 2½% to 1% of GDP during this period. (The states and lower-tier authorities have a structural surplus.) Further deficit-cutting measures will be necessary, however, if only because the savings ratio is too low. There is a broad consensus between the Republican-led Congress and the Clinton administration on the need to balance the federal budget within the foreseeable future, but not yet on the way in which this is to be achieved. Both parties are committed to a balanced budget by 2002, which would imply a small surplus for the public sector as a whole. Both want to reduce the deficit mainly by reining in expenditure. The Clinton administration is trying to protect healthcare for the aged and education more than Congress, which is also keen on tax cuts. It is worth noting that the White House plans are rather more realistic than earlier attempts to tackle the deficit problem, all of which failed in their objectives. This time, the administration's projections are not based on optimistic assumptions but on the more cautious figures used by the Congressional Budget Office (CBO). In macroeconomic terms the impact of both plans will be nearly identical in the first few years. The draft budget for fiscal 1997 (which starts on 1 October this year) provides for government borrowing of $ 161 bln, compared to $ 154 bln for this year. Even if, as expected, Congress will find some additional savings, the public-sector financing deficit still seems likely to hover around 1% of GDP in the coming years.

II.2 Asia

Japan

Japan's malaise continued most of last year. At 1% economic growth was nearly as meagre as in the previous year. Not only did the banking crisis prove intractable, the problem was aggravated by an extremely high yen rate in the first half year. Furthermore, public investment passed its peak. All this frustrated business and consumer confidence to such an extent that domestic demand growth stalled repeatedly. The expensive yen deepened import penetration and depressed export growth. Exporters also had to cope with slower growth in the United States, an important market. The situation was not helped by the bilateral trade negotiations skirting close to failure on several occasions.

Domestic demand perked up later in the year and broadened to private consumption and business investment. The yen started coming down and eventually returned to its 1994 level. The government also announced an ambitious new stimulation package, which improved the prospects for recovery and consequently sentiment. Private consumption continued its mild upward trend, and business investment was also slightly stronger. But in the meantime the contribution of the external sector continued to deteriorate and housing investment fell off. This pushed stock levels up too far, which in turn depressed industrial output. Unemployment rose continuously last year, and now stands at around 3½% of the labour force. Given the narrow definitions used in Japan, this is a high level. Merely adding in the discouraged-workers effect and involuntary part-time working already doubles the figure. The recent depreciation of the yen has stemmed price deflation, that has virtually stopped for consumer goods. Because import growth remained vigorous while export growth decelerated sharply, the trade surplus shrank.

So has the long-awaited recovery indeed begun? The forward-looking indicators are not conclusive: they have been pointing to an upswing since mid-1992, without a convincing output recovery materializing. But it is becoming increasingly likely that the Japanese economy is coming out of the doldrums. Domestic demand should improve further on the back of relaxed monetary conditions and strong fiscal impulses, while export growth should also recover now that the yen has become more competitive again.

A positive development is that the authorities and the banks themselves appear at last to be getting to grips with the banks' financial problems. An increase in demand does presuppose a lasting return of confidence, however. The surge in share prices over the past year may signal that the deep pessimism is ebbing away. At least the latest Tankan business survey suggests that business confidence is improving. The expansive effects of the low interest rates should become noticeable in the near future (especially in housing construction), as will those of the September 1995 stimulation package (equivalent to 3% of GDP), which will give a strong boost to public investment. Business investment should also strengthen under these circumstances, especially in typical growth sectors like data processing and telecommunications. There is scope for expansion here, and the higher profits and lower interest rates should lay the foundations for this. Investment by small businesses is unlikely to rebound significantly. Their financial positions are still precarious, and they will also have to adapt to greater competition both from abroad and at home, which can only become more intensive as the economy is deregulated in the coming years. Business investment will therefore probably rise less than in previous cycles, but its recovery will still mean more jobs, stronger consumer confidence and higher private consumption. The contribution of the external sector needs not shrink further in this situation, because export markets remain buoyant while the yen's recent depreciation has improved Japan's competitive position on the domestic and international markets. But imports will continue to soar for the time being, among them imports from Japanese-owned plants in other Asian countries.

The price deflation will probably abate this year, because of the less strong yen and higher capacity utilization rates. But prices will not start rising again for some time, not least because of the fierce competition from abroad.

With regard to fiscal policy Japan is clearly out of step with the other industrial countries. During the 1980s the Japanese government achieved spectacular improvements in the public finances, finding itself with an annual surplus equivalent to 3% of GDP in the early 1990s. But the recession has turned this surplus into a sizeable deficit, reaching 4% of GDP last year.

Over the coming period policy will remain focused on stimulating economic growth, with last September's ambitious investment programme playing a key role. The draft budget for the 1996/97 fiscal year (which starts on 1 April 1996) clearly intends to pep up the economy further. Expenditure is set to rise by nearly 6%, especially through public works, while tax receipts will lag behind because of the sluggish growth. Much of the shortfall will have to be made up by new government bond issues. Bailing out the *jusen*, the mortgage banks which are hamstrung by bad debts, will have to be financed in this way as well. The government budget deficit is likely to widen to around 4¾% of GDP in 1996. But as soon as the economy turns the corner, fiscal consolidation will again become a high priority. The deficit will probably start to narrow from next year onwards. The level of gross public debt, which has soared to 90% of GDP, should be reduced as a matter of urgency, since the deficits excluding the social funds are already running at no less than 8%, and the provisions for the ageing population will increase sharply in the coming years.

China and other Asia

The economies of China and the 'Dynamic Asian Economies' are expanding rapidly with, by developing countries' standards, low inflation rates. Last year's growth rates were slightly down on the previous years', ending up closer to the potential growth path (around 7% for the region as a whole). This moderation was due more to developments within the region than to the slowdown in the OECD countries, for the region now clearly has a dynamism of its own.

The Chinese economy in particular has cooled somewhat. Growth is now around 10%, reined in by a credit limitation and price regulation. Investment growth halved last year. Applications for foreign direct investment were down, not least because of political uncertainties. Inflation halved, albeit also thanks to price subsidies. But the acute danger of overheating is over. Imports continued to soar, as did exports to other

Tabel II.2 Economic growth Asia, 1995-1997 (CPB forecasts)

	Share of world-GDP	GDP volume 1995	1996	1997
	in %	annual percentage changes		
China	10,6	10	9½	9
Dynamic Asian Economies (DAEs)	3,2	7½	6½	6½
Southeast Asia[a]	3,6	7½	7½	7
South Asia[b]	4,5	5½	6	6
of which India	3,0	5¾	6	6
Asia	21,8	8¼	8	7¾

[a] Southeast Asia includes Indonesia, Thailand, Malaysia and the Philippines.
[b] South Asia includes India, Pakistan, Bangladesh and Sri Lanka.

countries in the region in particular. There is no doubt, then, that with its 1.2 billion people China is developing into an economic power of the first order, also in the commercial field.

In the other Asian countries, export growth was hampered by the Chinese cooling. In addition, monetary policy was generally tightened to reduce inflationary pressures. With some measure of success, since inflation fell from 22% in 1994 to below 15% last year. This dampened domestic demand. But both domestic and foreign sales will continue to boom over the coming years.

II.3 Latin America

The Latin American economies took a hard blow last year, both from the Mexican peso crisis and several banking crises. But appropriate policy interventions and ongoing structural reforms have already restored confidence. Foreign capital is again flowing into the region, against a background of rapidly improving trade balances. Mexico and Argentina have not quite overcome the effects of the financial crisis. Brazil's growth rate decelerated last year, with private consumption slipping in particular. Chile and Peru returned much better results. These days most countries attach a high priority to containing inflation, so that policies are restrictive all round. The external positions are sufficiently vulnerable, however, that the authorities must guard against mounting appreciation pressures in response to an excessive monetary squeeze. Another crisis along Mexican lines may then break in due course. The policy mix has a strong emphasis on austerity measures. In this way it is also possible to relieve inflationary pressures. Overall economic growth of the region is likely to run at around 4% over the coming years. By then the Argentine and Venezuelan economies should also be on the move again.

Tabel II.3 Economic growth Rest of the World, 1995-1997 (CPB forecasts)

	Share of world GDP	GDP volume 1995	1996	1997
	in %	annual percentage changes		
Latin America	9.1	1¾	3½	4
Middle East and North Africa	4.7	3½	3½	3½
Subsahara Africa	2.5	3½	3½	3½
Rest of the World	16.3	2½	3½	3¾

II.4 Commonwealth of Independent States

In the CIS countries of the former Soviet Union the steep fall in GDP appears to bottom out. Already last year Russia achieved strong growth in export-oriented sectors such as chemicals and engineering. This largely offset the continuing contraction of the light-industrial sector. But the order books thinned out in the course of last year, and in the last quarter also total industrial production declined. It therefore remains unclear whether Russia, the largest Soviet successor state, will be able to record positive growth already this year. If the reform policies remain in place, which will depend also on the results of the elections, a GDP growth rate of 3 to 4% is thought possible for next year. But other CIS countries, such as Ukraine, are not yet at this point.

III International markets

III.1 Goods markets

World trade volume

World trade growth decelerated sharply in 1995 following the industrial countries' domestic slowing-down. Owing to a substantial carryover from 1994 the average increase for 1995 still amounted to 8½%, but in the second half-year trade growth weakened markedly. The exports for Western Europe increased by 6¾%, compared to nearly 11% in 1994.

The trade boom in the non-OECD countries was sustained, however. Exports from the transition countries shot up last year by 13½%. Imports soared at a similar rate. Trade growth varied widely in the other non-OECD regions. Imports continued to surge in Asia and in the OPEC countries. In Latin America import demand was depressed by the Mexican crisis and lower output in Argentina and Brazil.

Because of the sluggish performances of the European economies in the early months of the present year, imports of the industrial countries will not pick up until later on. This means that world trade volume will expand by no more than 6½% this year, although demand from the rest of the world (Asia and Central and Eastern Europe) will remain strong. With reviving demand from the industrial countries in the course of this year, world trade growth should reach around 7½% next year.

Competitive positions are not expected to change significantly in the first few years. It is expected that the dollar will gain some ground on the European currencies. The effective depreciation of the German mark and the currencies linked to it may amount to around 1% in 1996 and 1997. So, no new impulses in this field have been assumed, but there will be the necessary lagged reactions to the changes in competitive positions having occurred in earlier years notwithstanding partial reversals of trends in the later part of 1995.

In addition to exchange-rate fluctuations, another key factor affecting competitiveness is the relative trends in unit labour costs. This year unit wage costs in Italy and France will rise faster than among their competitors, but next year all the major industrial countries will be broadly in step in this regard. Because of lagged reactions of markets to exchange-rate and wage-cost changes, the market positions of Japan, Germany and Europe as a whole will continue to deteriorate throughout 1996, while the market positions of the United States and the non-OECD countries should improve further.

World trade prices

Last year the price of world trade rose by around 7¾% in dollar terms. This was mainly due to the weakness of the US currency. In terms of weighted national currencies the increase was much more moderate, at around 3%. Prices of internationally traded industrial goods, which account for around three-quarters of total goods trade, reflected the subdued price inflation in the industrial countries. Prices of non-energy raw materials were also rather stable last year, but the carryover from 1994 pushed up the year-on-year increase. Oil prices fluctuated considerably during the year, but averaged over the year they rose broadly in line with industrial goods.

World trade prices are expected to remain fairly stable in 1996 and 1997. They should edge downwards in dollar terms. In weighted national currencies they should be slightly up in these two years by ½% and ¾% respectively. This has to do with the dollar's modest rally. The rise in terms of weighted national currencies is smaller than last year. In addition to the low inflation in the industrial countries, the economic downturn in Western Europe will also depress the prices of non-energy raw materials. The price of industrial goods is estimated to rise by ¾% in 1996 and 1997, compared to 2½% last year. Because wage costs in the industrial countries will move mildly upwards after falling in previous years, this implies a narrowing of producers' profit margins.

Balances of payments

The current accounts of the three major industrial countries are tending towards greater imbalance, but not extremely so. The German current-account deficit will widen from 1¼% of GDP in 1995 to 1½% and 1¾% in this and next year respectively, mainly as a result of worsening terms of trade. The US deficit will amount to around 2¾% of GDP, unchanged from 1995, although the bilateral deficit with Japan will gradually narrow, in part owing to the trade accords. Over the coming two years the Japanese current-account surplus will shrink to a low level by historical standards, less than 2% of GDP, mostly because of the expected economic recovery. (Between 1985-95 the surplus averaged 3% of GDP.) Among the other countries, the improvement in Italy's external position is striking. Its current account has been in surplus since 1993, and is expected to reach around 4% of GDP by 1997.

Energy and other raw materials

The projected global economic growth will boost energy demand by 2½% in 1996 and by 3% in 1997. These growth figures are higher than in 1994 and 1995, which is due to the economic upturn in the former centrally planned economies. Given the middling economic outlook, energy consumption in the OECD countries will increase moderately over the two years, by 1¼% and 1¾% respectively. But given the highly promising prospects for the Southeast Asian countries, the energy consumption in that region could rise by around 6½% per year.

In 1996 the rise in global demand will be more than fully met by the increase of non-OPEC supply. Assuming an agreement between the United Nations and Iraq for limited exports (to cover humanitarian needs), the call on OPEC (excl. Iraq) will decline to close to the cartel's actual production quotas, which is very low by historical standards. This will require an iron discipline from the OPEC countries if they are to prevent oilprices to nosedive. On the basis of the above, the estimated crude-oil price for 1996 comes out at $ 16½ (Brent, spot), despite occasionally higher

Table III.1 Key data world energy market, 1995-1997 (CPB forecasts)

	1995	1996	1997
	annual percentage changes		
Volume of primary energy consumption	1.8	2.5	3.0
Industrial countries	1.7	1.2	1.7
Transition countries	−4.0	1.8	3.2
Developing countries	5.0	5.1	5.1
	mln barrels/day		
Oil demand[a]	69.9	71.5	73.4
Industrial countries	40.3	40.6	41.2
Transition countries	6.1	6.3	6.6
Developing countries			
Oil supply[a]	70.1	71.8	73.6
Non-OPEC countries	42.3	44.2	45.5
OPEC	27.8	27.6	28.1
Market share, OPEC	39.8	38.6	38.3
Crude-oil price (Brent, $/barrel)	17.1	16.5	16.5

[a] Including natural gas liquids.

oil prices in the early months of this year.[1]

In 1997 OPEC should gain some benefit from the stronger demand for oil, because the non-OPEC producers will not be able to meet the increase in full. With Iraq's humanitarian exports rising slightly, OPEC should be able to hold on to its market share. Under these assumptions the price of crude will probably stay around $ 16½ in 1997. But if OPEC discipline weakens, or if oil demand increases less than anticipated, prices are likely to plummet. The slight increase of crude-oil prices forecasted by AIECE's Raw materials Working Group may be at the upper side of the possible margin.

After two years of substantial year-on-year price rises, raw material prices will probably lose some ground in 1996 and 1997. In dollar terms the commodity prices are likely to fall by 6% in 1996 and stabilize in 1997. Coupled with a slight weakening of manufactured goods prices this means that real raw material prices will fall in both years.

The market for foodstuffs and those for industrial raw materials both will see 1996 prices down on the previous year's. Prices for foodstuffs will probably hold up, but those for agricultural raw materials will fall sharply. Owing to the limited stocks of some foodstuffs, prices in this sector should be able to maintain their high levels during this year. That prices for 1996 will still be slightly weaker on a year-to-year basis is due to carryover. Owing to modest growth expectations and higher stock levels among users, nonferrous metal prices will fall. For industrial raw materials of agricultural origin the markdown compared to the 1995 level will be less significant.

Table III.2 International prices of raw materials, in dollars, 1995-1997

	1995	1996	1997
	annual percentage changes		
Non-energy raw materials[a]	14	−6	0
foodstuffs	3½	−1	−4
industrial agricultural raw materials	24½	−14	1
non-ferrous metals	22¼	−6	8
Crude oil[b]	9½	−3	0

[a] HWWA index.
[b] Import prices of OECD countries.

Only the foodindex is expected to rise in 1997. Assuming normal harvests in 1996 and 1997, the stocks/consumption ratio will return to an acceptable level next year,

[1]The energy price projections presented here are lower than those of the Working Group Report, more weight having been attached to downward risks.

especially in the case of cereals. The upshot is that prices for foodstuffs as a whole will fall. The economic upswing will have a positive effect on demand for industrial materials, leading to a small price increase next year.

III.2 Monetary markets

In the United States, and, to a certain extent, now also in Germany, the monetary authorities follow developments in the real economy with countercyclical policies. In Germany the first signs of a downswing were quickly followed by cuts in short-term interest rates. And in the United States the slowdown lead to a slight decline. The latter had been foreseen, but the German rate cuts were more surprising, since the sharp downturn in GDP growth was unexpected. In Japan the scope for monetary stimulation has been virtually exhausted, and short rates will remain close to the absolute minimum this year. Next year interest rates are expected to harden in all three major economies, on the back of more favourable developments in the real economy. The projection assumes a sustained gradual rally by the dollar against the German mark, and a constant nominal rate of yen 105½ to the dollar.

As anticipated, US short rates eased in 1995, so that they averaged nearly 6% over the whole year. In light of the expected economic developments in 1996 they are likely to tend further downwards. When the US economy returns to a steadier growth path next year, as anticipated in the projection, short rates will also start moving upwards. The yield curve (i.e. the gap between short and long rates) hovers around ½% in the United States. Provided interest rates do not shoot up unexpectedly, this differential can be maintained, so that long rates will stay around 6% both this year and next.

The dramatic economic slowdown in Germany has been followed by a sharp fall in German short rates, which may therefore average 3½% this year. This is the lowest annual nominal rate since 1965, although *real* rates have been lower, especially in the 1970s, when they were actually negative for several years. But the expected real short rates of 1½% are still very low compared to the 4½% average for the 1980s.

The last period of low nominal German short-term interest rates occurred between 1986 and 1988, when they averaged just over 4%. These years followed the collapse of the dollar and of oil prices. Both developments removed any inflation danger in Germany. Today's situation bears some comparison with these years. The 1996 inflation and growth forecasts for Germany are very similar to those for 1987. And more generally, there are no serious inflation dangers either. Raw material prices are settled, fiscal policy is restrictive worldwide, and wage pressures are weak. Yet there are some obvious differences with the situation a decade ago. The then West Germany recorded a current-account surplus equivalent to 4% of GDP in 1987, while Germany today has a substantial deficit in the aftermath of reunification. Then import prices were decreasing, while now they are following domestic price trends. And today the impending EMU makes an expansive monetary policy unlikely. In light of these differences, current interest-rate levels can indeed be considered low, and a reversal of the downward trend therefore seems likely. But a more telling argument for rate increases next year is the prospective economic recovery. If the current downturn is temporary, as is assumed here, then higher short-term rates are indeed on the cards. In view of the possible hardening of short-term rates in the foreseeable future, long rates are not expected to ease, so that they will remain fractionally higher than American long rates.

Table III.3 Nominal and real [a] interest rates, 1995-1997

	1995	1996	1997
	%		
Short-term rates nominal			
United States	5.9	5¼	5½
Japan	1.2	1	2
Germany[b]	4.5	3½	3¾
Long-term rates nominal			
United States	6.6	6	6
Japan	3.2	3¼	3¼
Germany[b]	6.8	6½	6¾
Short-term rates real			
United States	3.0	2.7	2.9
Japan	1.2	1.0	1.2
Germany[b]	2.7	2.0	2.2
Long-term rates real			
United States	3.7	3.4	3.4
Japan	3.2	3.2	2.5
Germany[b]	4.9	4.7	4.9

[a] Deflated by consumer prices.
[b] German Institutes.

Japanese short-term interest rates are currently at an absolute minimum of ½%, while long rates stand at around 3%. Since the Japanese economy is at last expected to strengthen this year, we expect interest rates to tend upwards as well. But both short and long rates will still remain very low, both by historical and international standards.

So what about exchange rates? In the past half-year the dollar/mark rate has risen, as many anticipated. There still seems some upward potential for the dollar, and the projected interest-rate differentials between Germany and the United States are too small to affect this rally significantly.

Graph III.1 Competitiveness, currencies and market performances
EU-4, US and Japan

Graph III.2 *Competitiveness, currencies and market performances*
Other European countries (alphabetical order)

Graph III.3 Competitiveness, currencies and market performances
Other European countries (alphabetical order)

The dollar/yen rate is if anything even more difficult to predict. On the one hand the yen seems likely to appreciate in response to the inflation differential. But on the other hand it may depreciate owing to the problems which the Japanese economy has now been grappling with for the last five years. These problems are partly attributable to a too expensive yen, and the Japanese authorities therefore seem intent on getting it down. Given these major uncertainties, this projection assumes a constant nominal dollar/yen rate.

IV Intermezzo: Economic and Monetary Union – progress and impact

IV.1 Introduction

Over the next few years, EMU will continue to be one of the major issues affecting the European economy. The sheer scale of the undertaking and the uncertainties associated with it (uncertainties as to whether, when and by whom it will be implemented as well as regarding its effects) are evident. 1997 is, furthermore, the year on which's basis admission to the monetary union will be decided in the spring of 1998. There is therefore good reason to pay attention to EMU when discussing the projections for 1996 and 1997.

This paragraph concentrates for obvious reasons on the shorter-term considerations, particularly the progress towards and macro-economic effects of convergence. No consideration is given here to longer-term issues such as how the transition to formal monetary union in 1998 should be managed, how the EMU should function and what the relationship should be between those EU countries within the system and those outside it.

IV.2 Timetable

At its Madrid Meeting in December 1995, the European Council reconfirmed its commitment to monetary union as provided for under the Treaty of Maastricht. The Council also made a number of important decisions regarding the introduction of a single currency, the most widely publicized of which were that monetary union would take effect on 1 January 1999 and that the new currency unit would be called the *euro*.

At present, the European Union is in Stage Two of the EMU project. As stipulated by the Treaty of Maastricht, the European Monetary Institute (EMI) has been set up as part of this second stage. This body is to undertake the legal, technical and institutional preparations for Stage Three and to promote co-operation between the central banks of the various member states.

The responsibility for exchange-rate and monetary policy, however, continues to rest with the national authorities during Stage Two. Another feature of this second stage is that member states are supposed to make their central banks independent.[2]
Finally, the various national governments are expected to pursue programmes designed to enable the convergence criteria to be met.

EMU convergence criteria

To be admitted to EMU, EU member states have to meet five criteria. These criteria relate to inflation, long-term interest rates, the net general government deficit (otherwise known as the EMU deficit), the gross general government debt to GDP ratio and participation in the EMS exchange rate mechanism (ERM). More specifically, the practical requirements are as follows. Inflation must not be more than 1½ percentage points above the average rise in the consumer price index in the three member states with the lowest inflation. Similarly, the interest rate on long-term government bonds should not be more than 2 percentage points above the average rate in the three countries with the lowest inflation. The net general government deficit should be less than 3% of GDP; however, this criterion is deemed to be met if the deficit is not too much above the reference value and either in structural decline or temporarily and exceptionally raised. Gross general government debt has to be less than 60% of GDP or approaching that value at a satisfactory pace. Finally, the national currency should have remained within its "normal" ERM bandwidth for two years without undue tension. At the time of the Treaty of Maastricht, the normal band was defined as extending 2¼% above and below the central rate (although in certain cases a band of plus or minus 6% was applicable). Since the August 1993 currency crisis, the normal band has been widened to plus or minus 15%.

It will be apparent that, even if the criteria are strictly applied (as the German government would like) the Maastricht Treaty allows considerable flexibility, especially in relation to government finances.

[2]A number of EU countries, including the Netherlands and Italy, have yet to implement this measure.

In the spring of 1998, the European Council will decide which EU member states may participate in the first round of monetary union[3]; the Council's decision will be based on advice from the EMI, the European Commission and Ecofin (the European Council of Finance and Economics Ministers). In some cases, including those of the Netherlands and Germany, the prior approval of the national parliament will be necessary for a nation's entry. The advice given to the Council is to be based on economic performance data for 1997. As soon as a decision has been taken, the Council will set up and appoint directors to the European Central Bank (ECB).

Monetary union of the participating countries will then take place on 1 January 1999. Upon creation of the EMU, the exchange rates between the various national currencies and between each of these currencies and the euro will be permanently fixed. From then on, the ECB will be responsible for monetary policy within the EMU; the central banks of the EMU countries will become part of the European System of Central Banks (ESCB), which will resemble the US *Federal Reserve* system in many respects.

Costs and benefits of monetary union

Benefits
* *Consolidation of the internal market*
* *Stable monetary and budgetary policy*
* *Reduced uncertainty over exchange rates, lower interest rates*
* *Reduced transaction costs*
* *The incorporation of Germany firmly within Europe*

Costs
* *Physical transition costs*
* *Cost of players' adaptation to new situation*
* *Loss of national exchange-rate control*

No later than 1 January 2002, euro notes and coinage are to enter circulation and withdrawal of the old money is to begin. The changeover to a single currency must be completed within a further six months, i.e. by 1 July 2002, after which date national banknotes and coinage will cease to be legal tender (although it will still be possible to exchange them for euros at a bank).

[3]The decision will be made on the basis of qualified majority voting.

Those countries which are not admitted to the EMU, the so-called *derogation* countries[4], will not be involved in the decision-making processes of the European Central Bank. Every second year the ECB will consider applications for admission from derogation countries. Applications will be judged on the basis of the same criteria used to determine eligibility for founder membership.

IV.3 Convergence

No attempt is made here to assess the relative merits of a sudden changeover to monetary union (as advocated by De Grauwe and others) and transition on the basis of convergence. The decision has already been made, with the main argument in favour of the more gradual approach being that the discipline displayed by the participants during the convergence period would create confidence in the new currency.

A number of observations can be made regarding the criteria themselves, and in particular regarding the suggestion that they are arbitrary, rigid and prohibitive. First, the criteria are undoubtedly arbitrary, in both qualitative and quantitative terms. Economic science does not provide a generally accepted theoretical foundation regarding the optimal levels of government debt and deficit, nor regarding optimal interest and inflation rates. The convergence criteria in the Treaty of Maastricht may be viewed as a negotiated compromise between the interests of those EU countries pursuing strict monetary and budgetary policies and those pursuing less strict policies.

Given that the purpose of setting the criteria was to provide a signal of the participants' willingness and ability to maintain the discipline required for membership of the EMU, the compromise nature of the criteria does not present any real problem. What matters more is that the convergence criteria should not be prohibitively strict. Over-strict criteria could be counterproductive. But neither should they be over-lax. At the time the Treaty of Maastricht was formulated, December 1991, the criteria appeared to serve their purpose. As Table IV.1 shows, eight or nine countries consistently met each criterion in 1991. However, the 1992-93 recession and the recent slowdown in economic growth have hampered convergence to an extent that had not been foreseen. With the deficit and the debt criterium narrowly interpreted, there would be in 1997 no sufficient basis even for a restricted, "hard core EMU". (Inflation and interest rate are no impediment for the vast marjority of countries.) With a more flexible interpretation, left open in the Treaty, with more indulgence than originally intended regarding the debt criterium and with a strong political will among the countries involved, the creation of

[4]A derogation is a notice exempting a treaty signatory from compliance with a particular provision.

such a hard core EMU would be conceivable. And even then, this would be jeopardized in case the projected economic upturn would not materialize.

This fact serves to highlight another feature inherent in a lengthy transition process: the likelihood of political and/or economic events interfering with convergence and creating uncertainty as to when and how monetary union will actually take place. It should, however, be noted that the slow pace of convergence is not simply due to circumstances beyond governmental control; certain countries have not made a serious enough effort to meet the criteria. Naturally, this has not helped to create confidence in the EMU project.

EMU, when and who? The Institutes' bet

In their answers to the questionnaire 50% of the responding institutes consider, with the necessary provisos, a "hard core" start in 1999 as most probable outcome. They underline that such a decision would necessitate a flexible interpretation of the criteria, within or perhaps even outside the limits set by the Treaty. "Hard core" nominees are usually, whenever mentioned, Germany, France, Benelux countries and Austria, while other potential candidates, Finland and Ireland, apparantly have been forgotten most of the time.

25% of the respondents opt for postponement, by 2 or 3 years, as most probable outcome.

The remaining 25% of the Institutes consider the question as unanswerable.

Table IV.1 EMU convergence indicators, 1991-1997 (CPB forecasts)

	Consumer price inflation				Long-term interest rate			
	1991	1995	1996	1997	1991	1995	1996	1997
	annual percentage changes				%			
EMU-criteria[a]	4.4	2.9	3½	3½	10.2	9.7	8¾	8¾
Austria	3.3	2.3	2¼	2¼	8.6	6.5	6¼	6¼
Belgium	3.2	1.4	2¼	2	9.3	7.4	6¾	6¾
Denmark	2.4	2.0	2½	2¾	9.3	8.3	7¾	7¾
Finland	4.3	1.0	2	2¼	11.8	7.9	7	7
France	3.2	1.7	2	1¾	9.0	7.7	7¼	7¼
Germany	3.6	1.8	2	2¼	8.5	6.8	6	6
Greece	19.6	9.3	8	7	.	19.3	16¼	14¾
Ireland	3.2	2.6	2½	2¾	9.2	8.3	8	8
Italy	6.4	5.4	4	3½	13.3	11.8	10¾	10½
Luxembourg	3.1	2.0	1¾	2	8.2	.	.	.
Netherlands	3.1	2.0	2½	2¼	8.7	6.9	6	6
Portugal	11.4	4.1	3¼	3	17.2	11.4	10½	10½
Spain	5.9	4.6	3½	3	12.4	11.0	10¼	10¼
Sweden	9.7	2.5	2½	3	11.7	10.2	9	9
United Kingdom	6.8	2.8	2½	2½	10.1	8.2	7½	7¾
Total EU countries	5.3	2.8	2½	2½	10.6	8.4	7¾	7¾

[a] The relevant criteria are: a. consumer price inflation must not exceed by more than 1.5 percentage point the average for the three member states with the lowest inflation, b. long-term interest rates must not be more than 2 percentage point higher than those in the same three member states, c. the general government deficit must not be greater than 3 percent of GDP and the public debt-GDP ratio no more than 60%. The Maastricht Treaty requires a substantial and continuous decline of fiscal deficits toward the reference value, and the debt-GDP ratio must be approaching the benchmark at a satisfactory pace.

Table IV.1 Continued

	General government balance				Gross government debt			
	1991	1995	1996	1997	1991	1995	1996	1997
	% GDP				% GDP			
EMU-criteria[a]	−3	−3	−3	−3	60	60	60	60
Austria	−2.4	−5.5	−5¼	−5	59	68 ↑	70	72
Belgium	−6.7	−4.5	−3½	−4	130	134 ↓	133	131
Denmark	−2.1	−1.7	−1¾	−1¼	65	73 ↓	73	71
Finland	−1.5	−5.4	−2½	−1¾	23	63 ↑	66	66
France	−2.2	−5.4	−5	−4	36	52 ↑	55	55
Germany	−3.3	−3.6	−3½	−3	42	59 ↑	60	60
Greece	−11.4	−9.3	−8½	−7½	85	114 −	114	113
Ireland	−2.2	−2.1	−2½	−1¾	97	85 ↓	82	77
Italy	−10.2	−7.4	−6½	−6	101	125 ↑	124	123
Luxembourg	1.9	0.4	½	¾	4	6 −	7	7
Netherlands	−2.9	−3.4	−3¼	−2¼	79	79 ↓	78	78
Portugal	−6.6	−5.4	−5	−4½	70	71 ↑	71	71
Spain	−4.9	−5.9	−5	−4	46	65 ↑	66	66
Sweden	−1.1	−6.8	−5	−4	53	81 ↑	81	81
United Kingdom	−2.6	−5.1	−4¼	−3¼	36	53 ↑	54	54
Total EU countries	−4.3	−5.0	−4½	−3¾	56	71	73	72

IV.4 Social consequences

As numerous studies have indicated[5], social security reforms will be necessary sooner or later, whatever is decided on the question of monetary union. Thus, the convergence criteria serve merely as the catalysts, accelerating inevitable reform. It may therefore be said that movement towards monetary union is beneficial, the more so since the longer the changes are delayed, the more painful they will be.

In this context, it should be recalled that the convergence criteria allow member states considerable freedom in how to consolidate government finance. The measures employed to bring about convergence are chosen by the individual governments on the basis of their own politico-economic priorities and the prevailing national conditions. In framing their policies, member states can take account of the rigidity of the labour market / welfare system and trends such as the impact of the internal market, the emergence of regions and the rate at which the general population is ageing.

Nevertheless, it cannot be denied that member states' national governments are faced with the problem of defending not only the logic of achieving EMU, but also that of their chosen tax and premium increases and/or expenditure cuts. The degree to which they are successful in doing so may be seen as a measure of the EMU's viability. If, for instance, the French government succeeds in persuading the nation of the necessity of social reform, this will be seen by other prospective EMU member states, and by Germany in particular, as evidence that France is prepared to accept the discipline which stable monetary and budgetary policies require, just as Germany has shown herself prepared to bear the cost of reunification.

Most EU countries are presently pursuing restrictive budgetary policies. The question is what repercussions this will have for the levels of effective demand and employment. First, it should be remembered that, insofar as reform is unavoidable, any associated possible reduction in demand is really only a question of timing. The wish to meet the EMU criteria merely obliges a number of nations to swallow the bitter pill of budgetary consolidation at an earlier stage.

Recent experience in Denmark and Ireland suggests that demand does not always fall in response to budgetary consolidation. In these countries, the downward pressures on demand were offset by increased consumption and investment, as a consequence of heightened confidence and a smaller risk component in interest rates. Compensating effects of this kind are most likely when budgetary reforms are of a structural nature,

[5]See, for example, OECD, "Structural Adjustment and Economic Performance", Paris, 1987; CPB, "Nederland in Drievoud" (The Netherlands in Triplo), Sdu, The Hague, 1992; OECD, "Jobs Study", Paris, 1994.

giving grounds for confidence that a government's finances are being put in order.[6] Lower nominal interest rates contribute directly to lower budgetary deficits, in particular in countries with high levels of government debt. Nevertheless, there is a risk that budgetary consolidation will suppress demand, especially if a number of EU countries simultaniously reduce deficits at an unfavourable point in the business cycle. Thus, a delicate balance has to be struck: too little consolidation undermines trust in EMU, while too much can damage fragile economic confidence.
In de longer run, if functioning effectively, the EMU will certainly bring down interest rates, reduce uncertainty and increase internal market efficiency, with positive effects on growth and employment. These effects will in turn bring social benefits for the European Union. Any negative consequences of heightened policy competition could in principle be tackled by supranational co-ordination at EU level. Political support for such co-ordination might well increase if the EMU project were successful. Monetary union could also affect the labour markets in member states. The removal of exchange rate controls could directly (by increasing the influence of market forces) or indirectly (as a consequence of increased co-ordination) promote flexibility in the labour market and thus reduce unemployment.[7]

Monetary union is not, however, a panacea for Europe's unemployment problems. Unemployment in the EU can only be addressed by structural changes in the labour, goods and services markets. Given the structural nature of unemployment and the differences between member states in terms of their unemployment patterns and their views on the most appropriate policy tools, central co-ordination of unemployment policy by the European Union does not appear practicable, despite the fact that an inefficient labour market compromizes the pursuit of monetary stability. The EU member states adopted this stance following the presentation of Delors' White Paper entitled "Growth, competitiveness and unemployment"[8] in 1993 and more recently in their reactions to the Santer's proposals at the Torino-summit.

[6]See, for example, Alberto Alesina and Roberto Perotti, "Fiscal Expansions and Adjustments in OECD countries", pp. 205-248, Economic Policy, October 1995.

[7]For more information on the effects of monetary union on the labour market, see Torsten Peters, "European Monetary Union and labour markets - what to expect?", International Labour Review, 1995.

[8]European Commission, "Growth, competitiveness and unemployment", Brussels, 1993.

V European economy

V.1 Western Europe

General picture

The downturn in Western Europe was recognized late. As recently as last December both the OECD and the European Commission thought that GDP volume of the European Union would expand by 2¾% in 1995. The same rate was projected for the second half of that year. Reality turned out to be rather different. GDP growth did not reach half the projected figure in the second half year, and investment growth almost came to standstill. Some stuttering is not unusual during the upward phase of an economic cycle, for instance when stockbuilding tails off or during the transition from export-led to domestic-demand-led growth, but the severity of the downturn took all analysts by surprise. The explanation offered is that the demand-depressing effects of last year's high long-term interest rates were probably underestimated, particularly their impact on the construction sector; the same could be true for the (initially) growth-dampening effects of wage moderation and government austerity measures. Other significant factors last year were the turbulence on the financial markets – also affecting the bilateral exchange rates between EU countries – which precipitated major shifts in national competitive positions, and growing concern over government policies on the road to EMU. The latter was true above all for France and Italy. From early last year, confidence among both producers and consumers steadily drained away in most European countries. Later in the year this was reflected in the output figure (see graph).

Yet, as for other world regions, the growth outlook for Europe is favourable. Company profits are still quite reasonable, inflation is set to remain low, wage increases are in general modest, and industrial capacity is sufficient to avoid tensions on product markets. The financial markets have calmed down. The exchange-rate shifts of last spring have been largely undone, and long-term interest rates have eased to low levels. And there is now greater clarity about the thrust of French government policy. Europe

Graph V.1 Production and economic sentiment European Union, 1992-1995

Table V.1.1 GDP volume growth Europe, aggregated AIECE forecasts

	1995	1996	1997	1995	1996	1997
	annual percentage changes			contribution in %-points		
Private consumption	1.8	1.9	2.2	1.1	1.1	1.3
Government consumption	1.2	0.9	0.7	0.2	0.2	0.1
Gross fixed investment	3.6	2.2	3.5	0.7	0.4	0.7
Stockbuilding				0.1	−0.2	0.2
Domestic demand	2.1	1.6	2.4	2.1	1.6	2.4
Exports goods & services	6.7	4.8	5.8			
Imports goods & services	5.8	4.1	5.3			
Net exports				0.3	0.2	0.2
GDP	2.5	1.7	2.5	2.5	1.7	2.5

should also benefit from encouraging economic developments in the United States and Japan and sustained growth in the rest of the world. Under these circumstances business and consumer confidence is likely to return. Helped by low interest rates, business investment could become one of the driving forces behind the upturn. Private consumption should move in line with GDP growth, while the impulses from net exports will gradually disappear. Because of a small carryover, the EU economies will probably expand by only 1¾% for the year as a whole, ¾ percentage point less than in 1995. But growth should accelerate in the course of this year, resulting in an annual growth figure of 2½% in 1997.

This year's production growth is too low to improve the unsatisfactory situation in the European labour market. Jobs growth is only barely keeping up with labour-supply growth. The downward trend in unemployment petered out in the course of 1995, but it may well resume next year on the back of sustained economic growth and job-creating programmes launched in a number of countries. At 10½ to 10¾% of the labour force, the rate of unemployment will remain very high, however (see p. 50).

Fundamentals and outlook for rebound

Not surprisingly, institutes interpret in various ways the somewhat vague concept of fundamentals. Most of them include inflation and interest rates, often adding the balance of payment situation. Quite a few institutes mention also the position of enterprises, either as competitiveness, profitability and/or solvency. The government deficit, or the ensuing budgetary policy, are also regularly mentioned. A number of institutes include unemployment among the fundamentals and so do others with respect to external demand.

Notwithstanding this diversity with regard to the concept a majority of institutes consider fundamentals in their country as favourable or at least improving. There are mixed views with respect to the government deficit; when judged favourable this is usually done in the sense of `improving' rather than 'healthy'. Institutes mentioning unemployment are unanimous in considering that element as unfavourable.

The wide spread opinion seems to be that fundamentals as such will not hamper a rebound to materialize in 1996.

The moderate demand growth will have a beneficial effect on inflation. Measured by consumer prices, it will ease further to 2½% in 1997. With output expected to rise less than 2¾%, no inflationary capacity constraints should develop. In this low-inflation climate it should also be possible to restrict wage-cost increases to 2 to 2½%. Whether the recovery in Europe will unfold as indicated here, or whether it will take longer for confidence and investment to revive, depends in part on developments in the financial markets. National governments can help to steady the markets by providing clarity about how they intend to proceed to EMU. This could also make a direct contribution to the investment recovery, since it would allay investors' fears.

Major EU countries

The key downward revision in growth forecasts relates to *Germany*. While the German economy expanded by an already modest 2% last year, the 1996 figure is unlikely to exceed 1¼%. The German institutes – with one exception – project at best 1% growth. This low figure does hide a recovery during the year, however. The prospects for a sustained recovery, extending into 1997, are generally favourable. But precisely when it will set in is difficult to predict. That is why a lower growth rate for 1996 cannot be ruled out.

Graph V.2 Industrial competitiveness of Germany and Other EU countries (1985=100)

German competitiveness

In the past decade, competitiveness of the (west-)german industry has deteriorated substantially. Unit labour costs have risen more than with competitors on international markets, while its European competitors, partly mirroring that development, experienced declining relative labour costs. German cost increases were nearly fully passed through into higher export prices, where the other European countries could maintain their export price position relative to competitors. They used their more favourable cost price development to reduce the labour share in industry income, while on the other hand the german labour share rose. Due to the erosion of price competitiveness, german industry has lost about one-third of its share on foreign export markets since 1985, excluding trade with East-Germany. Allegedly, german industry sacrificed market shares abroad due to the tremendous increase of sales to East-Germany, by raising profit margins and export prices. That vision is not supported, however, by the graphs, which show inter alia that relative export prices have not risen much faster than relative unit labour costs in the unification years 1990-1991, while there has not been an opposite movement in the following years. The labour share in total industry income did not rise either during the "boom" years 1990-1991. Germany's European competitors as a group experienced only a marginal loss of market share in the past decade, which can be attributed fully to the rising participation of the Third World countries in world trade. Naturally, that penetration has also negatively affected the german export performance.

Table V.1.2 Key data EU countries and Germany, 1995-1997 (CPB forecasts)

	EU countries[a] 1995	1996	1997	Germany 1995	1996	1997
	annual percentage volume changes					
Private consumption	1¾	1¾	2½	1½	2	2¼
Government consumption	1	1	1	1¾	1½	1½
Gross fixed investment	3½	2½	4¾	1¼	−½	4
Domestic demand	2¼	1½	2½	2	1	2½
Exports	7	4¾	6½	3	3½	6½
Imports	6	4	6½	2½	2½	6½
GDP	2½	1¾	2½	2	1¼	2½
	annual percentage price changes					
GDP	3	2¾	2½	2	2	2¼
Private consumption	3	2¾	2½	1¾	2	2¼
	levels in %					
Unemployment[b]	11	11	10¾	8¼	8¾	8¾
General government financial balance[c]	−5	−4½	−3¾	−3½	−3½	−3

[a] EU-15, weighted on the basis of purchasing power parities.
[b] As a percentage of the labour force.
[c] As a percentage of GDP (EMU definition).

German GDP growth stagnated after the first quarter of last year, and was even slightly negative in the fourth quarter. In the first half-year private consumption made an unexpectedly large contribution to output growth, despite a major tax hike through the 'solidarity tax', but later in the year consumer demand plummeted after all. Another setback was that the high capacity utilization rates in industry at the year's start did not spark an investment boom. Expenditure on plant and equipment even declined in the second half-year, not least because of disappointing export results and deteriorating profit expectations. Construction investment was only slightly up. The housing construction boom in western Germany collapsed at the end of 1994 when several tax breaks ran out, while in the eastern states the increase in building activity slowed for structural reasons. The contribution of the external sector plummeted. German industry's already weakened competitiveness was further eroded by the relentless appreciation of the D-mark and (in the eyes of many) excessive pay settlements. Foreign orders started to fall off, and businesses became increasingly pessimistic about their export opportunities.

Table V.1.3 GDP volume growth of European countries

Country	Institute	1995	1996	1996[a]	1997	1997[a]
		annual percentage changes				
Austria	WIFO	1.8	0.7		1.0	
Belgium	DULBEA	2.0	1.75	1.6	2.75	2.3
	IRES	1.9	1.5		1.8	
Czech Republic	IE-CNB	4.8	5.5		5.8	
Denmark	DOR	3.1	0.8		2.2	
Finland	ETLA	4.2	3.0		2.5	
France	BIPE	2.4	1.2	1.3	2.7	2.6
	COE	2.4	1.7		2.7	
	INSEE	2.4				
	OFCE	2.5	1.0		2.5	
	REXECODE	2.4	1.2		2.4	
Germany	DIW	1.9	0.5	0.9	1.0	2.2
	HWWA	1.9	1.0		2.5	
	IFO	1.9	1.0			
	IfW	1.9	0.6		2.6	
	RWI	1.9	1.5		2.5	
Greece	CPE	2.0	2.5		2.8	
Hungary	GKI	0.75	1.0	1.6	2.5	2.5
	KOPINT	1.25	2.25		2.5	
Ireland	ESRI	7.3	5.9		5.0	
Italy	CSC	3.2	2.5	2.1	2.8	2.3
	IRS	3.0	1.8		2.1	
	ISCO	3.3	2.2			
	PROMETEIA	3.3	1.7		2.0	
Netherlands	CPB	2.4	2.1		2.7	
Norway	CBS	3.7	3.7		2.4	
Poland	FTRI	7.0	6.0		5.5	
Slovenia	SKEP	4.5	4.0		4.5	
Spain	DGPC	3.0	3.4			
Sweden	Industriförbundet	3.0	0.4		1.3	
Switzerland	ETH	0.4	0.1		2.2	
United Kingdom	LBS	2.6	2.4		3.2	
	NIESR	2.6	2.4	2.4	3.2	3.2
Total European countries		2.5	1.7		2.6	

[a] Country average

Because of the faltering output growth the situation on the labour market could not improve. The shedding of labour continued and unemployment started edging up again. The appreciating D-mark and rising wage costs have made employers even warier of taking on staff. But quite apart from these temporary influences, over the coming period businesses will show a marked tendency to restore Germany's competitive position by realizing productivity gains. The projected output recovery will therefore probably create fewer jobs than historical relationships would suggest.

Inflation has fallen back sharply since early 1995. The mark's appreciation and weaker world commodity prices made imports cheaper and also ensured keener competition on the domestic market. The basing of the consumer price index to a more recent base-year produced an appreciably lower inflation figure (see box). Since last autumn it hovers around 1½%.

France may post an average GDP volume growth of around 1¼ to 1½% this year. Here too, output went sharply down during 1995, and this was reinforced by last December's strike wave. The downward trend in unemployment was reversed in the second half-year. Manufacturing industry in particular has scaled down its sales expectations. Consumption is only fractionally up. Consumers used most of last year's appreciable increase in purchasing power to replenish their savings. This year lower interest rates and increasing employment might boost consumption growth, at which point the saving ratio of households may come down again. Surveys suggest that business investment should still revive. There is quite some catching up to do after years of weak investment activity, and the financial position of French enterprises is reasonably healthy. But the plans will only be implemented when final demand strengthens. Exports took a knock last year, both because of flatter markets, particularly in Europe, and the appreciation of the franc. The external sector is not expected to make a positive contribution to GDP growth in the coming years. But final domestic demand is improving, investment is expected to revive in 1997 in particular, and GDP growth of 2½ to 2¾% seems within reach next year. Inflation remains in check. The increase for 1996 is still on the high side as a result of the 2% increase in the standard rate of VAT last August, but, as in Germany, the underlying trend is only a little above 1½%. Wage costs are not expected to rise. Employment is growing little this year, but could increase next year by over ½%, so standardized unemployment could stabilize in 1997 at 11¾%, or slightly fall.

The *United Kingdom* is in the fourth year of a cyclical recovery. Compared with earlier upturns, GDP growth is now remarkably even, although there are wide fluctuations in the components. Not unusually for this stage of the cycle, economic growth slackened last year. Growth came out at around 2% for the year, which is below the long-term average. Private consumption increased by 2%, twice as much as business investment, while stockbuilding contributed around ½%-point to GDP

Table V.1.4 Key data France and United Kingdom, 1995-1997 (CPB forecasts)

	France 1995	1996	1997	United Kingdom 1995	1996	1997
	annual percentage volume changes					
Private consumption	2	1	2¾	2	2	2½
Government consumption	2¼	1¾	1	¾	1¼	1½
Gross fixed investment	2½	2¼	4¾	¾	2	4
Domestic demand	2¼	1½	2¾	2	1½	2½
Exports	6¼	3	5½	4½	6	7½
Imports	4½	2¾	6	2½	4½	6½
GDP	2½	1½	2¾	2½	2	2¾
	annual percentage price changes					
GDP	2	2	2	2½	2½	2¼
Private consumption	1¾	2	1¾	2¾	2½	2½
	levels in %					
Unemployment[a]	11½	11¾	11¾	8¾	8½	8¼
General government financial balance[b]	−5½	−5	−4	−5	−4¼	−3¼

[a] As a percentage of the labour force.
[b] As a percentage of GDP (EMU-definition).

growth, the same as in 1994. Net exports were strongly positive. A striking feature is that services expanded at a far brisker pace than manufacturing output. Capacity utilization rates in manufacturing rose initially, but as output levelled off this trend stopped. There is still sufficient capacity for industrial production to expand by 2 to 2½% over the coming years. Because of the sluggish early months, economic growth will not exceed 2% in 1996, but will be substantially higher next year. The upswing will be driven primarily by net exports and business investment, while private consumption may also perk up. Given this moderate outlook, inflation should remain in bounds. The GDP deflator increase, which dropped to a historical low of 2½% last year, will probably be even marginally lower next year.

In *Italy* the sharp depreciation of the lira, coupled with a quite moderate domestic cost development, gave a strong boost to growth last year. The economy expanded by around 3¼%, driven mainly by exports. Burden relief for businesses had a favourable effect on investment, which continued to surge. The construction sector showed little sign of life, however. At least as weak was private consumption, held back by the minimal employment growth and loss of purchasing power. This was because wage increases were in line with the official inflation target, while the actual inflation rate was appreciably higher. Inflation was fuelled by the weaker lira, higher commodity prices and wider profit margins. Consumer prices rose by no less than 5¾% between the end of 1994 and the end of 1995. The rate of price increase has now peaked, however. The lira is rallying and the VAT increase does not show any more in the year-on-year changes. Economic growth is expected to decelerate this year. It will be driven less by exports, because the depreciation effect is wearing off, and more by domestic consumption. The latest collective labour agreements indicate that wages will rise marginally in real terms. This means that consumption growth should slope gently upwards next year, and that private investment should remain strong. Both will boost imports, so that the external sector's contribution to GDP growth will become negative. Overall growth should nevertheless accelerate to 2½%.

Table V.1.5 Key data Italy and Belgium, 1995-1997 (CPB forecasts)

	Italy			Belgium		
	1995	1996	1997	1995	1996	1997
	annual percentage volume changes					
Private consumption	1¼	2	2¼	1¼	1	1¾
Government consumption	−¾	0	¼	−¼	½	¾
Gross fixed investment	5¼	4½	6	5	2¼	4
Domestic demand	2	1¾	2½	1½	1	2
Exports	14	6	6½	8¼	4	6
Imports	10½	6	7½	8	3½	6
GDP	3½	2	2½	2	1½	2¼
	annual percentage price changes					
GDP	5	4½	3¾	2	2¼	2¼
Private consumption	5½	4	3½	1½	2¼	2
	levels in %					
Unemployment[a]	12¼	12¼	12	10	9¾	9½
General government financial balance[b]	−7½	−6½	−6	−4½	−3½	−4

[a] As a percentage of the labour force.
[b] As a percentage of GDP (EMU-definition).

Labour market and labour market policies

Unemployment is high in Europe. Structural unemployment has been so for many years now. For EU-15 e.g. the unemployment `low' of the last fifteen years was as much as 8%, attained in 1990. Since it has increased again and has featured double- digit figures from 1993 on. For 1996 it should stabilize around 11% and little decline is expected for next year.

Only few institutes sound a positive note. So does CBS for Norway, where unemployment is below 5% and declining. Ireland's EIRE, too, reports positive developments: an expected substantial decrease of unemployment by 3 percentage points in the period 1994-1997, although the level still remains high. Austrian and Swiss unemployment figures look bright in the European context, but in the Austrian case unemployment appears to be a subject of serious concern, according to the reply by WIFO. Also the Netherlands has recently performed relatively well, compared to its European partners: unemployment which was near to the European average in 1990 is now more than 4 percentage points below. But CPB signals high levels of hidden unemployment, especially among beneficiaries of the disability and early retirement schemes; taking account of these components would more than double the unemployment figure. Comparably Industriförbundet mentions for Sweden a substantial hidden unemployment of 5 percentage points above the unemployment of 8% of the labour force.

Institutes report, in answer to the questionnaire, a broad range of measures, taken or under discussion, but express at the same time little confidence in their effects. Results will, according to the replies, take anyhow time to materialize.

Quite a number of institutes indicate that a basic policy element in improving the labour market situation are the growth strategies aiming at increased competitiveness and increased adaptability of the economy in order to stimulate growth. Where public investment programmes are part of such strategies (i.a. Austria and Finland) there enters possibly a Keynesian demand stimulating element into them. (Such Keynesian elements are also brought into discussion, in a negative sense, when concern is expressed about the effects of the deficit consolidation policy, especially in the short run.)

Wage restraint is a second line for stimulating employment, especially, but not solely, for small open economies. Different approaches are followed. In Norway wage restraint was achieved thanks to centralized wage formation procedures. In Italy, on the contrary, decentralization inducing (regional) wage differentials and consequently mobility and higher labour supply in leading regions is seen as the appropriate strategy. In Greece a restrictive wage policy for the public sector is hoped to influence the bargaining process in the market sector. In Belgium the government has initiated negociations with the social partners in order to reduce unemployment, one of the elements being to arrive at wage increases not exceeding those of Belgium's main commercial partners. In Germany one component of the `Alliance for Labour' is a trade off of wage restraint and job creation. In the Netherlands much more restrictive rules concerning admittance to and maintenance within the disability schemes (inducing lower wage-rise by increased labour supply) are a newly introduced instrument in the policy aiming at wage moderation. Restricting the access to social security schemes is mentioned as part of the labour market strategies of i.a. Denmark and Switzerland, while the question is under discussion in Finland.

Lowering the labour costs by reduction of social contributions paid by employers is mentioned for different countries, i.a. Belgium, France, Greece and Italy, sometimes focussed on the lower end of the labour market and related to programmes of job

Table V.1.6 Unemployment rate[b] of European countries

Country	Institute	1995	1996	1996[a]	1997	1997[a]
		annual percentages				
Austria	WIFO	3.8	3.9		4.2	
Belgium	DULBEA	9.4	9.4	9.6	9.2	9.6
	IRES	9.4	9.8		10.1	
Czech Republic	IE-CNB	2.9	3.2		3.6	
Denmark	DOR	10.2	9.4		9.4	
Finland	ETLA	17.0	16.3		15.8	
France	BIPE	11.6	11.9	11.9	11.6	11.7
	COE	11.6	11.9		11.7	
	INSEE	11.6				
	OFCE	11.6	11.9		11.6	
	REXECODE	11.6	12.0		11.8	
Germany	DIW	8.3	9.1	8.9	9.4	9.1
	HWWA	8.3	9.1		9.0	
	IFO	8.3	8.3			
	IfW	8.3	9.2		9.2	
	RWI	8.3	8.9		8.6	
Greece	CPE	9.6	9.5		9.4	
Hungary	GKI	11.2	11.1	11.1	10.8	10.8
	KOPINT	11.2	11.2			
Ireland	ESRI	12.9	12.1		11.5	
Italy	CSC	12.2	11.8	11.9	11.0	11.4
	IRS					
	ISCO	12.2	12.0			
	PROMETEIA	12.2	12.0		11.8	
Netherlands	CPB	6.6	6.5		6.2	
Norway	CBS	4.9	4.5		4.4	
Poland	FTRI	14.9	14.1		13.5	
Slovenia	SKEP	13.9	13.5		13.1	
Spain	DGPC	22.9	21.6			
Sweden	Industriförbundet	9.2	9.5		9.2	
Switzerland	ETH	3.1	3.4		3.3	
United Kingdom	LBS		8.0		7.3	
	NIESR	8.7	8.0	8.0	7.1	7.2
Total European countries		10.7	10.6		10.3	

[a] Country average.
[b] Standardized unemployment.

promotions for long-term unemployment (e.g. the French contrat initiative emploi). Doubts are sometimes expressed with respect to the overall effectiveness of these measures: in the French case because of substitution effects; for Belgium a study of the Belgian Planning Bureau indicates that the macroeconomic effects of a (general) reduction of employers contribution is very low if it has to be compensated by tax increases or reduction of public expenses.

Labour time reduction is mentioned as an instrument to reduce unemployment in the case of Austria (where reduction of overtime is under discussion) and France (stimulation of early retirement). A study by CPB indicates that reduction of the weekly working time could have beneficial effects on unemployment, but only under strict conditions.

Flexibilisation of working time has been introduced in Finland and is under discussion in Switzerland and stimulation of parttime works is pursued on a small scale in Germany; Norway and the Netherlands have achieved very high degrees of parttime work compared to other OECD countries. Flexibilisation of labour time is one element in a more general move towards deregulation of the labour market in favour of adaptability to labour demand. The most spectacular example of such a more general deregulation is the reduction (the breaking in some cases) of power of labour unions in the United Kingdom. Quite different, but also aiming at adaptation to demand, are the training and (re)education programmes launched in many countries. Although the effects of the policies underway are difficult to assess, the feeling of the majority of the institutes is, as mentioned earlier, that the effects can only be modest and take time to materialize. For the short-term under discussion here, therefore, a more than marginal reduction of unemployment seems out of reach given the growth projections.

Fiscal policy

Fiscal policy is restrictive in all western European countries. In many the scope for an independent fiscal policy seems constrained by the agreed EMU convergence criteria, namely a maximum general government deficit at least close to 3% of GDP and a gross public debt that does not exceed 60% of GDP or is at least moving towards that level at an acceptable pace. But even without these commitments the view is gaining ground that budget deficits should only exceed 1% of GDP under very unfavourable conjunctural circumstances. Most countries are still a long way from that situation, however. The budget outturns for 1997 will help to decide whether a country qualifies for participation in EMU from 1 January 1999. In the current projections, based on policy intentions announced thus far, only a small number of countries meet the deficit and debt criteria. This select group cannot but include Germany. But several countries which do not qualify at the moment are likely to tighten their fiscal policies in the coming year. That could also ease interest rates in the countries concerned, which at the moment are still paying an appreciable premium on German interest rates.

Fiscal consolidation in *Germany* was given a proper footing early last year with the reintroduction of the 7½% 'solidarity surcharge' on income tax. But partly because of the growth shortfall, the general government's budget deficit rose to the equivalent of just over 3½% of GDP, 1% up on 1994. The weakness of the economy will peg the deficit at least at that level this year, despite the expenditure cuts agreed by the federal government. Because many of these 'savings' are in fact outlays passed on to lower-tier authorities, it is not certain whether these will be able to sustain their own austerity policies. Part of the funding for the recently announced 'Fifty-Point Programme for Investment and Employment' will supposedly be released by a reduction in the proportion of VAT receipts allocated to the states. Households' total tax and premium burdens will be relieved this year because minimum wages will be taken out of income tax and family allowances will be raised, while the Supreme Court has ruled the *Kohlepfennig*, a long-established energy tax, unconstitutional. At the same time social-security contributions will be raised, but consumers will still be considerably better off. Next year the federal government will continue its fiscal consolidation on the basis of reduced expenditure and higher social premiums, with the official target a deficit below 1% of GDP by 1999.

In *France* the government tightened fiscal consolidation policy last year. The general government deficit had widened to around 5½% of GDP at that time, well outside the 3% EMU norm. The 1996 budget provides for very few expenditure increases, concentrated in investment outlays, while civil servants' salaries will be frozen. Additional revenue will be generated this year primarily from the tax increases contained in last June's supplementary budget (covering VAT, corporate tax and property tax) and from privatizations. Last November the government also put the knife into the social-security system. The measures that will take effect this year are aimed at reining in healthcare costs, and also include a sharp rise in premiums and a new tax to reduce the deficits in the social-security funds. The tax relief on life insurance policies will be lowered, the increase in property tax introduced as a temporary measure in July 1995 will be extended, and family allowances will be frozen. All this should bring the general government deficit down to 4% of GDP this year and to around 3% next year. But these targets have already been overtaken by the lower growth expectations. The latest official figures project a deficit of about 5% for 1996. Further measures will therefore be required. In concert with its German counterpart the government earlier this year announced a package of measures to stimulate economic activity over the short run. Private consumption will receive impulses from a dissaving incentive (the tax-free interest on savings accounts will be cut by 1 percentage point) and a tax break on consumer credit.

The *United Kingdom* has been moving rapidly towards budget balance since 1993, when the deficit reached nearly 8% of GDP. Next year it will probably be among the select group of countries that will meet the EMU criteria. The public-sector borrowing requirement for the current fiscal year (1995/96) is projected at close to 4% of GDP, and in the following year it is expected to be just above 3%, largely by way of further expenditure cuts. The level of gross public debt is already below the Maastricht norm of 60% of GDP.

European Institutes see downward risks

As far as the ***international*** *development is concerned, most institutes mention a* ***downward*** *risk with respect to the recovery in western Europe, in particular in Germany. Transition countries report possible negative repercussions for Central Europe.*

- *The weaker European profile is often related to more restrictive fiscal policies than assumed in the projection.*
- *Many institutes also see the risk of a recurrence of financial turbulence in EMU, with capital flows leading to higher interest rates, in general and in particular outside the appreciating DM-block,*
- *Some suggest a stronger than projected growth outside Europe, but other a possible weaker development, in particular in the United States.*
- *Only a few mention international inflationary risks, on world commodity markets, but also related to too loose monetary policies.*

Also on the ***domestic*** *side* ***downward*** *risks prevail. Lack of confidence may depress demand more than projected. Several institutes connect this with the fiscal policy stance: on the one hand a too lax consolidation (Germany, Greece, Hungary, Italy, Spain, UK), on the other a too strict fiscal tightening (France, Switzerland).*

- *Some are not confident about the projected interest rate decline.*
- *A possible stronger wage- and price development is mentioned for Transition countries as well as for Italy and Ireland.*

Last year *Italy* made significant progress in sorting out its public finances for the first time in many years, thanks to swingeing austerity measures and a strong economic performance. The general government deficit was reduced by 1½ percentage point, to 7¼% of GDP, and the government accounts excluding interest payments showed a surplus equivalent to 3% of GDP. The relentless rise of the debt/GDP ratio was stopped at 125%. This year's budget aims to maintain this pace of fiscal consolidation. Cutting expenditure (transfers to lower-tier authorities, healthcare and pensions) and raising additional revenue (more efficient tax collection, fewer tax breaks for companies) are to make an equal contribution to reducing the deficit to 6% of GDP and boosting the primary surplus to 4%. Under stated policies the deficit could then only be trimmed by another ½ percentage point, to 5½%, but because growth will be lower than in the budget forecast the deficit will probably end up ½ percentage point higher than officially projected, in both years. Significant additional austerity measures will therefore be required if the official medium-term target of meeting the Maastricht criteria by 1998 is to be achieved.

V.2 Central Europe

In economic terms the former centrally planned economies are generally heading in the right direction. They are making clear progress in their transition to market-oriented economic systems, in such spheres as macroeconomic stabilization, price liberalization, the establishment of financial markets, and budget reform. Some countries, such as the Czech Republic (which was recently admitted to the OECD), have already adopted many features of a market economy. The private-sector share of GDP has already climbed to 60-70% in many countries. Romania and Bulgaria are lagging far behind in the privatization stakes, however. In these countries inflation is still unacceptably high, privatization has still not been completed, commercial banking is still in its infancy, and the social-security systems have still not been pared down to reflect the straitened public finances.

Table V.2.1 Economic growth Transition countries, 1995-1997 (CPB forecasts)

	Share of world GDP	GDP volume 1995	1996	1997
	in %	annual percentage changes		
Central Europe	2.3	4	4	4½
of which Visegrád[a]	1.4	4½	4¾	5
CIS	3.4	−5	1½	3
Transition countries	5.7	−1½	2½	3½

[a] Czech Republic, Hungary, Poland, Slovak Republic.
Followed in May by Hungary.

The Transition countries of Central Europe (and the Baltic states) have been recovering for several years now. The region's real GDP grew by a mere 1% in 1993, but accelerated to 4% in 1994 and 1995. This expansion has been largely export-led. The rapid intensification of trade relations with other countries (especially with Western Europe, but also within the region) also applies to imports, so that in the Czech Republic, for instance, the external sector makes only a modest net contribution to GDP growth. Until now the economic performances of the various countries have diverged widely. Growth rates have ranged from 1% to 6% in recent years, with the most reform-minded countries posting the best results. Leading the way is Poland, which has already made up the huge loss of output that followed the collapse of the communist system. Stragglers like Romania and Bulgaria (slower in implementing reforms) and Hungary (held back by a fiscal squeeze) are expected to catch up gradually.

Transition countries' trade and western European cycle

All institutes of the Transition countries report an increased sensitivity of their trade performance to cyclical weakness in western Europe. Important reason is the increased share of western Europe in their exports, at this moment some 60 to 70%. In the case of Poland and Hungary the pattern of exports is referred to as particularly cycle sensitive, although in the latter case the situation has improved somewhat. ECE-studies, published in 1994 and 1995, are mentioned, which indicate the relatively strong cyclical sensitivity on western European imports coming from Transition economies when compared to their total imports. According to one institute sensitively to downturns is stronger than to upturns.

Some countervailing factors are, however, also indicated: increased competitiveness after devaluation, and enlarged productive capacity offer room for market gains, while also increased opportunities for exports to other eastern European countries (with their own economic momentum) can counterbalance the effect of western European weakness; for the Czech Republic it is observed that recent very favourable figures of exports to Germany and Austria do not confirm the fears concerning the effects of slackening western European demand.

While the former centrally planned economies are likely to share growth rates of 3 to 5% over the coming years, there are wide differences with regard to the labour market, inflation, budget balances and external positions. Most Central European countries are struggling with high unemployment (10 to 15% of the labour force), although this should come down in the coming years as output recovers. But unemployment in the Czech Republic, at 3% low by western standards as well, may well rise, not least as a result of rationalizations and restructurings. This country can boast a balanced government budget, as can Slovenia, while other countries are projecting deficits between 2 to 4% of GDP. For Hungary this amounts to a halving of the 1994 deficit, however, and Russia has been able to reduce the shortfall even more quickly. The inflation picture is similarly varied. Prices are rising by less than 5% in Croatia and Albania and by less than 10% in the Czech Republic, Slovakia and Slovenia, but by more than 30% in Bulgaria and Romania. Most countries expect inflation to ease further this year. Current-account balances show sizeable deficits for the Czech Republic, Hungary and Poland.

VI Country notes

In this paragraph we present the most recent forecasts submitted by the AIECE Member institutes, together with a brief note on the main characteristics of the current development and the short-term prospects as seen by the institute in question. The countries and the institutes per country are ranked in alphabetical order.
To harmonize presentation, and to facilitate international comparison, CPB has in some cases slightly altered text and/or tables, e.g. data on standardized unemployment and interest rates.

Annex I EMU convergence indicators: Institutes' forecasts

AI.1 EMU convergence indicators: Consumer price inflation

Country	Institute	1995	1996	1996[a]	1997	1997[a]
		annual percentage changes				
EMU-criteria		2.9	2.6		3.2	
Austria	WIFO	2.2	2.1		1.9	
Belgium	DULBEA	1.5	2.0	2.1	2.3	2.2
	IRES	1.5	2.2		2.1	
Denmark	DOR	1.8	2.5		2.9	
Finland	ETLA	1.1	1.5		2.0	
France	BIPE	1.7	1.9	1.8	1.6	1.5
	COE	1.7	1.6		1.4	
	INSEE	1.7				
	OFCE	1.7	1.6		1.2	
	REXECODE	1.7	1.9		1.7	
Germany	DIW	1.9	1.5	1.7	1.0	1.7
	HWWA	1.9	1.5		2.0	
	IFO	1.9	2.0			
	IfW	1.9	1.4		1.4	
	RWI	1.9	1.9		2.2	
Greece	CPE	9.2	7.5		4.9	
Ireland	ESRI	2.5	2.0		2.5	
Italy	CSC	5.3	3.8	3.9	3.4	3.7
	IRS	5.3	4.0		3.6	
	ISCO	5.3	3.8			
	PROMETEIA	5.3	4.1		4.0	
Luxembourg		2.0	1.8		2.0	
Netherlands	CPB	2.0	2.5		2.3	
Portugal		4.1	3.3		3.1	
Spain	DGPC	4.6	3.7			
Sweden	Industriförbundet	2.9	1.6		2.1	
United Kingdom	LBS	2.8	2.8	2.9	2.6	3.0
	NIESR	2.8	2.9		3.4	
Total European Union		2.8	2.5		2.4	

[a] Country average

AI.2 EMU convergence indicators: Long-term interest rate

Country	Institute	1995	1996	1996[a]	1997	1997[a]
		annual percentage changes				
EMU-criteria		9.7	6.5		8.3	
Austria	WIFO	6.5	5.6		5.6	
Belgium	DULBEA	7.4	7.2	7.1	7.5	7.6
	IRES	7.4	6.9		7.8	
Denmark	DOR	8.3	7.7		7.9	
Finland	ETLA	7.9	7.0		7.0	
France	BIPE	7.7	6.4	6.6	6.4	6.4
	COE	7.7	6.6		6.6	
	INSEE	7.7				
	OFCE	7.7	6.7		6.5	
	REXECODE	7.7	6.5		6.0	
Germany	DIW	6.8	6.5	6.5	7.0	6.8
	HWWA	6.8	6.3		7.0	
	IFO	6.8	7.3			
	IfW	6.8	6.1		6.4	
	RWI	6.8	6.3		6.8	
Greece	CPE					
Ireland	ESRI	8.3	7.9		8.3	
Italy	CSC			9.8		8.7
	IRS					
	ISCO					
	PROMETEIA	11.8	9.8		8.7	
Luxembourg						
Netherlands	CPB	6.9	6.1		6.1	
Portugal		11.4	10.5		10.5	
Spain	DGPC	11.0	9.2			
Sweden	Industriförbundet	10.2	8.3		7.8	
United Kingdom	LBS	8.2	7.9	7.8	7.6	7.6
	NIESR	8.2	7.7		7.7	
Total European Union		8.4	7.5		7.5	

[a] Country average

AI.3 EMU convergence indicators: General government balance

Country	Institute	1995	1996	1996[a]	1997	1997[a]
		annual percentage changes				
EMU-criteria		-3	-3		-3	
Austria	WIFO	-6.2	-4.5		-3.0	
Belgium	DULBEA	-4.4	-3.3	-3.7	-3.0	-3.0
	IRES	-4.4	-4.0			
Denmark	DOR	-1.7	-2.1		-1.6	
Finland	ETLA	-5.5	-3.4		-2.8	
France	BIPE	-5.3	-4.7	-4.6	-3.6	-3.8
	COE	-5.3	-4.1		-3.7	
	INSEE	-5.3				
	OFCE	-5.3	-4.8			
	REXECODE	-5.3	-4.6		-4.2	
Germany	DIW	-3.5	-3.5	-3.6	-3.2	-3.2
	HWWA	-3.5	-3.7		-3.0	
	IFO	-3.5	-3.3			
	IfW	-3.5	-3.8		-3.5	
	RWI	-3.5	-3.5		-3.0	
Greece	CPE	-8.9	-7.2		-4.5	
Ireland	ESRI	-2.1	-2.0		-2.0	
Italy	CSC	-7.2	-6.2	-6.4	-5.3	-5.4
	IRS	-7.2	-6.5		-6.1	
	ISCO	-7.2	-6.2			
	PROMETEIA	-7.2	-6.7		-4.7	
Luxembourg		0.4	0.6		0.7	
Netherlands	CPB	-3.4	-3.2		-2.3	
Portugal		-5.4	-5.0		-4.5	
Spain	DGPC	-5.8	-4.4			
Sweden	Industriförbundet	-8.0				
United Kingdom	LBS	-5.3	-3.6	-3.7	-3.0	-2.9
	NIESR	-5.3	-3.7		-2.8	
Total European Union		-5.0	-4.3		-3.6	

[a] Country average

Annex II Key assumptions of AIECE Institutes

GDP volume growth of Western Europe

Country	Institute	1995	1996	1996[a]	1997	1997[a]
		annual percentage changes				
Austria	WIFO	2.5	1.5		1.8	
Belgium	DULBEA	2.5	1.8	1.7	2.5	2.4
	IRES	2.5	1.6		2.3	
Czech Republic	IE-CNB					
Denmark	DOR	2.9	1.6		2.5	
Finland	ETLA	2.6	2.0		2.5	
France	BIPE	2.5	1.7	1.7	2.8	2.7
	COE	2.5	1.8		2.8	
	INSEE					
	OFCE					
	REXECODE	2.5	1.6		2.4	
Germany	DIW	2.5	1.4	1.5	2.3	2.5
	HWWA	2.5	1.5		2.5	
	IFO	2.5	1.3			
	IfW	2.5	1.4		2.8	
	RWI	2.5	2.0		2.5	
Greece	CPE	2.8	2.8		3.0	
Hungary	GKI			1.8		2.5
	KOPINT	2.5	1.8		2.5	
Ireland	ESRI	2.5	1.7		2.5	
Italy	CSC			1.8		2.4
	IRS					
	ISCO	2.6	2.1			
	PROMETEIA	2.6	1.5		2.4	
Netherlands	CPB	2.6	1.8		2.5	
Norway	CBS					
Poland	FTRI	2.8	2.4		2.7	
Slovenia	SKEP	2.5	1.5		2.8	
Spain	DGPC	2.7	2.8			
Sweden	Industriförbundet	2.5	1.4		2.4	
Switzerland	ETH	2.8	1.6		2.6	
United Kingdom	LBS	2.5	1.2		2.6	
	NIESR	2.5	2.1		2.8	
Total European countries		2.6	1.8		2.5	

[a] Country average

GDP volume growth of the United States

Country	Institute	1995	1996	1996[a]	1997	1997[a]
		annual percentage changes				
Austria	WIFO	3.0	2.5		2.5	
Belgium	DULBEA	2.5	2.0	2.1	2.3	1.4
	IRES	2.5	2.2		0.6	
Czech Republic	IE-CNB					
Denmark	DOR	3.0	2.0		2.0	
Finland	ETLA	3.0	2.0		2.0	
France	BIPE	2.1	2.4	1.9	1.3	1.8
	COE	2.1	1.8		1.9	
	INSEE					
	OFCE	2.1	1.6		2.0	
	REXECODE	2.1	1.8		1.9	
Germany	DIW	2.1	2.0	1.8	2.8	2.4
	HWWA	2.1	2.0		2.3	
	IFO	2.1	1.5			
	IfW	2.1	1.5		2.2	
	RWI	2.1	2.0		2.5	
Greece	CPE	3.0	2.5		2.1	
Hungary	GKI			2.0		2.3
	KOPINT	2.1	2.0		2.3	
Ireland	ESRI	3.2	2.0		2.0	
Italy	CSC			2.1		2.3
	IRS					
	ISCO	2.1	2.2			
	PROMETEIA	2.1	2.0		2.3	
Netherlands	CPB	2.1	2.0		2.3	
Norway	CBS					
Poland	FTRI	2.3	2.0		2.5	
Slovenia	SKEP	2.1	1.5		2.2	
Spain	DGPC	1.8	1.9			
Sweden	Industriförbundet	2.0	1.8		2.2	
Switzerland	ETH					
United Kingdom	LBS	2.0	1.9		2.1	
	NIESR	2.1	2.1		2.3	
Total European countries		2.3	2.0		2.1	

[a] Country average

Crude oil price

Country	Institute	1995	1996	1996[a]	1997	1997[a]
		annual percentage changes				
Austria	WIFO	17.2	17.0		17.0	
Belgium	DULBEA	17.0	17.0	17.1	17.0	17.1
	IRES	17.0	17.1		17.2	
Czech Republic	IE-CNB					
Denmark	DOR					
Finland	ETLA	17.0	17.5		17.5	
France	BIPE	17.1	17.7	16.8	18.2	16.6
	COE	17.1	15.5		16.0	
	INSEE	17.1				
	OFCE	17.1	16.9		15.0	
	REXECODE	17.1	17.0		17.0	
Germany	DIW	17.1	17.5	17.4	17.5	17.9
	HWWA	17.1	17.5		17.5	
	IFO	17.1	17.0			
	IfW	17.1	17.6		18.5	
	RWI	17.1	17.5		18.0	
Greece	CPE	17.0	17.5		18.3	
Hungary	GKI			16.2		16.0
	KOPINT	17.2	16.2		16.0	
Ireland	ESRI					
Italy	CSC	17.0	17.3	17.3	17.4	17.6
	IRS	17.0	17.5		18.0	
	ISCO	17.0	17.0			
	PROMETEIA	17.0	17.4		17.5	
Netherlands	CPB	17.1	16.5		16.5	
Norway	CBS	16.8	16.5		17.0	
Poland	FTRI	17.0	17.5		17.5	
Slovenia	SKEP	17.1	17.6		18.5	
Spain	DGPC	16.9	17.4			
Sweden	Industriförbundet	17.0	17.0		16.8	
Switzerland	ETH	17.1	17.0		17.0	
United Kingdom	LBS	16.4	17.6		16.9	
	NIESR	16.7	16.7		17.2	
Total European countries		17.0	17.1		17.2	

[a] Country average

Dollar exchange rate of the Deutschemark

Country	Institute	1995	1996	1996[a]	1997	1997[a]
		annual percentage changes				
Austria	WIFO	1.43				
Belgium	DULBEA	1.43	1.48	1.47	1.50	1.55
	IRES	1.43	1.45		1.60	
Czech Republic	IE-CNB	1.43	1.38		1.45	
Denmark	DOR	1.43	1.50		1.55	
Finland	ETLA	1.43	1.50		1.50	
France	BIPE	1.43	1.50	1.48	1.53	1.52
	COE	1.43	1.47		1.49	
	INSEE					
	OFCE	1.43	1.48		1.54	
	REXECODE	1.43	1.48		1.50	
Germany	DIW	1.43	1.50	1.49	1.50	1.54
	HWWA	1.43	1.50		1.50	
	IFO	1.43	1.45			
	IfW	1.43	1.52		1.60	
	RWI	1.43	1.48		1.55	
Greece	CPE	1.43	1.53		1.49	
Hungary	GKI			1.47		1.65
	KOPINT	1.43	1.47		1.65	
Ireland	ESRI	1.43	1.48		1.48	
Italy	CSC	1.43	1.50	1.49	1.53	1.51
	IRS	1.43	1.52		1.55	
	ISCO	1.43	1.46			
	PROMETEIA	1.43	1.49		1.44	
Netherlands	CPB	1.43	1.47		1.52	
Norway	CBS					
Poland	FTRI	1.43	1.48		1.50	
Slovenia	SKEP	1.43	1.50		1.55	
Spain	DGPC					
Sweden	Industriförbundet	1.43	1.55		1.59	
Switzerland	ETH	1.43	1.47		1.47	
United Kingdom	LBS	1.43	1.49		1.52	
	NIESR	1.43	1.48		1.46	
Total European countries		1.43	1.49		1.52	

[a] Country average

Annex III AIECE and CPB

AIECE is the Association of European Conjuncture Institutes (in French: Association d'Instituts Européens de Conjoncture Économique), founded in 1957. The AIECE now groups 42 members and observing institutes, representing 20 countries and 4 international organizations (EU, OECD, IMF and ECE). The membership is open to independent European institutes involved in surveying economic development and macroeconomic forecasting. Independent is interpreted as not directly being involved in conducting economic policies and not representing some economic interests. The main objective of the association is to intensify the exchanges between its members with a view to improve their insight into international economic developments.

The **CPB** Netherlands Bureau for Economic Policy Analysis, though administratively and financially belonging to the Ministry of Economic Affairs, operates as a fully independent institute for (macro)economic forecasting and analysis. Its main tasks are *a* the preparation of independent economic analyses and forecasts, which are scientifically sound and relevant for policymaking - for the Government and other social organizations (like parliament and social-economic council), *b* doing scientific research, including modelbuilding, aimed at the improvement of forecasting and analysis, *c* the evaluation of the results of national and international research relevant for the CPB work, *d* the preparation of the annual publications Central Economic Plan and Macroeconomic Outlook, and *e* periodically reporting on the prospects on medium and longer term for the Netherlands economy and its branches.

The CPB is a long-standing member of AIECE, which is appreciated as a valuable platform for exchange of views with mostly non-governmental institutes, next to the Bureau's official contacts with in particular OECD and EU. Moreover, it is a useful source of information when making CPB-forecasts.

Annex IV Members and observers of the AIECE

Austria	WIFO – Österreichisches Institut für Wirtschaftsforschung
Belgium	DULBEA – Département d'Économie Appliquée de l'Université Libre de Bruxelles
	IRES – Institut de Recherches Économiques
Czech Republic	IE-CNB – Institute of Economics of the Czech National Bank
Denmark	DOR – Det Okonomisk Rad
Finland	ETLA – The Research Institute of the Finnish Economy
France	BIPE – Bureau d'Information et de Prévisions Économiques
	EHESS – Centre de Conjoncture et Prospective
	COE – Centre d'Observation Économique de la Chambre de Commerce et d'Industrie de Paris
	INSEE – Institut National de la Statistique et des Études Économiques
	OFCE – Observatoire Français des Conjonctures Économiques
	REXECODE
	SEAE – Service d'Étude de l'Activité Économique
Germany	DIW – Deutsches Institut für Wirtschaftsforschung
	HWWA – Institut für Wirtschaftsforschung
	IfW – Institut für Weltwirtschaft an der Universität Kiel
	IFO – Institut für Wirtschaftsforschung
	RWI – Rheinisch-Westfälisches Institut für Wirtschaftsforschung
Greece	CPER – Center of Planning and Economic Research
Hungary	GKI – Economic Research Company
	KOPINT-Datorg – Institute for Economic and Market Research and Informatics
Ireland	ESRI – Economic and Social Research Institute
Italy	CSC – Centro Studi Confindustria
	IRS – Istituto per la Ricerca Sociale
	ISCO – Istituto Nazionale per lo Studio della Congiuntura
	Prometeia – Associazione per le Previsioni Econometriche
Netherlands	CPB Netherlands Bureau for Economic Policy Analysis
Norway	CBS – Norway Statistics
Poland	FTRI – Foreign Trade Research Institute
Slovenia	SKEPP – Economic Outlook and Policy Services
Spain	DGPC – Direccion General de Prevision y Coyuntura
Sweden	Industriförbundet
Switzerland	ETH – Konjunkturforschungsstelle an der Eidgenössischen Technischen Hochschule
United Kingdom	LBS – London Business School

	NIESR – National Institute of Economic and Social Research
Yugoslavia	FTRI – Foreign Trade Research Institute
	ZTI – Marketing Research Institute
Observers	EC – Commisssion of the European Communities, Brussels
	ECE – Economic Commission for Europe, Geneva
	EFTA – European Free Trade Association, Geneva
	IMF – Office in Europe, Paris
	OECD – Organisation for Economic Cooperation and Development, Paris