

III

Policies for Stronger Noninflationary Growth in Industrial Countries

In most industrial countries, inflation is now very low by historical standards. Although vigilance is required to safeguard the progress that has been made, the medium-term goal of price stability appears to be within striking distance for many countries (Box 2). In contrast, the persistence of unsustainably large fiscal imbalances remains a critical obstacle to stronger growth and to greater stability in financial and foreign exchange markets. Much also remains to be done to eliminate structural impediments to saving and investment and to improve the functioning of labor markets, especially in Europe.

Stance of Monetary Policies

Because of pervasive economic weakness and developments in the EMS, *monetary conditions* have eased further in several of the major industrial countries during the past six months.⁷ In the United States, the degree of easing is apparent from a variety of indicators, including the growth of M1, the decline of nominal and real short-term interest rates, and the steepening of the yield curve (Chart 14).⁸ Long-term interest rates have been declining steadily, probably in anticipation of a serious package of deficit-reduction measures, but also because of lower inflation expectations. Although the slack in the U.S. economy should allow inflation to decline somewhat further, short-term interest rates can be expected to firm gradually during 1993 as economic activity continues to recover.

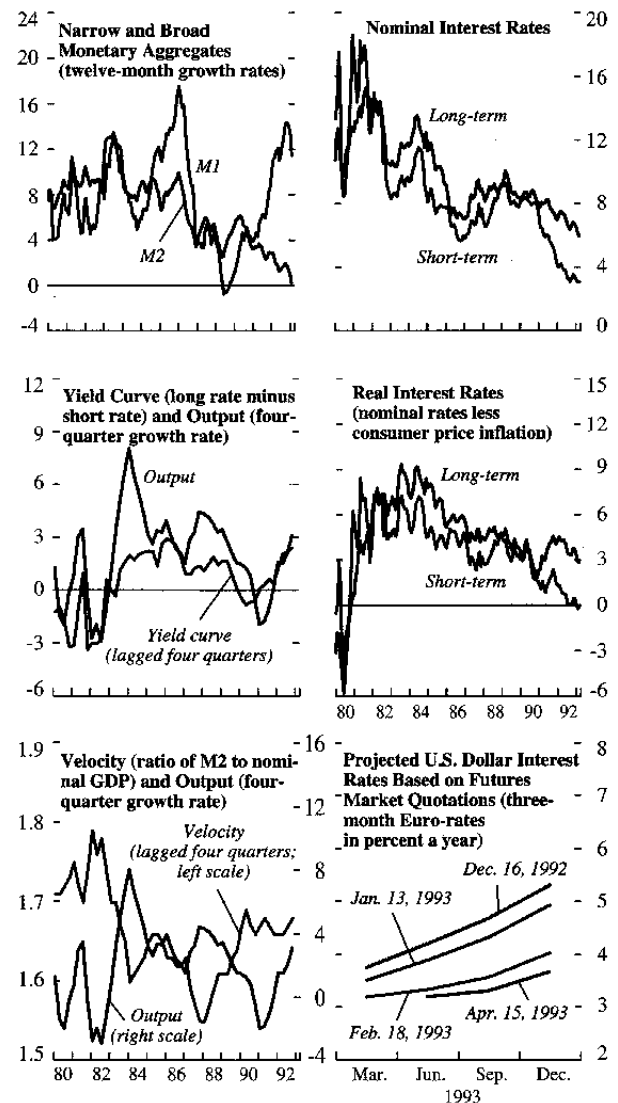
In Japan, the weakness of the monetary aggregates mirrors the present sluggishness of activity,

⁷Annex I discusses the lessons for monetary policy that can be drawn from the recent run-up and subsequent abrupt corrections of asset prices in many industrial countries.

⁸The growth of the broad monetary aggregate M2 has remained sluggish; early in the year, the Federal Reserve made a technical reduction of 1/2 of 1 percentage point in the target ranges for M2 and M3 growth for 1993. As discussed in the annex to the January 1993 *Interim Assessment of the World Economic Outlook*, M2 may have lost its usefulness as an indicator of the stance of U.S. monetary policy. This is mainly because the emergence of a steep yield curve has reduced the attractiveness of short-term assets in M2 relative to both demand deposits and longer-term assets, but also because of other special factors.

Chart 14. United States: Monetary Indicators

(In percent unless otherwise noted)



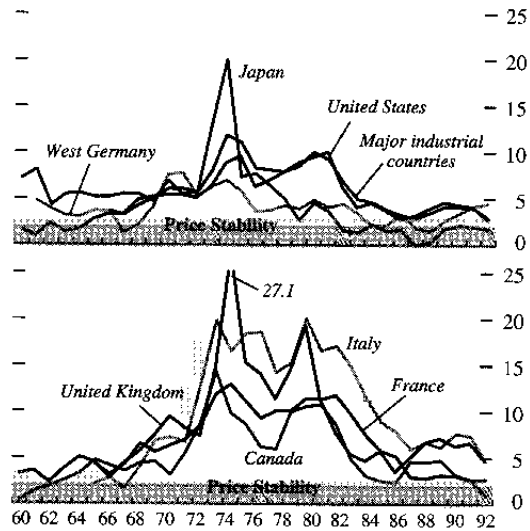
Box 2. Price Stability

Since the gradual escalation of price increases in the 1960s and the worldwide surge of inflation in the 1970s, it has taken more than a decade for many countries to reduce rates of price increases to sustainable levels. But the persistent efforts to control inflation have by and large succeeded, and inflation in many countries has now been reduced to rates not seen for close to thirty years. In many countries, a reasonable degree of price stability has been restored or is within reach (see chart; see also Table 2 in Chapter II).

Price stability may be defined to mean that changes in the average price level are small enough and gradual enough that they do not materially enter business and household decisions.¹ This definition does not imply stability in relative prices, nor does it require that a particular aggregation of prices remain constant month to month or year to year. Inflation differs by region and type of product, and there is a range of indices covering different kinds of prices.

The most commonly used measure of inflation is the consumer price index, which has the advantage of being available on a monthly basis for most countries. Consumer price indices are well understood, even though they may be influenced by temporary factors such as indirect tax changes, seasonal fluctuations in food prices, and changes in the terms of trade. For some of these reasons, broader measures such as the implicit price deflator for GDP, which represents an average price of the flow of domestically produced goods and services, may provide a better measure of underlying inflation.² Too narrow a focus on the relationship between money and income transactions can be misleading, however. As discussed in Annex I, neither consumer prices nor GDP deflators captured

Major Industrial Countries: Inflation
(Annual percent change)



the strong inflation pressures in asset markets during the mid- to late 1980s in many industrial countries. The flow of goods and services constitutes a relatively small share of total transactions, and other measures of inflation—covering changes in the average price of all transactions—may be useful additional indicators of economy-wide inflationary pressures.³

Price indices, as conventionally measured, typically do not properly account for changes in the quality of goods and services.⁴ Because this mis-measurement may impart an upward bias to measured inflation that is not related to demand pressures, true price stability may be consistent with small measured increases in, for example, consumer price indices. For the United States, it has been estimated that

¹Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, defined price stability in such terms in a statement to the U.S. Senate Committee on Banking, Housing, and Urban Affairs (*Congressional Record*, U.S. Senate, February 19, 1993, p. 21). The objective of price stability was addressed in the May 1990 *World Economic Outlook*. See also *Zero Inflation: The Goal of Price Stability*, edited by Richard G. Lipsey, Policy Study, No. 8 (Toronto: C.D. Howe Institute, 1990).

²The GDP deflator is a more comprehensive measure of price developments than the consumer price index, in part because it is not tied to a specific basket of consumer goods in a base year. Moreover, the GDP deflator is not directly affected by changes in import prices and thus is a more accurate measure of domestic demand and supply conditions. In very open economies, however, the impact of import prices on consumer price indices is an important source of information about price pressures stemming from exchange rate changes, which are typically related to domestic economic policies.

³Irving Fisher thought that all transaction prices were relevant regardless of whether they were prices of consumption or capital goods, inputs or outputs, intermediate or final goods, tangible or financial goods, or domestic or foreign purchases; see *The Purchasing Power of Money* (New York: Macmillan, 1913; A.M. Kelley, 1985).

⁴For a discussion of other biases in measurement, see P. Lebow, J. Roberts, and D. Stockton, "Economic Performance Under Price Stability," Federal Reserve Board Working Paper 125 (Washington: Board of Governors of the Federal Reserve System, 1992).

average inflation in consumer prices would have been 1½ to 2 percentage points lower during 1947–83 if consumer prices had been properly adjusted for changes in the quality of consumer durable goods; similar estimates have emerged for other countries.⁵ With this estimated quality adjustment extended to other countries and into the 1990s, price stability in the major industrial countries may be considered to be consistent with consumer price inflation in the range of 1½ to 2 percent.

Although all of the major industrial countries pursue price stability as an objective of monetary policy, only a few central banks have the statutory obligation to achieve price stability as their sole objective (see the table on monetary policy objectives).⁶ In the *United States*, for example, the Federal Reserve Act specifies that the Federal Reserve System and the Federal Open Market Committee "shall maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."⁷ In view of the interdependence of objectives, the Federal Reserve Board emphasizes that price stability is the means to achieving maximum sustainable growth in both production and employment.⁸ More generally, inflation in the major industrial countries is viewed as a primary cause of cyclical fluctuations in the levels of production and employment.⁹

The Bank of *Japan* has a broad statutory mandate to conduct monetary policy to support national economic objectives, which have included the more explicit objectives of potential growth, full employment, low inflation, and a sustainable balance of

Major Industrial Countries: Monetary Policy Objectives

| | Statutory Objectives ¹ | Current Emphasis |
|-----------------------|---|---|
| United States | Potential growth, high employment levels, stable prices | Maximal sustainable growth; price stability |
| Japan | To support national objectives | Noninflationary and sustainable growth |
| Germany | To safeguard currency | Price stability |
| France | Stable prices, external equilibrium, full employment, economic growth | Price stability and exchange rate |
| Italy | To protect saving and control credit activity | Price stability; exchange rate |
| United Kingdom | | Growth and price stability |
| Canada | To protect currency; stable production and prices | Price stability |
| <i>Memorandum</i> | | |
| European Central Bank | Price stability; to support general economic objectives in the EC | |

¹For the United States, Federal Reserve Act, Section 2A, 1913 and subsequent amendments; for Japan, Bank of Japan Act of 1942, Law No. 67; for Germany, Deutsche Bundesbank Act, Part I, paragraph 3; for France, Bank of France Act, January 3, 1973; for Italy, Banking Act of 1936, Law No. 375, and related legislation; for Canada, see Bank of Canada Act, Preamble; for European Central Bank, see Protocol on the Statute of the European System of Central Bank and the European Central Bank, attached to the Maastricht Treaty on economic and monetary union.

⁵See Robert J. Gordon, "Measuring the Aggregate Price Level: Implications for Economic Performance and Policy," NBER Working Paper 3969 (Cambridge, Massachusetts: National Bureau of Economic Research, January 1992).

⁶The independence of the central bank to rigorously pursue the objective of price stability is as important as the objective itself. The Deutsche Bundesbank has the highest degree of statutory independence among the major industrial countries, followed by the U.S. Federal Reserve Board. Other central banks in the major industrial countries do not have statutory independence.

⁷Federal Reserve Act, Section 2A, 1913 and subsequent amendments.

⁸See the statement by Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, before the Joint Economic Committee of the U.S. Congress, January 27, 1993.

⁹Early proponents of this view were Irving Fisher, *The Purchasing Power of Money*, and John Maynard Keynes, *A Tract on Monetary Reform* (London: Macmillan, 1923).

(Box continues on following page.)

Box 2 (concluded)

payments. During the mid-1960s, for example, the objective of the government was to eliminate external imbalances, and the Bank of Japan pursued monetary policies that were consistent with achieving external balance. More recently, the Bank of Japan has reinvigorated its efforts to secure noninflationary sustainable growth while maintaining the stability and efficiency of the financial system.

In Germany, the Deutsche Bundesbank Act specifies that the Bundesbank should regulate "the quantity of money in circulation and of credit supplied to the economy . . . with the aim of safeguarding the currency."¹⁰ The objective of price stability has been the focus of monetary policy in Germany, and virtual price stability was achieved by the mid-1980s. Although inflation in west Germany, as measured by the GDP deflator, has increased above 4½ percent recently, this can be mainly attributed to the policies followed in connection with the process of unification.¹¹ Price stability remains the sole objective of monetary policy in Germany, and the decline in long-term interest rates seen recently demonstrates the confidence of markets that inflation will soon return to a sustainable level.

Although all industrial countries are committed to a high degree of price stability, only the United Kingdom, Canada, Finland, New Zealand, and Sweden have adopted explicit inflation targets as operational objectives for monetary policy (see the table listing such targets). However, while the government is committed to price stability as a medium-term objective in all these countries, only New Zealand has made price stability the sole statutory objective of the central bank. Other countries have medium-term inflation objectives that are not explicit targets but are instead used in the formulation of other operational targets. In Germany, for example, a medium-term inflation objective is used in the formulation of an announced monetary growth target; the target for inflation underlying the monetary target for 1993 is 2 percent.

¹⁰The Bundesbank, "without prejudice to its functions," is also required to "support the general economic policy of the Federal government" (Deutsche Bundesbank Act, Part II, section 12).

¹¹For Germany as a whole, the GDP deflator rose by 5 percent in 1992, reflecting the catching up of prices and wages in east Germany to levels prevailing in west Germany. Such adjustments in price and wage levels should be distinguished from persistent inflationary pressures and expectations about high inflation in the future.

Industrial Countries: Explicit Inflation Targets

| | Inflation Target | Latest Twelve-Month Inflation Rate |
|-----------------------------|---------------------------------------|------------------------------------|
| Canada ¹ | | |
| End-1992 | 3 | 2.3 (Feb. 1993) |
| Mid-1994 | 2½ | |
| End-1995 | 2 | |
| Thereafter | Further reductions to price stability | |
| Finland ² | | |
| 1995 | 2 | 2.7 (Mar. 1993) |
| New Zealand ³ | | |
| December 1993 | 0 to 2 | 1.0 (Mar. 1993) |
| Thereafter | Price stability | |
| Sweden ⁴ | | |
| 1995 | 2 | 4.9 (Mar. 1993) |
| United Kingdom ⁵ | | |
| Through end-Parliament | 1 to 4 | 3.5 (Mar. 1993) |
| End-Parliament (April 1997) | Lower end of range | |

¹Midpoints of target ranges for the consumer price index excluding food, energy, and the temporary effects of changes in indirect taxes, measured on a twelve-month basis (December-December or June-June). For the definition of price stability, the Bank of Canada stated in a February 26, 1991 press release that its work on price stability "suggests a rate of increase in consumer prices that is clearly below 2 percent. However, a more precise definition is not being specified now, in the event that further evidence and analysis relevant to this matter become available in the next few years."

²Refers to consumer price index, although changes owing to public charges, taxes, and developments in housing prices are not taken into account in the formulation of monetary policy.

³These targets, which refer to the consumer price index, are specified in the Reserve Bank of New Zealand Act of 1989, section 9(2), as amended on March 2, 1990. Part 2, a, of this section of the Act states that "for the purpose of this agreement, annual rises of the CPI of between 0 and 2 percent will be considered consistent with price stability."

⁴Midpoint of the target range for the consumer price index, with a degree of tolerance of ±1 percent.

⁵Refers to the retail price index excluding mortgage interest payments. The Governor of the Bank of England has stated that the Bank's definition of price stability is consistent with the view of U.S. Federal Reserve Board Chairman Greenspan noted in the text of this box.

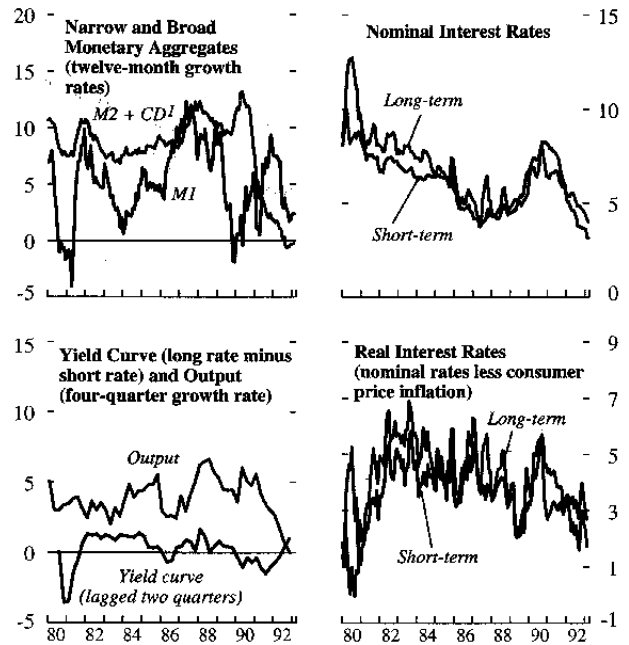
the effect of past asset price declines on financial wealth, and the cautious lending behavior by financial intermediaries after a sharp increase in nonperforming loans in the wake of recent asset price declines. Since mid-1991, the Japanese authorities have reduced the official discount rate significantly to support activity. Both short- and long-term interest rates have declined markedly, and the official discount rate is at a historic low, but recent indicators do not yet provide evidence of an imminent recovery in growth (Chart 15).

Price and wage pressures and monetary growth above the target range continued to be of major concern for monetary policy in Germany during the second half of 1992. Official interest rates remained high, despite increasing signs of an economic slowdown and the prolonged crisis in European foreign exchange markets. Nevertheless, both short- and long-term market interest rates declined somewhat after August 1992, probably in anticipation of future cuts in official interest rates (Chart 16). In December 1992, the Bundesbank raised its target range for M3 growth from 3½ to 5½ percent in 1992 to 4½ to 6½ percent for 1993. By February 1993, improved prospects for inflation, including indications of slower monetary growth, and for budgetary consolidation allowed the Bundesbank to reduce its discount rate, from 8¼ percent to 8 percent, and its Lombard rate from 9½ percent to 9 percent. In mid-March the Bundesbank lowered the discount rate to 7½ percent and left the Lombard rate unchanged. Further cuts in official interest rates will probably be necessary to revive the German economy during 1993, and such cuts are likely as price and wage pressures continue to subside and as monetary growth slows.

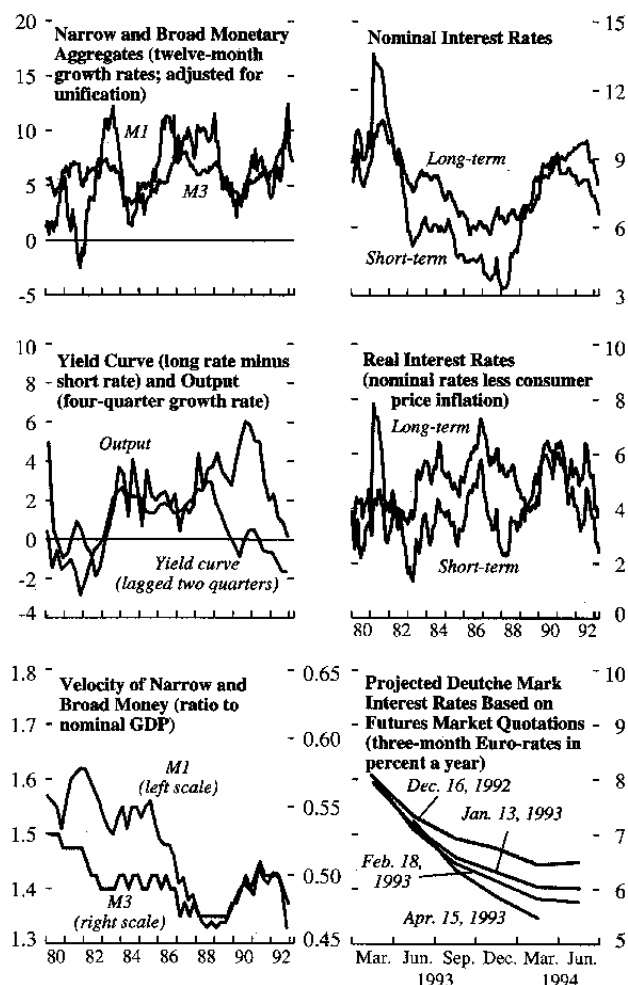
In the rest of Europe, monetary policy and financial market developments have been dominated by the currency turmoil that began in September 1992. Interest rates generally have declined somewhat with the easing of tensions in the ERM, but for most countries tight monetary conditions remain an obstacle to stronger growth and a threat to exchange market stability. In France, speculative attacks on the franc required significant increases in official interest rates in order to keep the exchange rate within the ERM band; despite subsequent declines, real interest rates in France remain extremely high. After withdrawing sterling from the ERM in mid-September, the U.K. authorities reduced interest rates progressively to promote recovery while adopting an explicit target range for inflation (1-4 percent). However, the latest cut in interest rates, on January 26, 1993, was accompanied by a significant further fall in the exchange rate, which may exert upward pressure on prices in the short run. In Italy, the authorities have adopted monetary targeting to guide monetary policy toward the objective

Chart 15. Japan: Monetary Indicators

(In percent unless otherwise noted)



¹CD, certificate of deposit.

Chart 16. Germany: Monetary Indicators
(In percent unless otherwise noted)


of reducing inflation sufficiently to permit an early return of the lira to the ERM. The large risk premium on long-term interest rates over those in Germany has come down only slightly because of continued uncertainty about the fiscal outlook.

Among the smaller European countries, Finland, Norway, and Sweden chose to float their currencies during the exchange market crisis; this has eased pressures on their interest rates somewhat, although interest rates have remained relatively high. Interest rates have also remained above pre-crisis levels in Ireland and Spain, despite the devaluation of these currencies within the ERM. Meanwhile, in Australia, monetary policy has aimed to support the economic recovery, but exchange market intervention has been required periodically to maintain order in currency markets.

Reinvigorating Fiscal Consolidation

The medium-term strategy calls for fiscal policies that raise national saving and achieve a more efficient balance of public and private spending. By improving opportunities for private investment and reducing the cost of capital, fiscal consolidation raises countries' medium-term growth potential. In the early to mid-1980s, in accordance with these objectives, most of the major industrial countries adopted programs of fiscal consolidation. By 1989, only Italy and Canada had not reduced their general government budget deficits below 2 percent of GDP, and Japan, Germany, and the United Kingdom had general government budget surpluses (Table 4).⁹

Despite these efforts, beginning in 1990 most of the major industrial countries encountered substantial setbacks in their consolidation efforts. Budget gaps widened because of the operation of the automatic stabilizers as growth slowed, the increased expenditures in Germany associated with unification, and the need to finance the 1990-91 regional conflict in the Middle East.¹⁰ In addition, however, there was a deterioration in underlying budgetary

⁹Two other developments in the 1980s are worth noting. During the consolidation process there was a disproportionate reduction in public investment. To the extent that infrastructure investment tends to raise private sector productivity and the economy's overall supply potential, this imbalance may warrant reconsideration. By contrast, current government spending grew very rapidly during the 1970s and the early to mid-1980s, and since then current outlays have tended to stabilize at fairly high levels in relation to GDP.

¹⁰See the discussion in the May 1992 *World Economic Outlook*, pp. 14-16; and the section entitled "Fiscal Policy in the Current Business Cycle" in the October 1992 *World Economic Outlook*, pp. 25-27.

Table 4. Major Industrial Countries: General Government Financial Balances Including and Excluding Social Insurance
(In percent of GDP)

| | 1980 | 1985 | 1989 | 1990 | 1991 | 1992 | Projections ¹ | | |
|-----------------------------------|-------|-------|-------|-------|-------|-------|--------------------------|-------|------|
| | | | | | | | 1993 | 1994 | 1998 |
| <i>Including social insurance</i> | | | | | | | | | |
| All industrial countries | ... | -3.6 | -1.3 | -2.1 | -3.0 | -4.0 | -4.4 | -3.8 | -1.8 |
| Major industrial countries | -2.6 | -3.4 | -1.2 | -2.1 | -2.8 | -3.9 | -4.2 | -3.3 | -1.6 |
| United States | -1.3 | -3.1 | -1.5 | -2.5 | -3.4 | -4.6 | -4.1 | -3.2 | -1.8 |
| Japan | -4.4 | -0.8 | 2.5 | 2.9 | 3.0 | 2.1 | 0.9 | 1.3 | 1.9 |
| Germany ² | -2.9 | -1.1 | 0.1 | -1.9 | -3.2 | -2.8 | -3.6 | -3.0 | -2.9 |
| France | — | -2.9 | -1.1 | -1.4 | -1.9 | -3.8 | -5.7 | -5.1 | -2.1 |
| Italy ³ | -8.5 | -12.5 | -9.9 | -10.9 | -10.2 | -10.2 | -10.3 | -8.9 | ... |
| United Kingdom | -3.4 | -2.9 | 0.9 | -1.3 | -2.7 | -6.2 | -8.8 | -7.7 | -3.8 |
| Canada | -2.8 | -6.8 | -3.0 | -4.1 | -6.1 | -6.4 | -5.9 | -4.3 | -1.6 |
| Other industrial countries | ... | -4.6 | -2.0 | -2.7 | -4.1 | -5.0 | -5.3 | -4.7 | -2.7 |
| Spain | -2.6 | -7.0 | -2.7 | -4.0 | -4.9 | -4.8 | -4.7 | -4.9 | ... |
| Netherlands | -4.0 | -4.8 | -5.2 | -5.3 | -3.9 | -4.0 | -3.6 | -2.9 | ... |
| Belgium | -9.3 | -9.1 | -6.7 | -5.8 | -6.7 | -6.9 | -6.5 | -4.8 | ... |
| Denmark | -3.3 | -2.0 | -0.5 | -1.5 | -2.2 | -2.3 | -2.9 | -2.5 | ... |
| Greece | ... | -16.5 | -20.6 | -19.3 | -15.9 | -13.8 | -12.6 | -10.9 | ... |
| Portugal | 3.8 | -6.9 | -4.3 | -6.7 | -6.7 | -5.7 | -5.2 | -4.0 | ... |
| Ireland | -13.0 | -11.3 | -1.9 | -2.5 | -2.2 | -3.0 | -3.7 | -3.1 | ... |
| Sweden | -4.0 | -3.8 | 5.6 | 3.9 | -1.2 | -8.9 | -11.6 | -11.4 | ... |
| Switzerland | ... | 0.3 | 0.2 | — | -1.7 | -1.8 | -2.4 | -2.5 | ... |
| Austria | -1.7 | -2.5 | -2.8 | -2.2 | -2.2 | -1.9 | -3.1 | -2.6 | ... |
| Finland | 0.5 | 0.1 | 2.9 | 1.1 | -6.0 | -8.9 | -11.2 | -9.5 | ... |
| Norway | 9.4 | 10.3 | 1.4 | 2.5 | -0.4 | -2.9 | -3.5 | -3.3 | ... |
| Iceland | 1.7 | -1.4 | -2.8 | -2.7 | -3.2 | -2.3 | -2.7 | -3.5 | ... |
| Australia | -0.9 | -4.4 | 1.6 | 0.5 | -2.5 | -4.5 | -4.5 | -3.0 | ... |
| New Zealand ⁴ | -6.6 | -4.1 | -1.2 | -3.5 | -3.3 | -4.2 | -3.7 | -3.0 | ... |
| <i>Excluding social insurance</i> | | | | | | | | | |
| Major industrial countries | ... | -4.0 | -2.4 | -3.2 | -3.7 | -4.4 | -4.7 | -4.0 | -2.3 |
| United States | -1.8 | -4.5 | -3.8 | -4.8 | -5.3 | -6.1 | -5.6 | -4.7 | -3.3 |
| Japan | -7.1 | -3.9 | -0.7 | -0.6 | -0.8 | -1.7 | -2.8 | -2.3 | -0.9 |
| Germany ² | -3.2 | -1.4 | -0.6 | -2.6 | -4.0 | -2.9 | -3.9 | -3.7 | -2.9 |
| France | -0.8 | -3.2 | -1.5 | -1.5 | -1.9 | -3.4 | -4.8 | -4.3 | -2.1 |
| Italy ³ | ... | -8.0 | -5.4 | -6.2 | -5.5 | -5.4 | -5.6 | -4.8 | ... |
| United Kingdom ⁵ | ... | 2.1 | 4.5 | 2.4 | 1.9 | -0.3 | -2.4 | -1.7 | 1.2 |
| Canada | -3.7 | -7.5 | -3.3 | -4.4 | -6.3 | -6.8 | -6.4 | -4.8 | -2.1 |

¹The projections are based on the assumptions of unchanged policies and constant real exchange rates.

²In percent of GNP.

³Given uncertainties about interest rates and their large impact on debt service costs, 1998 projections for Italy are not shown.

⁴Central government only; excludes the proceeds from asset sales.

⁵This concept is less meaningful for the United Kingdom, where a significant proportion of social security outlays is financed through general revenues.

positions in many countries stemming from policy slippages and from efforts to support economic activity (Table 5).

During the 1980s, the United States and Japan reformed and strengthened the financing of their social security systems. These reforms generated large surpluses—in 1992 equivalent to about 1 percent of GDP in the United States and about 3½ percent of GDP in Japan—that masked the underlying budgetary position. Excluding social security expenditures and revenues, the budget deficit in the United States, for example, was 6 percent of GDP

in 1992. In Japan, excluding social security, the budget showed a deficit of 1½ percent of GDP. By contrast, in Italy, more than half of the general government deficit, which was 10 percent of GDP in 1992, was the result of a shortfall in social security revenues. In Germany, France, and Canada, social security expenditures and revenues have been roughly in balance, but under present contribution and benefit rates existing social security programs are likely to result in significant deficits over the longer run given demographic trends and the prospective aging of populations.

Table 5. Major Industrial Countries: Structural and Cyclical Changes in General Government Budget Balances
(In percent of GDP)

| | Change in Budget Balance | | | | Change in Structural Budget Deficit ¹ | | | | Implied Impact of the Cycle on the Budget ² | | | |
|----------------|--------------------------|------|------|------|--|------|------|------|--|------|------|------|
| | 1991 | 1992 | 1993 | 1994 | 1991 | 1992 | 1993 | 1994 | 1991 | 1992 | 1993 | 1994 |
| United States | -0.9 | -1.2 | 0.5 | 0.9 | 0.2 | -1.1 | 0.1 | 0.7 | -1.1 | -0.1 | 0.4 | 0.3 |
| Japan | 0.1 | -0.9 | -1.2 | 0.4 | 0.1 | -0.1 | -0.4 | 0.3 | — | -0.8 | -0.8 | 0.1 |
| Germany | -1.3 | 0.4 | -0.8 | 0.8 | -1.0 | 0.8 | 1.0 | 1.2 | -0.3 | -0.4 | -1.8 | -0.4 |
| France | -0.5 | -1.9 | -1.9 | 0.6 | 0.2 | -1.6 | -0.7 | 0.7 | -0.7 | -0.3 | -1.2 | -0.1 |
| Italy | 0.7 | — | -0.1 | 1.4 | 1.2 | 0.7 | -0.8 | 1.5 | -0.5 | -0.7 | -0.9 | -0.1 |
| United Kingdom | -1.5 | -3.4 | -2.6 | 1.1 | 0.2 | -2.2 | -2.2 | 0.5 | -1.6 | -1.3 | -0.5 | 0.6 |
| Canada | -2.0 | -0.3 | 0.5 | 1.6 | 1.1 | 0.6 | 0.3 | 0.6 | -3.1 | -0.9 | 0.2 | 0.9 |
| Total | -0.7 | -1.1 | -0.4 | 0.9 | 0.1 | -0.7 | -0.2 | 0.7 | -0.9 | -0.4 | -0.1 | 0.2 |

¹The structural budget balance is the budgetary position that would be observed if the level of actual output coincided with potential output. Changes in the structural budget balance consequently include effects of temporary fiscal measures, the impact of fluctuations in interest rates and debt-service costs, and other noncyclical fluctuations in the budget balance. The computations of structural budget balances are based on preliminary staff estimates of potential GDP and revenue and expenditure elasticities. The methodology used to estimate potential GDP and tax elasticities is under review. The figures in the center panel should be regarded as indicative only of the magnitude of change in the structural budget balance. A negative sign means a deterioration in the budget balance. For Japan, the changes in the structural deficit in 1991–94 on a fiscal year basis and in percent of GDP are 0.2, -0.8, -0.6, and 0.8. The deterioration in FY 1992–93 is partly attributable to the recent economic stimulus packages (see Box 3).

²The impact of the cycle on the budget is calculated as the difference between the change in the budget balance and the structural deficit. A negative sign means a deterioration in the budget balance.

Although some of the recent deterioration in fiscal balances can be attributed to cyclical weakness, staff estimates of cyclically adjusted budget deficits indicate the persistence of large structural imbalances in many of the major industrial countries that would remain even after full economic recovery. In 1989, before the recent slowdown, there were underlying structural budget deficits amounting to roughly 1–3 percent of GDP in the United States, France, and the United Kingdom, 4 percent of GDP in Canada, and even more in Italy. By contrast, both Japan and Germany had attained general government structural surpluses; in both cases, however, surpluses in the social security accounts (particularly large in the case of Japan) masked continuing small deficits for central and local authorities combined.

By 1992, the structural deficit had again widened substantially in the United States and the United Kingdom. In addition, a large structural budget gap emerged in Germany starting in 1991, reflecting the costs of unification. In 1993, the structural deficits of Germany, France, Canada, the United States, and the United Kingdom are all estimated to be in the range of 2 to 5 percent of GDP, and that of Italy considerably higher. In the United States the tendency for the structural deficit to widen further over the medium term, in the absence of new fiscal measures, reflects the growth in health-related outlays and the expiration of certain revenue measures included in the baseline budget assumptions.

The prospect of continuing large structural budget deficits should be seen in the context of the deteriorating saving performance of the industrial

countries since the early 1970s (Chart 17). As stressed in earlier issues of the *World Economic Outlook*, the most important reason for the trend decline in national saving has been the general increase in budgetary imbalances. After some improvement in 1986–89, national saving rates again dropped significantly in 1990–92, reflecting the renewed decline in government saving. The persistent failure to achieve an adequate degree of fiscal consolidation has had costly macroeconomic consequences: a lower level of potential output because of reduced capital formation; lower productivity growth; high debt-GDP ratios and debt-service payments; pressure on real long-term interest rates; and, most recently, low consumer and business confidence because of uncertainties about future economic policies.

The adverse consequences of large deficits are increasingly recognized, and many countries are in the process of implementing deficit-reduction plans. The major countries requiring the largest adjustments are the United States, Italy, the United Kingdom, Canada, and Germany, but deficit reduction is also necessary over the medium term in France and Japan.

In the *United States*, the fiscal deficit (on a unified basis) is projected by the administration to reach \$387 billion (6 percent of GDP) in FY 1998 despite a narrowing of the gap between projected and potential output, as well as continued restraint over discretionary outlays. This deterioration reflects the baseline assumption of extremely rapid growth in health-related outlays, as well as the expiration of certain revenue measures. In February

1993, the administration proposed the adoption of a fiscal package that included a small near-term stimulus (implying a \$12 billion increase in the FY 1993 deficit on a unified basis) as well as measures to achieve medium-term fiscal consolidation.

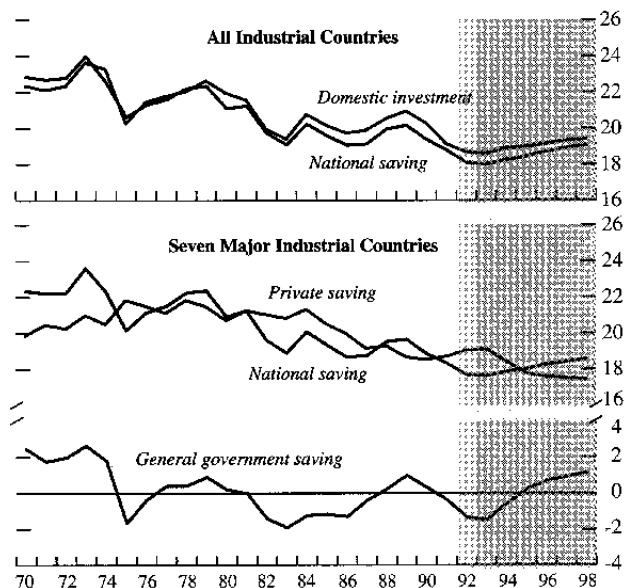
The administration has estimated that its proposals would begin to reduce the deficit in FY 1994, and that by FY 1998 the deficit would be roughly \$140 billion (1¼ percent of GDP) lower than its baseline level (Table 6). Revenue proposals are expected to yield 1 percent of GDP in FY 1998 and include an increase in the amount of social security benefits subject to income tax, increases in top marginal income and corporate tax rates, the introduction of a tax on energy based on BTU (British thermal unit) content, and the introduction of an investment tax credit. Expenditure measures include further cuts in defense and other discretionary outlays (equivalent to ½ of 1 percent and ¼ of 1 percent of GDP in FY 1998, respectively) and cuts in entitlement programs (½ of 1 percent of GDP in 1998), which would be partially offset by increased spending on infrastructure and education. Overall, gross budgetary savings of \$704 billion during 1993–98 would be partly offset by \$230 billion of new spending and tax reductions.

Achievement of the administration's objective would represent a considerable effort, but the full enactment and implementation of the plan would still leave the structural budget deficit above 3 percent of GDP in FY 1998 (over 4 percent of GDP excluding social security)—about where it was in 1988, despite a reduction in defense spending by more than 2 percent of GDP. Further measures will therefore be necessary to ensure adequate fiscal consolidation. Health-care reform is a top priority of the administration, and a proposal is currently being formulated. Particularly given the planned extension of health-care coverage to the U.S. population more widely, it will be essential to contain the costs of health care, both to help lower costs in the private sector and to provide additional budgetary net saving.¹¹ Even with such saving, however, additional sources of revenue also appear to be necessary—for example, in the form of a broadly based federal consumption tax. More generally, in the period immediately ahead it is important that deficit reduction be accomplished in ways that

¹¹During the past twenty years, the rise in the overall cost of health care in the United States has outstripped that in all other industrial countries by a wide margin. As a result, the present ratio of health costs to GDP in the United States, some 12–13 percent, is 3–6 percentage points above the ratio in other industrial countries. See *OECD Economic Surveys: United States* (Paris, 1992); and Liam P. Ebrill, "The U.S. Health Care Industry: Performance and Issues," in *The United States Economy: Performance and Issues*, edited by Yusuke Horiguchi (IMF, 1992), pp. 499–530.

**Chart 17. Industrial Countries:
Saving and Investment¹**

(In percent of GDP)



¹Blue shaded areas indicate staff projections.

Table 6. United States: Estimates of the Federal Budget Balance*(In billions of U.S. dollars unless otherwise noted; fiscal years)*

| | 1991 ¹ | 1992 ¹ | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|--|-------------------|-------------------|------|------|------|------|------|------|
| U.S. administration estimates | | | | | | | | |
| (March 1993 baseline; current services)² | | | | | | | | |
| Unified budget | -270 | -290 | -310 | -302 | -301 | -298 | -347 | -387 |
| Social security | 54 | 51 | 46 | 60 | 66 | 75 | 81 | 89 |
| Deposit insurance | 66 | 3 | 3 | 8 | -1 | -13 | -11 | -7 |
| Unified budget excluding social security and deposit insurance cash flows | -257 | -338 | -353 | -354 | -368 | -386 | -439 | -483 |
| In percent of GDP | -4.6 | -5.8 | -5.7 | -5.4 | -5.4 | -5.4 | -5.8 | -6.1 |
| Proposed package | | | | | | | | |
| Unified budget | -270 | -290 | -322 | -264 | -247 | -212 | -214 | -241 |
| Social security | 54 | 51 | 46 | 60 | 66 | 75 | 81 | 89 |
| Deposit insurance | 66 | 3 | 3 | 8 | -1 | -13 | -11 | -7 |
| Unified budget excluding social security and deposit insurance cash flows | -257 | -338 | -365 | -316 | -314 | -300 | -306 | -346 |
| In percent of GDP | -4.6 | -5.8 | -5.9 | -4.9 | -4.6 | -4.2 | -4.1 | -4.4 |
| IMF estimates³ | | | | | | | | |
| Unified budget | -270 | -290 | -316 | -254 | -236 | -200 | -197 | -228 |
| Unified budget excluding social security and deposit insurance cash flows | -257 | -338 | -360 | -307 | -304 | -288 | -289 | -324 |
| In percent of GDP | -4.6 | -5.8 | -5.8 | -4.6 | -4.3 | -3.9 | -3.7 | -4.0 |

¹1991 and 1992 figures are actual.²Based on figures contained in *Budget of the United States Government: Fiscal Year 1994* (Washington: Government Printing Office, April 8, 1993) and assumes U.S. administration's baseline projection for inflation and growth.³The IMF staff estimates assume implementation of the U.S. administration's proposed budget but reflect adjustments to the administration's baseline for differing assumptions regarding inflation, interest rates, and real GDP growth. The staff's assumption of faster real GDP growth and higher inflation than in the administration's baseline projections account for the lower projected path for the deficit. Note that projections of U.S. fiscal variables on a national accounts basis described elsewhere in the report were based on earlier estimates of the administration's proposals by the Congressional Budget Office and will differ slightly.

increase the incentives for private saving, improve allocative efficiency, enhance environmental protection, and improve productivity.

In *Italy*, in reaction to the financial crisis in 1992, the government is implementing budgetary reforms in the areas of pensions, health care, local government finance, and public employment. To reduce the deficit in 1993, the government has also increased revenues and implemented across-the-board spending reductions. Furthermore, it has outlined plans for a major privatization effort and has proposed a program of sales, to begin shortly. The government's medium-term objective is ambitious—a primary surplus of 6½ percent of GDP in 1995 (an overall deficit-GDP ratio of 4¾ percent)—although a greater front-loading of the fiscal adjustments would have been desirable. Moreover, as the government now recognizes, a shortfall from the 1993 budget targets is likely in the absence of further measures this year. To correct the estimated noncyclical shortfall in the primary balance for 1993, the government has called for new fiscal measures of ¾ of 1 percent of GDP and it has proposed advancing cabinet approval of the 1994 budget to July. Assuming no further fiscal measures for 1993 (in the context of the 1994 budget), the staff expects a shortfall relative to the government's budget defi-

cit targets of about 1¼ percent of GDP in 1993, partly reflecting the cyclical slowdown, partly the risk of additional revenue losses and, to a lesser extent, expenditure overruns. A similar shortfall is assumed in 1994-95, which could be offset by stronger measures than presently expected. Measures that would help to achieve the government's objective in 1993 include reductions in state subsidies, further restrictions on transfers to local authorities and public agencies, tighter limits on health spending, and cuts in government investment and wage costs. Revenue shortfalls from slippage in the implementation of the 1993 budget also need to be offset by additional tax measures. Beyond 1993, measures should concentrate on expenditure control, including in particular firm limits on public sector wages and employment, and on the maintenance of the tax ratio, which is expected to decline in the absence of further measures.

In the *United Kingdom*, the general government deficit increased to 7¾ percent in the current fiscal year (1992/93), because of the recession, but also because of a relaxation of the underlying policy stance. Partly in response to the deteriorating fiscal position, the November 1992 Autumn Statement called for public sector pay increases to be limited to 1½ percent in 1993 and for real expenditure

growth (net of cyclical effects) to be limited to 1½ percent a year in the period through 1995/96. In addition, tax measures were announced in the March 1993 budget—to take effect on April 1, 1994—that would raise revenues totaling 1½ percent of GDP in 1995–96. In the current fiscal year, however, the general government deficit is set to rise further to 9 percent of GDP. Nevertheless, even if these objectives are met, it is expected that the public sector borrowing requirement (PSBR) excluding privatization receipts would still amount to more than 4 percent in 1997/98.¹² In the absence of further restrictions on expenditures, additional revenue measures would be needed to eliminate the structural component of the PSBR during the next several years.

In *Canada*, despite earlier efforts at consolidation, the federal deficit increased to 4½ percent of GDP in 1991/92 under the influence of the automatic stabilizers. In December 1992, the government reaffirmed its commitment to balance the budget over the medium term and announced tighter eligibility requirements and lower benefits for unemployment insurance, a 10 percent reduction in grants, a two-year freeze of public sector salaries, and a 3 percent cut in nonsalary operating budgets for 1993/94. Even with these measures and the expected recovery, the budget deficit is projected at about 2 percent of GDP in 1997/98, most of which would be structural. To balance the budget by 1997/98, further measures will therefore be needed once the economic expansion is firmly established.

In November 1992, the authorities in *Germany* were projecting a reduction in the deficit of the territorial authorities from 4¼ percent of GDP in 1993 to 2 percent of GDP by 1995 (Table 7). In early January, after the extent of the slowdown in growth became apparent, the government envisaged a reduction in the territorial authorities' deficit to only about 3 percent of GDP by 1995 and to 2 percent by 1996. As part of the government's fiscal consolidation efforts, the value-added tax (VAT) rate was increased from 14 to 15 percent in January 1993, and fiscal consolidation will be supported by a relatively modest wage settlement of 3 percent in the public sector. In mid-March, the federal government reached an agreement with the lower levels of government and the major opposition party on a package of revenue increases and expenditure restraints intended to achieve the desired reduction in the deficit. Measures taken or planned include the reimposition of a 7½ percent surcharge on wage and income taxes beginning in 1995, the elimina-

¹²This projection is consistent with the elimination of the output gap, reduction of inflation to below 3 percent, and achievement of a sustainable balance of payments position by 1997/98.

Table 7. Germany: Territorial Authorities' Finances¹

(In percent of GNP)

| | 1992 | 1993 | 1994 | 1995 | 1996 |
|--|------|------|------|------|------|
| Official medium-term projections of budget balance | -3.9 | -4.2 | -3.2 | -2.8 | -2.0 |
| IMF projections of budget balance | -3.9 | -4.9 | -4.5 | -3.4 | -3.4 |

¹Staff projections take account of measures in the fiscal package agreed in mid-March. The operations of the Treuhand and the railway and postal services are not included in the Territorial Authorities' accounts.

tion of numerous tax expenditures, and expenditure cuts of about 1⅓ percent of GNP, most of which are as yet unspecified. No decision has been taken on the government's plan to increase the petroleum tax in 1994. Notwithstanding these measures, the staff's projections indicate the persistence of a relatively large deficit over the medium term; deficits in various extrabudgetary funds that are used to finance some expenditures related to eastern Germany are also expected to increase somewhat.

In *France*, the general government deficit is expected to rise to more than 5 percent of GDP in 1993–94. Although an important reason for the recent increase in the deficit has been the operation of automatic stabilizers, there also appears to have been a structural decline in revenues, suggesting the need to review the efficiency of the tax system. In addition, the growth of expenditures has exceeded government targets, and the incoming government has announced a commitment to reduce expenditures. The government intends to formulate a medium-term fiscal plan to reduce the central government deficit from 4½ percent of GDP in 1993 to less than 2½ percent of GDP in 1997, to balance the social insurance accounts, and to alter the structural mix of revenues by reducing the excessive burden of direct taxes—with a view to stimulating employment—and by increasing indirect taxes. Also envisaged is a large-scale privatization program. Overall, the adoption of such a multiyear fiscal strategy—one that allows for the symmetric operation of the automatic stabilizers during the recovery—will help to impose discipline on public sector finances.

In *Japan*, the general government position has deteriorated as a result of weakening economic growth, as well as the stimulative measures taken recently to support economic activity and to restore financial stability. The authorities announced on April 13 a new package of stimulative measures totaling ¥13.2 trillion (2¾ percent of GNP), exceeding the ¥10.7 trillion package introduced in August 1992 (Box 3). These actions have been

Box 3. The Economic Stimulus Package in Japan

The Japanese government announced on April 13 an economic stimulus package designed to consolidate the economic recovery. New measures total ¥13.2 trillion (2 3/4 percent of GNP), compared with the August 1992 package of ¥10.7 trillion (2 1/4 percent of GNP). In addition, public works expenditures already in the initial FY 1993 (April-March) budget are to be front-loaded, as had been the case a year ago. Implementation of the central government portion of the package requires the passage of a supplementary budget, which will be submitted to the Diet shortly. The prompt passage of the initial FY 1993 budget indicates the Diet's recognition of the need for timely action.

The table provides the main elements of the new package (as well as those of the August 1992 package, for comparison). Public capital expenditures would increase by ¥8.8 trillion (1.8 percent of GNP), including public investment outlays (1.6 percent of GNP) and land purchases (0.2 percent of GNP). The package also includes increased lending through the Housing Loan Corporation and other government financial institutions, tax incentives to promote housing acquisition and equipment investment, and measures to stabilize employment. The package specifies that three-quarters of the public works spending is to be contracted out in the second and third quarters of 1993. Finally, the government has requested that some firms, such as Nippon Telephone and Telegraph (NTT), increase their equipment investment.

The economic impact of these measures varies: increased public investment and tax reductions directly raise spending on goods and services; enhanced recycling of funds raised through the fiscal investment and loan program is expected to stimulate demand and activity through effects on private spending; and measures such as increased land purchases, which constitute asset transactions, provide support for land prices and may thereby enhance confidence.

The Japanese authorities estimate that the overall package, excluding land purchases and increased operational lending, would raise output by 2.6 percent over a year on the basis of the multiplier properties of the world economic model of the Japanese Economic Planning Agency. The IMF staff's preliminary estimates assume that about one-half of the total package—1 1/4 percent of

GNP—would raise domestic demand directly. These measures include public investment (adjusted by the staff for spending not reflected in purchases of goods and services, mainly land), disaster relief, and tax reductions. In addition to their first-round effect, these measures generate second-round effects on output through other components of demand and through financial markets. Private spending will rise in response to higher incomes generated by higher government spending, but imports will also increase, causing some of the initial stimulus to "leak out." An appreciation of the yen would tend to moderate the overall increase in demand. On the basis of simulations with MULTIMOD, the IMF's macroeconomic model, these second-round effects roughly offset one another. Therefore, the estimated multiplier associated with the direct measures is about 1, and the full-year first- and second-round impact of these measures is likely to be 1 1/4 percent of GNP.

Other measures in the package, such as increased lending by government financial institutions, are also expected to have a positive, though indirect, influence on demand. Although difficult to quantify, the effect will depend on the extent to which the associated lending rates are below market rates, and on the interest sensitivity of the targeted spending. In current circumstances, increased financial intermediation through government channels may be particularly important in counterbalancing the negative effects of fragilities elsewhere in financial markets. The large overall size of the package may also have a positive impact on confidence by signaling the government's willingness to act. In this regard, the initial reaction of financial markets has been particularly encouraging.

The determined pursuit of fiscal consolidation during the 1980s provided the room to introduce economic stimulus packages in August 1992 and April 1993. The fiscal expansion embodied in these packages, however, has significantly eroded the budgetary position and, partly as a result, according to IMF estimates the general government budget balance has deteriorated in structural terms by about 1 1/2 percent of GNP between FY 1991 and FY 1993. Fiscal consolidation will be required over the medium term, particularly in view of the expected adverse effects of demographic changes on domestic savings and the budget.

Japan: Economic Stimulus Packages

| | August 1992 | | April 1993 | |
|---|------------------|----------------|------------------|----------------|
| | Trillions of yen | Percent of GNP | Trillions of yen | Percent of GNP |
| Total package | 10.7 | 2.3 | 13.2 | 2.7 |
| Public investment and land purchases | 7.9 | 1.6 | 8.8 | 1.8 |
| Public investment (including disaster relief) | 6.3 | 1.3 | 7.6 | 1.6 |
| Land purchases | 1.6 | 0.3 | 1.2 | 0.2 |
| Tax reductions | — | — | 0.2 | — |
| Increased lending by Housing Loan Corporation | 0.8 | 0.2 | 1.8 | 0.4 |
| Increased lending by government-affiliated financial institutions | 2.1 | 0.4 | 2.4 | 0.5 |
| <i>Memorandum</i> | | | | |
| Additional investment by NTT, electric companies, and the like | 0.7 | 0.1 | 0.6 | 0.1 |

possible because of Japan's record of fiscal consolidation in the past. As growth recovers, however, it would be appropriate to resume progress toward medium-term fiscal consolidation in view of the relatively large deficit (excluding social security) and given the prospective demands on the budget associated with the aging of the population.

Many of the *smaller industrial countries* have also experienced deterioration in fiscal positions in recent years, pointing to the need now for considerable fiscal restraint. In Sweden, the general government deficit widened from 1 percent of GDP in 1991 to 9 percent in 1992, reflecting some unexpected revenue shortfalls (associated in part with tax reform) but mostly owing to a sharp rise in expenditures (to almost 70 percent of GDP). Part of the deficit in 1992 was also related to the government's efforts (in the amount of 1½ percent of GDP) to stabilize the financial system. Although the emergency fiscal packages announced in September 1992, along with earlier measures, will reduce future deficits by about 5 percentage points of GDP, significant further budget cuts will be needed to eliminate the structural deficit over the medium term. Government deficits also widened in Finland and Norway; an economic downturn in the former and cyclical weakness in the latter have raised government expenditures and reduced revenues. In Belgium, the budget deficit remained unsustainably high, at 7 percent of GDP, in 1992, and the debt-GDP ratio rose to about 121 percent. Although the Greek budget deficit declined to 13¾ percent of GDP in 1992, it is expected to remain at about 11 percent in the absence of further measures. Already large fiscal imbalances have widened further in Australia and Spain, owing to a combination of cyclical effects and discretionary measures. By contrast, discretionary actions resulted in a somewhat lower general government deficit in Austria.

European Monetary Policy in the Transition to EMU

For more than a decade, exchange rate cooperation in the EMS has fostered an anti-inflationary environment in support of member countries' overall economic objectives. But the recent exchange market turmoil has brought into question the ability of the EMS, as it has operated so far, to continue to provide its members with a stable monetary framework consistent with their broader economic goals. This issue arises at a time when the EC is in the process of ratifying the Maastricht Treaty on economic and monetary union (EMU), the implementation of which may eventually provide a solution to some, though clearly not all, of the difficulties ex-

perienced recently.¹³ But until EMU takes effect—which is intended to occur between 1997 and 1999—the Community will face the need to reinforce the convergence process and monetary cooperation in order to reduce the risk of a recurrence of tensions between domestic and external policy objectives.

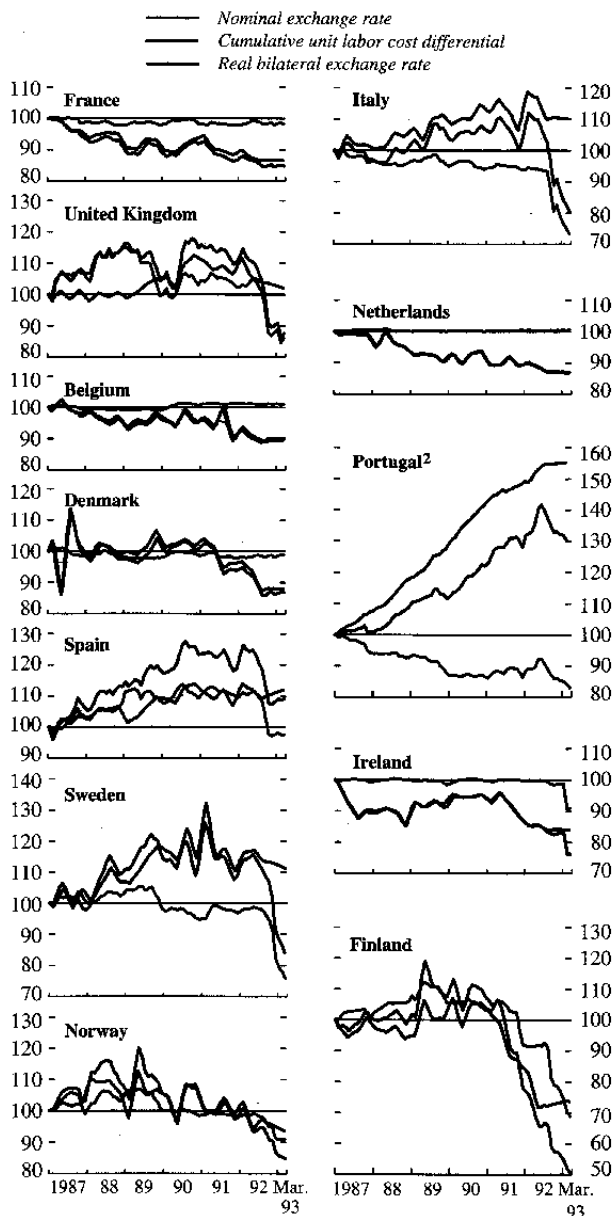
Until September 1992, monetary policy within the EC was largely defined by the commitments to the exchange rate parities of the ERM. Germany, as the only large economy with sufficiently strong anti-inflation credentials, was the *de facto* anchor of the system and operated a relatively independent monetary policy. Most other monetary authorities in Europe followed the German lead, seeking to gain added credibility for their own efforts to reduce inflation. With the entry of the Portuguese escudo in April 1992, all of the EC currencies except the Greek drachma had become members of the ERM, and several non-EC countries—including Austria, Finland, Norway, and Sweden—had pegged their exchange rates either to the deutsche mark or to the ECU.

The success of the arrangement meant that the EMS gradually had become the central pillar of monetary and exchange rate policy in Europe. Although exchange rate realignments were not ruled out, the central rates in the ERM had come to be viewed as relatively immutable, given the long period of calm in foreign exchange markets after the last general realignment in 1987. For the future, the establishment of a European Monetary Institute in Stage II of EMU, and of a European System of Central Banks in Stage III, promised a smooth transition toward a further strengthening of monetary cooperation and eventually a single European currency and a common monetary policy.

The persistent turmoil in European exchange markets that began in mid-1992 dramatically changed this outlook. The past six months have witnessed the suspension of the pound sterling and the Italian lira from the ERM; no less than four realignments, resulting in the devaluation of the lira (before its suspension), the Spanish peseta (on two occasions), the Portuguese escudo, and the Irish pound; and the floating of the Finnish markka, the Swedish krona, and the Norwegian krone. At the same time, a vigorous defense was required to hold the French franc and the Danish krone within the system, notwithstanding comparatively strong fundamentals in both cases. In the process, interest rates generally increased in countries whose currencies were under attack, in most cases in conflict with the domestic objective of supporting activity in

¹³The main objectives of the Maastricht Treaty are summarized in the May 1992 *World Economic Outlook*, Annex II, pp. 52–55.

Chart 18. Nominal and Real Bilateral Exchange Rates vis-à-vis Germany¹
(January 1987 = 100)



¹Changes in real bilateral rates vis-à-vis the deutsche mark can be inferred as the product of the change in the nominal exchange rate and the cumulative inflation differential (inflation measured either by unit labor costs or by consumer prices). This chart includes estimates through March 1993. Because of revisions in the source data, the exchange rate appreciations for a number of countries up to mid-1992 shown by present data are somewhat less pronounced than those shown in Chart 11 in the January 1993 *World Economic Outlook: Interim Assessment*.

²For Portugal, the cumulative inflation differential is measured by consumer prices through February 1993.

an environment of moderate inflationary pressures and increasing economic weakness.

Events since September have alleviated some of the immediate tensions.¹⁴ The exchange rate adjustments that have taken place have generally been consistent with the need to improve the competitive position of countries that had experienced an upward drift in their real exchange rates and deteriorating external positions (Chart 18).¹⁵ However, for several currencies that are now floating, the large real depreciations appear to have exceeded what was required to restore external competitiveness. For these currencies, a lowering of interest rates across Europe should help to avoid excessive downward pressure on their exchange rates. To avoid misalignments within the ERM in the future, countries will need to intensify their convergence efforts. Given that this process may take time, however, small exchange rate adjustments may be necessary occasionally to avoid the buildup of pressures for larger, more disruptive adjustments.

The need to strengthen convergence is particularly acute in the fiscal area, where most countries are still quite far from complying with the Maastricht criteria (Table 8). In several cases, budgetary problems seem to have contributed substantially to the recent currency turmoil because of market perceptions that large fiscal imbalances eventually might add to inflationary pressures. Some countries were also constrained in their ability to raise interest rates sufficiently in defense of their currencies. Large public debt-service burdens or the prospect of additional claims on the budget from fragile banking systems had increased the sensitivity of some economies to high interest rates.

The problems associated with divergent cost developments may have diminished in the short term, but the difficulties stemming from cyclical divergences may require more fundamental adaptations of the EMS. The critical issue is the asymmetric operation of monetary policies, with one country (Germany) pursuing an independent monetary policy and other members following the anchor country's lead. This was a successful arrangement for the 1980s, when the desire to control inflation was the primary goal of monetary policy throughout Europe. But the tightening of monetary policy in Germany, made necessary by the extraordinary strains associated with unification, created a situation in which monetary conditions in many other European countries had to be tightened to an extent that was

¹⁴For a more detailed analysis of the EMS crisis, see the January 1993 *Interim Assessment of the World Economic Outlook*, pp. 19-27.

¹⁵It should be noted that due to data revisions, the real exchange rate appreciation was somewhat less pronounced than in the January 1993 *Interim Assessment*, particularly for Italy.

Table 8. European Countries: Convergence Indicators for 1992 and 1993
(In percent)

| | 1992 GDP Weights | | Consumer Price Inflation | | General Government Balance/GDP | | Gross Government Debt/GDP ¹ | Long-Term Interest Rates |
|--|------------------|----------|--------------------------|------------|--------------------------------|-------------|--|--------------------------|
| | In EC | In world | 1992 | 1993 | 1992 | 1993 | 1992 | 1992 |
| EC countries | | | | | | | | |
| France | 19.2 | 3.6 | 2.8 | 2.0 | -3.8 | -5.7 | 50.4 | 8.6 |
| Germany | 23.2 | 4.3 | 4.5 | 4.4 | -2.8 | -3.6 | 42.7 | 7.9 |
| Italy | 18.4 | 3.4 | 5.5 | 5.7 | -10.2 | -10.3 | 108.6 | 13.1 |
| United Kingdom | 17.7 | 3.3 | 3.7 | 2.1 | -6.2 | -8.8 | 39.4 | 9.1 |
| Largest four countries ² | 78.5 | 14.6 | 4.1 | 3.6 | -5.6 | -6.9 | 59.3 | 9.6 |
| Belgium | 3.1 | 0.6 | 2.4 | 2.6 | -6.9 | -6.5 | 121.0 | 8.6 |
| Denmark ³ | 1.7 | 0.3 | 2.0 | 1.7 | -2.3 | -2.9 | 71.3 | 9.8 |
| Greece ⁴ | 1.7 | 0.3 | 15.9 | 13.3 | -13.8 | -12.6 | 108.6 | 22.5 |
| Ireland | 0.7 | 0.1 | 3.0 | 3.2 | -3.0 | -3.7 | 100.4 | 9.4 |
| Luxembourg | 0.1 | — | 3.2 | 3.3 | 1.3 | 0.1 | 5.8 | 7.9 |
| Netherlands | 4.7 | 0.9 | 3.7 | 2.0 | -4.0 | -3.6 | 80.0 | 8.1 |
| Portugal | 1.5 | 0.3 | 8.9 | 6.9 | -5.7 | -5.2 | 61.5 | 16.1 |
| Spain | 8.1 | 1.5 | 5.9 | 4.5 | -4.8 | -4.7 | 46.9 | 12.6 |
| Smallest eight countries ² | 21.5 | 4.0 | 5.5 | 4.3 | -5.4 | -5.2 | 74.2 | 11.7 |
| All EC ² | 100.0 | 18.6 | 4.4 | 3.7 | -5.5 | -6.5 | 62.5 | 10.0 |
| Maastricht convergence criteria⁵ | ... | ... | 3.9 | 3.4 | -3.0 | -3.0 | 60.0 | 11.0 |
| Non-EC countries | | | | | | | | |
| Austria | ... | 0.4 | 4.1 | 3.6 | -1.9 | -3.1 | 55.0 | 8.3 |
| Finland | ... | 0.3 | 2.6 | 3.4 | -8.9 | -11.2 | 37.0 | 12.4 |
| Norway | ... | 0.3 | 2.3 | 2.7 | -2.9 | -3.5 | 47.0 | 9.8 |
| Sweden | ... | 0.5 | 2.3 | 6.5 | -8.9 | -11.6 | 55.0 | 9.4 |
| Switzerland | ... | 0.7 | 4.1 | 3.3 | -1.8 | -2.4 | 34.3 | 5.5 |
| Five non-EC countries ² | ... | 2.3 | 3.2 | 4.0 | -4.6 | -6.2 | 45.3 | 8.4 |

Sources: National sources and staff projections.

Note: The table shows the convergence indicators mentioned in the Maastricht Treaty. The relevant convergence criteria are (1) consumer price inflation must not exceed, by more than 1½ percentage points, the average for those three member states with the lowest inflation rates; (2) interest rates on long-term government securities must not be more than 2 percentage points higher than those in the same three member states; (3) the currency must have been held within the narrow band of the ERM for two years without a realignment at the initiative of the member state in question; and (4) the financial position must be sustainable, which is defined as a general government deficit no greater than 3 percent of GDP and a public debt-GDP ratio of no more than 60 percent. The 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." See "The Maastricht Agreement on Economic and Monetary Union," Annex II in the May 1992 *World Economic Outlook*, pp. 52-55.

¹Debt data refer to end of year. They relate to general government but may not be consistent with the definition agreed at Maastricht.

²Average weighted by 1992 GDP shares.

³The debt-GDP ratio would be below 60 percent if adjusted in line with the definition agreed at Maastricht.

⁴General government balance includes capitalized interest; long-term interest rate is twelve-month treasury bill rate.

⁵Unweighted averages. The Treaty does not indicate precisely how these indicators should be weighted across the reference countries.

inappropriate on domestic grounds. Indeed, with inflation having been substantially reduced, or at least put on a satisfactory downward trend, there was a growing perception in financial markets that the weak growth performance would make it difficult for countries to raise interest rates in defense of their currencies. This made the system vulnerable to speculative attacks. Although such tensions persist, as indicated by continuing large interest rate differentials, a progressive decline in the level of interest rates in Germany would remove this second

source of instability in the EMS, at least for a period. But the broader question of monetary cooperation during the transition to EMU—both to reduce the risk of systemic instability and to strengthen conditions for noninflationary growth throughout—would remain to be addressed.

In this regard, a key issue that needs to be considered is the implication for monetary policy of the rapid increase in the degree of integration of the European economies that has occurred, a process that can only be expected to continue in coming

years. This integration has resulted not only in very important trade ties, but also in a sharp increase in cross-border deposits and other types of capital flows.¹⁶ The liberalization of intra-European capital markets associated with the single market project is leading to the creation of a single financial market in which banks and other financial institutions operate freely throughout the EC and the associated countries in the European Economic Area, and in which holders of liquid assets can readily switch from one currency denomination to another. One result of this development is that the distinction between resident and nonresident enterprises and financial institutions is being rapidly eroded. Another is that the appropriate treatment of the effects of external transactions on national monetary aggregates is becoming increasingly problematic.

These issues are particularly important during periods of currency turmoil, as illustrated by the unprecedented scale of capital inflows into Germany during the recent EMS crisis. The Bundesbank, through its money market operations, was as usual able to neutralize to a large extent the impact on bank liquidity of inflows directly into the banking system, and thus to prevent such inflows from swelling domestic credit or the money stock. However, the Bundesbank is less able to control the monetary impact of inflows to the nonbank sector, which accounted for a large proportion of the capital inflows into Germany during the September crisis. If it had attempted to offset the monetary impact of these nonbank flows by reducing bank liquidity, the result would have been a further tightening of monetary conditions, which would in turn have tended to generate additional inflows and exacerbate exchange market pressures. The Bundesbank was thus unable to prevent capital inflows during the recent turbulence from affecting monetary growth, which remained strong in the last four months of 1992 despite the slowdown in economic activity and tight monetary stance.¹⁷ It is reasonable to infer that the same factors that contributed to the substantial capital inflows into Germany and the rapid growth in German money supply in the last four months of 1992 also contributed to the sluggish growth of the money supply in most other ERM countries during the same period.

This discussion suggests that the economic significance of national monetary indicators across the

ERM must be viewed in a wider context. As national financial markets become more and more integrated, the distinction between national monetary aggregates is likely to become increasingly blurred and the relations between national aggregates and nominal GDP more unstable. One lesson is the familiar one—that monetary policy needs to be based on a range of indicators and not only on monetary aggregates. A growing body of research indicates, however, that there may be a relatively stable demand for an ERM-wide monetary aggregate.¹⁸ Further work will be necessary to judge the significance of these findings, but at present they do appear to be consistent with increased levels of currency substitution. Although these results cast doubt on the operational significance of national monetary aggregates as reliable guides for monetary policy, especially during periods of currency market turmoil or of cyclical disturbances across ERM countries, they suggest scope for pursuing a stability-oriented coordination of monetary policies in the ERM as a whole before the introduction of a single currency. Because such an approach would need to focus on aggregate inflation and activity indicators across the participating countries—to supplement national indicators—the responsibility for dealing with the consequences of economic disturbances that have a particularly large effect on activity and inflation in specific countries or regions would fall on fiscal and structural policies.

Structural Reform and Unemployment

Structural reform policies are the crucial third dimension of the medium-term strategy. Broadly speaking, the primary role of monetary and fiscal policies is to stabilize the macroeconomic environment in which private decisions are made and to

¹⁶The implications of the rapid growth of cross-border deposits, especially since 1988, are analyzed in Ignazio Angeloni, Carlo Cottarelli, and Aviram Levy, "Cross-Border Deposits and Monetary Aggregates in the Transition to EMU," IMF Working Paper 91/114 (November 1991).

¹⁷For an extensive discussion of the difficulties the Bundesbank faced in controlling the money stock during the recent EMS crisis, see *Deutsche Bundesbank Monthly Report* (January 1993).

¹⁸See Massimo Russo and Giuseppe Tullio, "Monetary Policy Coordination Within the European Monetary System: Is There a Rule?" in *Policy Coordination in the European Monetary System*, Occasional Paper 61 (IMF, September 1988), pp. 41–82; Jeroen J.M. Kremers and Timothy D. Lane, "Economic and Monetary Integration and the Aggregate Demand for Money in the EMS," *Staff Papers* (IMF), Vol. 37 (December 1990), pp. 777–805, and the comment by David Barr, "The Demand for Money in Europe," *Staff Papers* (IMF), Vol. 39 (September 1992), pp. 718–29; Timothy D. Lane and Stephen S. Poloz, "Currency Substitution and Cross-Border Monetary Aggregation: Evidence from the G-7," IMF Working Paper 92/81 (October 1992); and Tamim Bayoumi and Peter Kenen, "Using an EC-Wide Monetary Aggregate in Stage Two of EMU," IMF Working Paper 92/56 (July 1992). See also M.J. Artis, R.C. Bladen-Hovell, and W. Zhang, "A European Money Demand Function," in *Policy Issues in the Operation of Currency Unions*, edited by Paul R. Masson and M.P. Taylor (New York: Cambridge University Press, 1993); and Carlo Monticelli and Marc-Olivier Strauss-Kahn, "European Integration and the Demand for Broad Money" (unpublished; Basle, 1992).

release resources from the public sector that could be used more productively by the private sector. The complementary purpose of structural reform is to increase the flexibility with which the economy responds to shocks and to enhance the efficiency with which resources are allocated. That growth remains considerably lower than in the 1960s—despite the reduction of inflation to levels broadly comparable to those prevailing thirty years ago—highlights the importance of determined actions to remove impediments to growth and trade that have built up over the past three decades.

Progress in implementing structural reforms has been uneven. Almost all of the industrial countries have adopted tax reforms and liberalized financial markets. In some countries, subsidies to declining industrial sectors have been substantially reduced, regulations and controls have been removed or relaxed, and privatization programs have been undertaken. The full benefits of reform have not always materialized, however, in some cases because the removal of constraints through deregulation has not been matched by actions to reduce distortions to incentives. For example, financial deregulation in most cases was not accompanied by improvements in prudential supervision, which might have prevented some of the speculative excesses that occurred in the mid- to late 1980s (see Annex I).¹⁹ These distortions may themselves have been aggravated by deregulation.

Less progress has been made toward structural reform in the areas of trade, agriculture, and labor markets. As discussed in Chapter VI, distortions in international trade have actually increased during the past few decades with the proliferation of non-tariff barriers in the industrial countries. There has been broad appreciation of the importance of improving the functioning of labor markets. In general, governments have increasingly refrained from attempting to control wages or protect jobs through regulations and have attempted to reduce the bargaining power of labor unions. Nevertheless, there is little if any evidence that the cost of disinflation has declined, and the persistence of high unemployment in a large number of countries remains a visible indication of the lack of progress in increasing the flexibility of labor markets.

The recent rise in unemployment in the industrial countries is primarily cyclical. In the United States and Canada, for example, unemployment can be expected to decline significantly during the expansion phase of the business cycle, as typically happened during expansions in these countries in the past three decades. For some European countries

and for Australia and New Zealand, however, large increases in unemployment in the mid-1970s and the early 1980s that appeared at the time to be cyclical have persisted.²⁰ Thus, for many countries, there is a risk that the recent cyclical increases in unemployment, which have come at a time when unemployment was already high by historical standards, will persist.

There are now a number of theoretical models, with well-developed microeconomic foundations, that explain why non-market-clearing wages—and hence high unemployment—can persist.²¹ A common feature of these models is the focus on the relationship between employers and employees and the existence of labor turnover costs. If turnover costs bestow market power to the employed—the insiders—or if the unemployed—the outsiders—have little influence on wage bargaining, high unemployment may have little restraining effect on wages. When unemployment increases, and if real wages do not adjust rapidly, the number of outsiders may increase, and a smaller group of insiders may be able to bargain for high wages that prevent the re-employment of those who lost their jobs. High unemployment will therefore be consistent with quasi-equilibrium in the labor market because wages remain above the level required for full employment.

This explanation of persistent unemployment suggests the importance of policies that avoid increases in unemployment, or speed up the reduction of unemployment before persistence mechanisms set in. At the level of macroeconomic policies, this consideration must be weighed against the need to provide a stable noninflationary environment. An important lesson of the 1970s is that it is not possible to sustain macroeconomic policies that attempt to trade off increases in inflation against higher growth. It is also crucial that microeconomic or structural policies avoid increasing the equilibrium or “natural” rate of unemployment.

Successful market economies are characterized, at least to some extent, by “creative destruction,” whereby new firms better able to exploit new technologies and improve managerial efficiency replace existing, less efficient enterprises. To prevent structural unemployment from increasing during periods of rapid technological or structural change requires a highly trained labor force that has the flexibility to adapt to new production techniques, perhaps in different industries. The need to increase the

¹⁹For a more detailed examination of this issue, see Annex I in the October 1992 *World Economic Outlook*.

²⁰See the box on “Unemployment in the Industrial Countries” in the October 1991 issue of the *World Economic Outlook*, pp. 40–41.

²¹These are summarized in Assar Lindbeck’s presidential address to the European Economic Association, “Macroeconomic Theory and the Labor Market,” *European Economic Review*, Vol. 36 (1992), pp. 209–32.

flexibility of labor markets has highlighted the importance of active labor market policies, as distinct from passive policies that do little more than provide income support for the unemployed.²² Active labor market policies encourage job search and training and aim to reduce the level of equilibrium unemployment. This is particularly important in Europe, where structural unemployment remains at record levels and where progress in enhancing the flexibility of labor markets has been disappointing. A failure to tackle Europe's labor market problems would substantially erode the benefits of EMU. It would also increase the need for government subsidies and transfers to economically weaker regions, which could jeopardize fiscal consolidation efforts in Europe.

The difficulty of implementing reforms in this area is related to the fact that policies that impinge on labor markets are often intended to achieve social or distributional objectives. Because policies such as minimum wages or overly generous unemployment insurance systems can create distortions in labor markets, they often have the perverse result of increasing structural unemployment, particularly among the most vulnerable members of the labor force. Rather than introducing regulatory distortions that reduce the efficiency and flexibility of the labor market, the incidence of which is at best uneven, distributional objectives should be pursued through the tax and transfer system and through active, market-oriented labor market policies. The appropriate policy response to the problem of low wages, for example, is to increase labor productivity—the ultimate determinant of real standards of living—through improved training and education, rather than to treat the symptoms of low productivity through minimum wages or other regulations.

Structural reform issues have an important multilateral dimension.²³ Although structural policies cannot play the same role in international policy coordination as fiscal and monetary policies, they nevertheless may have important spillover effects on the rest of the world. This particularly concerns agricultural and industrial subsidies and regulations that affect market access for other countries' exports. But other structural policies—including tax policies, labor market policies, and financial sector reforms—may have significant effects on productivity, external competitiveness, inflation, trade performance, the saving-investment balance, financial conditions, and the real exchange rate. Struc-

tural policy questions therefore need to figure prominently in multilateral surveillance, as acknowledged in the mandate that the industrial countries have given to the OECD in this area. Structural policy issues also play a central role in the IMF's surveillance activities, not least because of the potential effects of structural impediments and rigidities on countries' ability to adjust to adverse domestic and external disturbances.

Alternative Scenarios: Risks and Opportunities

Measures to address the policy issues discussed above not only are essential to improve the medium-term outlook, they might also limit the depth and duration of the present slowdown in Europe and Japan and help to underpin the recoveries under way in the United States and Canada. Despite the relatively large downward revisions to the projections since the October 1992 *World Economic Outlook*, and the relatively slow return to potential levels of output projected for the medium term, there still appear to be considerable downside risks to the outlook for the next few years. In some industrial countries, it is uncertain to what extent the effects of asset price deflation and financial fragility will continue to restrain demand, and growth could well remain sluggish even after recoveries have begun. Moreover, the large budgetary imbalances in many countries may continue to hold back consumer and business confidence because of uncertainties about future economic policies. For Europe, there is a risk that high real interest rates, weak confidence, continuing exchange market turbulence, and uncertainties about implementation of the Maastricht Treaty may continue to delay recovery. An additional risk for all countries is the tensions over trade and the continuing uncertainty about the conclusion of the Uruguay Round of multilateral trade negotiations.

Although there is also the potential for growth to be stronger than projected, the policy implications are clearly more serious if growth turns out to be significantly weaker than in the baseline. Margins of slack are quite large in most countries; unemployment is approaching earlier peaks, particularly in Europe; and financial sector problems in many countries are being aggravated by the weakness of growth. A further worsening of the recession might also increase protectionist pressures and reduce governments' resolve to resist such pressures.

The downside risks, if realized, would tend to delay the projected upturn in economic activity, especially in Japan and Europe. The timing of the turning point will depend on the extent to which the process of debt deflation continues to depress demand and on the speed with which activity responds

²²See OECD, *Employment Outlook* (Paris, 1991).

²³See Jeffrey R. Shafer, "Structural Reform in the Process of International Policy Coordination," in *The Reality of International Economic Policy Coordination*, edited by Hans J. Blommestein (Amsterdam and New York: North-Holland, 1991), pp. 107–22.

to recent (and potential future) policy changes. These factors will have an important bearing on the timing of the turnaround in consumer and business confidence, which will be crucial to ensure recovery.

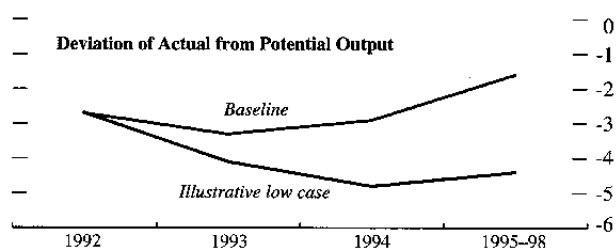
In Europe, the baseline projections assume that the turning point in the cycle will occur in mid-1993 (see Chart 3 in Chapter II). There is a considerable risk, however, that the prospective reduction of interest rates in Germany and across Europe might occur too late, or be insufficient, to contain the negative forces operating at present (the typical response lag between changes in interest rates and economic activity is about six months). Economic confidence might also remain depressed until interest rates—and thereby exchange market tensions in Europe—have been reduced significantly. In the United Kingdom, Sweden, Finland, and other countries that are going through the process of balance sheet consolidation in the private sector, there is also a risk of continued sluggish growth of consumer spending and business investment.

In Japan, the turning point in the baseline projection is around mid-1993. Although the baseline takes account of the recent stimulus package, the absence of firm signs of an imminent upswing in private demand suggests a continuing risk that the turnaround could be delayed. The problems in the financial sector and the recent appreciation of the yen also increase the uncertainty about the outlook. As in the case of Europe, the turning point may therefore be delayed until well into the second half of 1993.

For the United States, the risks in the outlook are of a somewhat different nature. The recent strength of the recovery—which started in the second half of 1991, hesitated during the spring of 1992, and gained momentum in the final quarter of 1992—suggests relatively little downside risk to the projection of 3 percent growth for 1993, which might even prove to be on the conservative side. But if the ongoing efforts of the administration to secure a significant package of deficit-reduction measures run into difficulties, confidence could be adversely affected, and the recent decline in long-term interest rates might be reversed. Under such circumstances, growth could again falter in 1994, and this might hinder further deficit-reduction efforts.

If the turning points were delayed as suggested, growth in the industrial countries in 1993–94 could fall significantly short of the baseline projections, particularly in Europe and Japan. An illustrative order of magnitude for such a “low case” is indicated in Chart 19. Although a deeper-than-expected recession might result in a relatively strong rebound in 1995, there would also be a risk of an adverse impact on medium-term growth from increased structural unemployment, reflecting the persistence effects described above; higher risk premiums on

Chart 19. Industrial Countries: Alternative Scenarios
(In percent)



long-term interest rates associated with larger cyclical and structural budget deficits; and reduced growth of potential output.

One way to counterbalance the downside risks would be for the major industrial countries to implement appropriate policy actions to alleviate the short-term obstacles to recovery and to promote higher noninflationary growth over the medium term. Such a cooperative effort, the need for which is discussed in Chapter I, would aim to lower interest rates throughout Europe and to ensure credible fiscal consolidation in countries with large structural fiscal imbalances. The result of such a policy initiative would be to raise the level of production and employment above the baseline projections and to limit the downside risks. In the short term, these measures would improve the economic climate and reduce interest rates, thus helping to offset the short-term effects of fiscal contraction in the United States and Italy, in particular. Over the medium term, stronger growth would raise income and saving and would support higher investment and consumption.

The specific assumptions underlying the cooperative policy scenario are as follows. In the United States, the administration would forgo short-term fiscal stimulus and implement a medium-term deficit-reduction package to reduce the structural deficit by about twice as much over the medium term as envisaged in the economic plan presented in February. Adoption of such a package is assumed to have an immediate beneficial impact on long-term interest rates, which would help to offset any short-term dampening effects of expenditure cuts or tax increases.

In accordance with the recently announced package, Japan's contribution would be to introduce additional stimulative fiscal measures to supplement the FY 1993 budget proposals, thereby permitting a continued injection of stimulus during the period ahead; such stimulus should be gradually reversed over the medium term in view of the need for

medium-term fiscal consolidation.²⁴ In Europe, the principal contribution would be a further significant and progressive reduction of interest rates, starting in Germany. This would reduce exchange market tensions and permit a marked narrowing of interest differentials vis-à-vis Germany in other European countries.²⁵ Such a lowering of interest rates is generally warranted in light of the current weakness of activity and declining inflation in most countries, including the prospects of decelerating inflation in Germany. However, several countries—including Italy, Germany, and the United Kingdom—would need to introduce additional budget consolidation measures to safeguard the credibility of their commitment to resist inflationary pressures, to increase national saving, and to permit a general lowering of

²⁴See Box 3 earlier in this chapter for an analysis of the economic stimulus package introduced by the Japanese government in April 1993.

²⁵A gradual reduction of interest rates in Europe is already assumed in the baseline projections. The cooperative policy scenario assumes a more rapid and somewhat more pronounced reduction of interest rates in Germany and of interest differentials vis-à-vis Germany in the rest of Europe.

long-term interest rates. In addition to positive effects on growth in 1993 and 1994, the cooperative growth scenario would tend to raise output over the medium term because of higher investment rates and, hence, stronger growth of potential output. Simulation results of the impact of such a scenario, relative to an unchanged policy scenario, are presented in Annex II.

The probability of the risk scenario materializing is difficult to assess in isolation from the cooperative policy scenario. If the industrial countries do not seize the opportunity for effective action, a further deterioration of the economic climate and rising tensions over trade might be difficult to avoid. Under such circumstances, business investment would remain sluggish, and households and enterprises would likely continue to consolidate their financial positions. Conversely, the announcement and implementation of a cooperative policy strategy would undoubtedly help to raise confidence by reducing uncertainty about future policies, thereby spurring both consumption and investment. The cooperative strategy—in addition to its direct beneficial effects—would therefore also be a way to buy insurance against the downside risks.