

CHAPTER 2

THE GLOBAL CONTEXT AND THE WESTERN MARKET ECONOMIES

2.1 The global context

The assessment of global economic developments has become more optimistic since the final months of 1999. The adverse effects on economic activity due to the severe financial turbulence in 1997 and the second half of 1998, waned progressively in the course of 1999 and have been partly reversed. This return of stability to the global economy was accompanied by a general strengthening of cyclical growth forces, which is forecast to gain further momentum in 2000. There appears now to be a better balance between upside and downside risks, with perhaps the former gaining the upper hand. This is also reflected in business surveys, which suggest that the global business climate in early 2000 had reached its highest level in two decades.²⁹ Forecasts of economic growth in 2000 have been revised upward after a better than expected performance in 1999. World output is estimated to have increased by 3 per cent in 1999 about $\frac{3}{4}$ of a percentage point more than expected in the spring of 1999. Current forecasts are for an annual increase in world GDP by 3.5 per cent in 2000 (compared with 1999).³⁰ The strengthening of global economic activity in 1999 was accompanied by an upturn in world trade which had slowed down markedly during 1998. The volume of merchandise trade is estimated to have increased by 5 per cent in 1999, the same as in 1998,³¹ and current forecasts are for an acceleration to 7 per cent in 2000.

These optimistic short-term forecasts for the global economy, however, are conditional on a number of important assumptions, notably that there will be no financial crisis in the major emerging market economies, that the rise in oil prices will peter out and possibly be

partly reversed in 2000, and that the United States economy will achieve a “soft landing”.³²

The millennium date change (the so-called Y2K problem) did not have any significant adverse impact on macroeconomic developments in early 2000. The available evidence suggests that this was only a problem for a rather small proportion of firms in the various countries. The absence of disruption reflects the massive business spending on measures introduced to cope with the problem (which, simultaneously, often involved a substantial modernization of the stock of computers), although it cannot be excluded that the problem itself may have been exaggerated. There was also little reporting of adverse effects in Russia and developing countries where problems had been forecast in telecommunications, transport and energy because of a perceived lack of preparedness.

In the international financial markets, the general sentiment towards emerging market economies has improved significantly. The increase in investors' confidence was reflected in record high equity investment in 1999 and a substantial lowering of the risk premia (spreads) on emerging market bonds.³³ The overall cautious attitude of commercial banks vis-à-vis this group of countries was reflected in a continued net repayment of loans. Aggregate net private flows amounted to \$149 billion in 1999, broadly the same as in 1998. Current forecasts are for significantly higher inflows, of some \$195 billion in 2000. Larger inflows are required to ensure the financing of increased current account deficits associated with rising imports of capital goods required for the restructuring and enhancement of productive capacity in the years ahead.

In the international oil markets there was a sharp rise in the price of crude oil in 1999, which has continued in early 2000 (chart 2.1.1). This was, in general, the main source of upward pressures on the still relatively moderate rates of inflation in the industrialized countries. In early March 2000, the spot price of Brent crude was around \$30 per barrel, compared with \$9.9 in early February 1999. The March price was the highest level

²⁹ Based on the Ifo international business cycle test in 81 countries. This survey was carried out for the first time in 1981. Ifo Institut für Wirtschaftsforschung, *ifo Schnelldienst 7/2000* (Munich), 7 March 2000, pp. 3-10.

³⁰ IMF, *World Economic Outlook* (Washington D.C.), October 1999; OECD, *Economic Outlook* (Paris), December 1999.

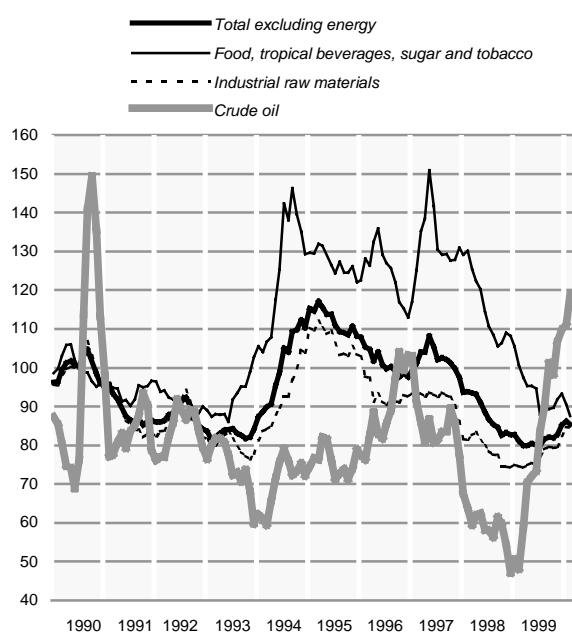
³¹ The unchanged average annual growth rate masks the considerably different growth dynamics in the course of these two years. The sluggish performance in 1998 is illustrated by the fact that about 3.5 percentage points of the annual world trade growth in 1998 *ceteris paribus* was already ensured by the substantial statistical carry-over effect from the high level attained at the end of 1997. The corresponding carry-over effect at the end of 1998 was only some 1.5 percentage points. Based on data in OECD, *Main Economic Indicators* (Paris), various issues.

³² Sect. 2.2(iv) below.

³³ Institute of International Finance (IIF), *Capital Flows to Emerging Market Economies* (Washington D.C.), 24 January 2000.

CHART 2.1.1

World commodity prices, January 1990-February 2000
(Indices, 1990=100)



Source: Hamburg Institute for Economic Research (HWWA).

Note: Indexes calculated on the basis of current dollar prices.

since the 1991 Gulf war. This surge reflects in the main the adherence to the supply quotas agreed by the oil exporting countries in March 1999 and intended to reverse the depressing effect on prices of excess supply and abundant stocks. The more rapid rate of economic expansion in the course of 1999, moreover, led to an increase in oil demand, which was only partly met by the available new supply. As a result, oil stocks in the industrialized countries in the final quarter of 1999 fell at their highest rate in a decade.³⁴ When measured in real terms (i.e. relative to the unit value index of manufactured exports of the developed market economies), the price of oil in early 2000, however, was still some 40 per cent below the average during 1980-1985, the last sustained period of high real oil prices. More recently there have been growing concerns about the potential inflationary effects of further increases in the price of oil and calls by industrialized countries for oil producers to raise output.³⁵ The more rapid expansion of global economic activity has also tended to support the prices of industrial materials, which started to rise in the second half of 1999, although for the year as a whole there was still a small decline (table 2.1.1). Persistent excess supply has led to further sharp declines in the prices of agricultural commodities, notably food and tropical beverages (chart 2.1.1).

³⁴ International Energy Agency, *Oil Market Report* (Paris), 11 February 2000.

³⁵ A formal OPEC review of the production ceilings has been scheduled for the end of March 2000.

TABLE 2.1.1

World commodity prices, 1996-1999
(Percentage change over previous year)

	Weights ^a	1996	1997	1998	1999
Food and beverages	9.9	-2.1	5.9	-12.3	-18.7
Industrial raw materials	29.5	-12.5	-1.5	-14.5	-2.2
Energy	60.5	15.6	-3.6	-29.0	30.1
Crude oil	55.5	17.6	-3.6	-31.1	35.7
Total	100.0	3.3	-1.7	-22.3	11.8
Total, excluding energy	39.5	-9.6	0.9	-13.8	-7.6

Source: Hamburg Institute for Economic Research (HWWA).

Note: Growth rates calculated on the basis of current dollar prices.

^a Weights refer to average commodity shares in total imports of western industrialized countries in 1989-1991.

Despite the upturn in global economic growth, the cyclical positions of the major economies and regions, and the underlying strength of the forces for growth, continue to differ significantly. Economic growth has maintained a very high momentum in North America. In western Europe, the strengthening of growth in the four major economies has put the regional recovery, which was largely due to the smaller economies in 1998, on a broader basis. In central and eastern Europe, the adverse trade shocks of the Russian crisis have been largely overcome, and economic activity has been increasingly supported by the improved economic performance and the associated strengthening of domestic demand in western Europe. In Russia, the deep recession has bottomed out and output has started to rise again, although the foundations for a sustained recovery still appear to be rather weak. There has also been an upturn in economic activity in most of the other member countries of the CIS.

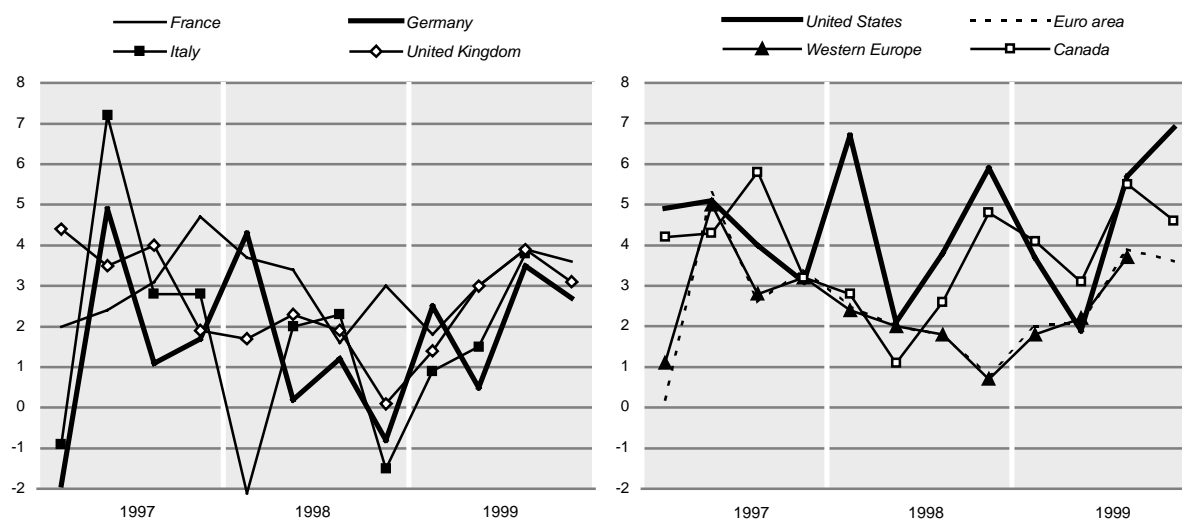
In *Latin America*, real GDP stagnated in 1999, the first time in the 1990s that the region as a whole did not experience positive economic growth.³⁶ Nevertheless, even this performance was still better than expected earlier in the year and it is largely accounted for by the moderate recovery in Brazil, where real GDP rose by about 0.5 per cent compared with 1998. Sharp recessions in a number of countries (Argentina, Chile, Ecuador, Honduras, Uruguay, Venezuela) largely reflected the combined effects of reduced capital inflows, exchange rate crises, and a deterioration in the terms of trade due to weak commodity prices. In contrast, Mexico and most of the Central American economies grew rapidly in 1999, largely because of their close trade links with the buoyant economy of the United States.

In the five *Asian emerging markets* most directly affected by the financial crisis of 1997, there was an unexpectedly strong recovery from the depression of

³⁶ ECLAC, "Preliminary overview of the economies of Latin America and the Caribbean 1999", *ECLAC Notes*, No. 8 (Santiago), January 2000.

CHART 2.2.1

Quarterly changes in real GDP in western Europe and North America, 1997-1999
(Percentage change over preceding quarter, seasonally adjusted at annual rates)



Source: National statistics.

Note: Data for western Europe cover 13 countries (Austria, Belgium, Denmark, Finland, France, Germany, Italy, the Netherlands, Norway, Spain, Sweden, Switzerland and the United Kingdom). Data for the euro area exclude Ireland and Portugal.

economic activity in 1999. The cyclical upturn partly reflects the global recovery in demand for electronic products and partly the impact of expansionary economic policies. Also, progress in structural reforms, such as the rehabilitation of the financial sector, and the strong yen have contributed to this performance. In the Republic of Korea, real GDP rose by 10 per cent in 1999, more than offsetting the decline of 5.8 per cent in 1998. Aggregate output increased by some 5 per cent in Malaysia and Thailand and by 3 per cent in the Philippines. In contrast, Indonesia remained mired in deep crisis. Outside these five economies, there was robust growth in Taiwan and Singapore. In China, expansionary economic policies helped to maintain economic growth at a high rate of some 7 per cent in 1999.

In *Japan*, hopes that the economy might be on the way towards a gradual, sustained recovery have been disappointed. Real GDP fell in both the third and fourth quarters of 1999 (over the preceding quarters): technically, the economy has therefore moved back into recession.³⁷ This occurred despite massively expansionary fiscal packages and, since February 1999, a zero-interest rate policy of the central bank. The strong yen restrained exports, but there was also a conspicuous weakening of private consumption and public investment in the final quarter of 1999. For the year as a whole, real GDP rose by only 0.3 per cent. There are also mounting concerns about the rapid deterioration of the public finances: a succession

of large budget deficits have led to a significant rise in the general government's gross financial liabilities, which corresponded to about 105 per cent of GDP in 1999.

2.2 Western Europe and North America

(i) Western Europe

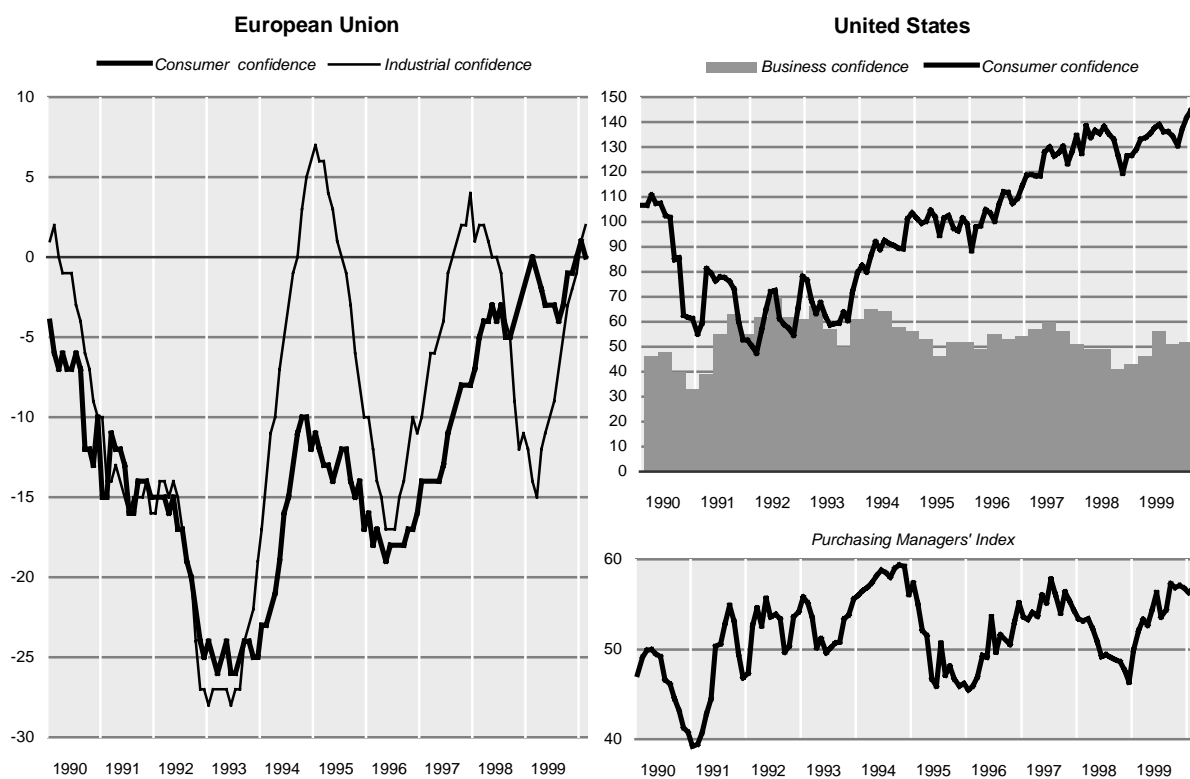
After a hesitant start in early 1999, the cyclical upturn in *western Europe* gathered significant momentum in the second half of 1999. Real GDP rose by 0.9 per cent between the second and third quarters, equivalent to an annual rate of some 3.5 per cent.³⁸ This was the strongest quarterly increase since the second quarter of 1997, which preceded the eruption of the Asian crises. The acceleration was broadly based across countries, but there was notably a marked simultaneous strengthening of economic activity in the four major economies. Within the *euro area*, the degree of cyclical divergence between the smaller member countries and the larger ones diminished somewhat in the course of 1999. Partial national accounts data for the final quarter of 1999, available at the time of writing, confirm the continuation of this favourable performance, although the overall rate of expansion weakened slightly in France, Germany and the United Kingdom (chart 2.2.1). Between the third and

³⁷ It has been noted recently that the underlying cyclical strength of the Japanese economy is difficult to gauge because of biases in data collection. "A question of supply and demand: why Japan's figures don't add up", *Financial Times*, 13 February 2000.

³⁸ The term annual rate is not to be confused with an *actual* annual growth rate. If g is the quarter-to-quarter percentage change, then the annual rate (AR) is defined as $[(1+g/100)^4] - 1$. Thus, AR is the annual growth that *would* result if the current quarterly growth rate were maintained over a full year period. This transformation of the quarter-to-quarter changes allows a better comparison with (past) annual growth rates.

CHART 2.2.2

Business cycle indicators for the European Union and the United States, January 1990-February 2000



Source: Data for the European Union: European Commission, *European Economy*, Supplement B (Luxembourg), monthly and direct communications. Data for the United States: consumer and business confidence: the Conference Board, New York (www.conference-board.org), and direct communications. Purchasing Managers' Index: website of the National Association of Purchasing Management, Arizona, and direct communications.

Note: European Union data show net balances between the percentages of respondents giving positive and negative answers to specific questions. For details see any edition of the source. United States: consumer confidence is measured in index form with base year 1985=100. Business confidence is compiled on the basis of answers to specific questions, with the following scale applying: 100 = substantially good; 75 = moderately good (+); 50 = moderately good (-); 25 = moderately bad; (0) = bad. The Purchasing Managers' Index (PMI) is a composite index pertaining to the business situation in manufacturing industry. An index value above (below) 50 per cent indicates that manufacturing industry is generally expanding (contracting). A PMI above (below) 44.5 per cent, over a period of time, indicates that overall economic activity, as measured by real GDP, is generally expanding (contracting).

fourth quarters, real GDP is estimated to have increased by 0.9 per cent equivalent to an annual rate of 3.6 per cent. In the final quarter of 1999 GDP was about 3 per cent higher than a year earlier. Monthly economic indicators point to a continued favourable environment in early 2000. Industrial confidence rose to high levels (chart 2.2.2), reflecting an optimistic assessment of production prospects in the light of increases in domestic and foreign orders. The average growth performance for 1999 as a whole, however, masks the pronounced improvement in cyclical conditions in western Europe in the second half of the year. Thus, real GDP rose on average by only 2 per cent in 1999, down from 2.7 per cent in 1998 (table 2.2.1). In the European Union and the euro area, real GDP increased by 2.3 per cent in 1999.

Viewed from the supply-side, the current cyclical upturn reflects the reversal of the weakening of industrial activity that occurred in the second half of 1998. In fact, output had fallen sharply in the final quarter of 1998, largely reflecting the direct and indirect effects of the crises in Asia and other emerging markets on west

European exports. But activity started to recover after the first quarter of 1999, with export demand stabilizing and, in most countries, strong growth of consumption and fixed investment, and the rundown in stocks coming to an end. For the year as a whole, industrial output rose, but only by 1 per cent (against 3.3 per cent in 1998) and manufacturing output increased by 1.3 per cent. The decline in manufacturing capacity utilization rates since late 1998 started to be reversed in the final months of 1999 when, in fact, they were close to their long-term (1989-1998) average (chart 2.2.3).

Viewed from the demand side, the recovery in 1999 was largely export-led (chart 2.2.4). But domestic demand proved, in general, to be quite resilient to the deteriorating economic environment in the second half of 1998. Exports were supported by the improved price competitiveness deriving from the strong dollar and the revival of domestic demand in emerging markets. Exports also benefited from the stronger than expected economic growth in the United States and Canada. The strengthening of demand from outside the region then fed

TABLE 2.2.1

Annual changes in real GDP in western Europe and North America, 1997-2000

(Percentage change over previous year)

	1997	1998	1999 ^a	2000 ^b
Western Europe	2.8	2.7	2.0	3.2
4 major countries	2.1	2.3	1.9	2.9
France	2.0	3.4	2.7	3.5
Germany	1.5	2.2	1.5	2.8
Italy	1.8	1.5	1.4	2.5
United Kingdom	3.5	2.2	2.0	3.0
17 smaller countries	4.1	3.4	2.4	3.5
Austria	1.2	2.9	2.2	2.8
Belgium	3.5	2.7	2.3	3.2
Cyprus	2.5	5.0	4.5	4.1
Denmark	3.1	2.7	1.3	2.0
Finland	6.3	5.0	3.5	4.5
Greece	3.4	3.7	3.3	3.7
Iceland	5.3	5.1	6.0	2.9
Ireland	10.7	8.9	8.3	7.5
Israel	2.9	2.2	2.0	3.5
Luxembourg	7.3	5.0	5.1	4.3
Malta	4.8	3.1	4.8	4.8
Netherlands	3.8	3.7	3.5	3.5
Norway	4.3	2.1	0.8	2.7
Portugal	3.5	3.5	3.1	3.3
Spain	3.8	4.0	3.7	3.7
Sweden	2.0	3.0	3.8	4.0
Switzerland	1.7	2.1	1.7	2.5
Turkey	7.5	2.8	-2.3	4.6
North America	4.5	4.2	4.1	4.0
Canada	4.0	3.1	4.2	3.9
United States	4.5	4.3	4.1	4.0
Total above	3.6	3.4	3.1	3.6
Japan	1.6	-2.5	0.3	0.7
Total above, including Japan	3.3	2.5	2.6	3.1
Memorandum items:				
European Union	2.6	2.7	2.3	3.1
Euro area	2.3	2.8	2.3	3.1

Source: OECD national accounts; national statistics and national economic reports.

Note: All aggregates exclude Israel. Growth rates of regional aggregates have been calculated as weighted averages of growth rates in individual countries. Weights were derived from 1991 GDP data converted from national currency units into dollars using purchasing power parities.

^a Preliminary estimates or forecasts.

^b Forecasts.

through to domestic demand which, in turn, stimulated intra-European trade. This kind of virtuous circle is well known from previous upswings. Although increased exports and strengthening domestic demand led to rising imports, changes in real net exports supported economic activity after the first quarter of 1999. For nearly two years net exports, on average, had been a drag on domestic activity (chart 2.2.4). In addition, domestic demand continued to be supported by the expansionary stance of monetary policy and the increases in income due to rising levels of output and employment. Low interest rates stimulated the demand for interest-sensitive expenditure items, such as consumer durables and investment goods, including housing.

For 1999 as a whole, private consumption was the mainstay of economic growth in western Europe. Household expenditures rose on average by 2.5 per cent compared with 1998, but consumer spending was more buoyant in a number of smaller economies (table 2.2.2). The general background to this was a marked rise in consumer confidence to its highest level in the 1990s (chart 2.2.2). Confidence was bolstered by the improving situation in the labour markets and, partly related to this, to gains in real income in a context of continued moderate inflation. Household spending was also stimulated by rising net wealth due to increases in the prices of shares and, in some countries, real estate. This wealth effect, together with favourable financing conditions, led many households to finance purchases of “big ticket” items by means of borrowing. In many countries, falling savings ratios supported private consumption in 1999. *Government consumption* expenditures rose somewhat more strongly in 1999 than in 1998, a reflection of reduced pressure for fiscal consolidation.

Fixed investment strengthened in the course of 1999 (chart 2.2.4), although for the year as a whole the increase was only about 4¼ per cent, down from 5.5 per cent in 1998 (table 2.2.2). There was a somewhat stronger growth of expenditure on machinery and equipment than on construction, but it is noteworthy that construction – both residential and public infrastructure – picked up in 1999, after rather sluggish growth in the two preceding years. Apart from favourable financing conditions, business investment was supported by improved sales expectations and relatively high and rising capacity utilization rates, all factors which have tended to increase profitability. To some extent business investment in machinery was also stimulated by the need to ensure Y2K compliance of EDP equipment. Changes in inventories had little impact on economic activity in 1999.

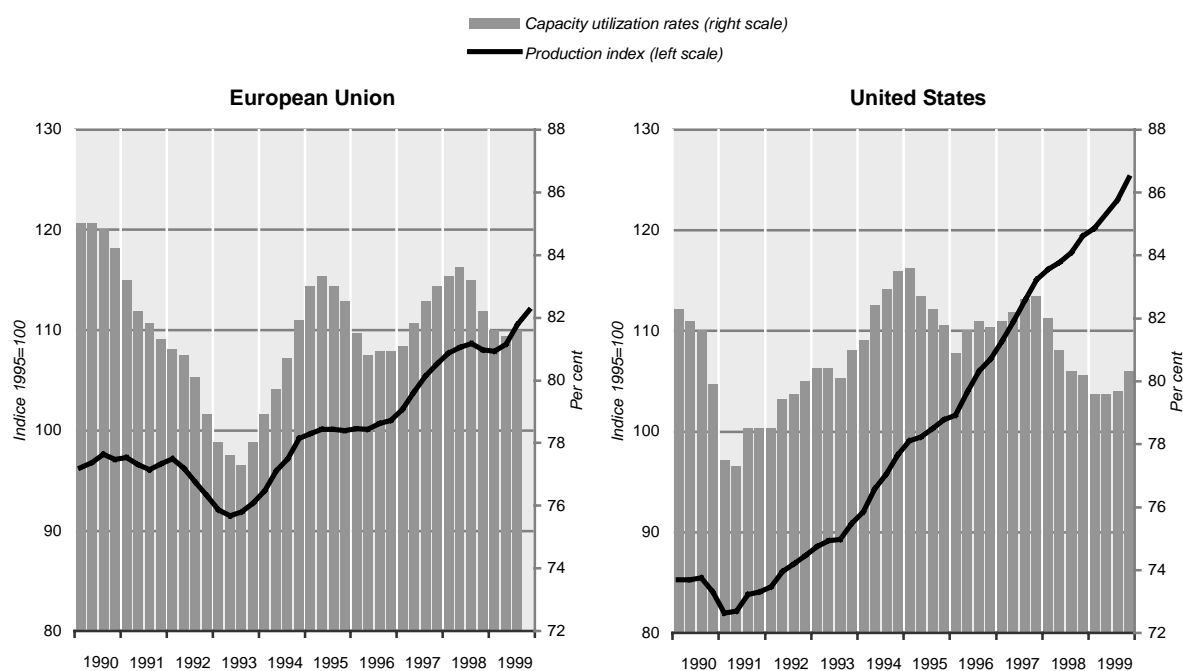
Although there was a marked recovery of exports after the second quarter of 1999, this only partly offset the weak performance in the preceding quarters. For the year as a whole, the volume of exports of goods and services rose by some 3 per cent, about half the increase of 1998. The deterioration in real net exports held back the overall growth rate of GDP in 1999 by half a percentage point.

The relative contributions of the major demand components to the annual growth of real GDP in 1999 do not differ significantly between the broader aggregate of western European countries and the euro area. Apart from exports, the higher levels of activity were mainly sustained by private consumption and fixed investment (table 2.2.3).

As is usually the case, the average growth rates of GDP and the underlying components of demand conceal variations in the performance of individual countries (tables 2.2.1 and 2.2.2), although a lower annual rate of growth of real GDP in 1999 is a general feature.

CHART 2.2.3

Manufacturing production and capacity utilization rates in the European Union and the United States, 1996QI-1999QIV



Source: OECD, *Main Economic Indicators* (Paris), various issues; European Commission, direct communications; national statistics.

Note: Data are seasonally adjusted. Output refers to total industry for the European Union. Original capacity utilization rates for the European Union area refer to January, April, July and October of each year. Quarterly rates were estimated as simply moving arithmetic averages of January/April (QI) April/July (QII) etc.

In the *euro area*, economic conditions generally remained buoyant in most of the smaller economies (Finland, Ireland, Luxembourg, Netherlands, Portugal, Spain) with strong domestic demand offsetting the temporary weakness of exports. These countries had rates of economic growth significantly above the European average and it is evident that they are at a more advanced stage of the business cycle than France, Germany and Italy, with attendant risks of overheating. But the underlying strength of the business cycle also continued to differ among the three larger economies, with a stronger upturn in France compared with the other two countries. This reflects, to a large degree, the asymmetric trade effects of the Asian crisis, which hit France much less than Germany and Italy. To some extent, the current boom in Ireland, Portugal and Spain also reflects the considerable monetary stimulus that these economies received in the run-up to EMU in 1998, when there was a substantial reduction in interest rates. This was accentuated by the further lowering of interest rates by the ECB in April 1999, although it was hardly appropriate for these countries in view of their cyclical position. (The same holds *mutatis mutandis* for Finland and Luxembourg.)³⁹

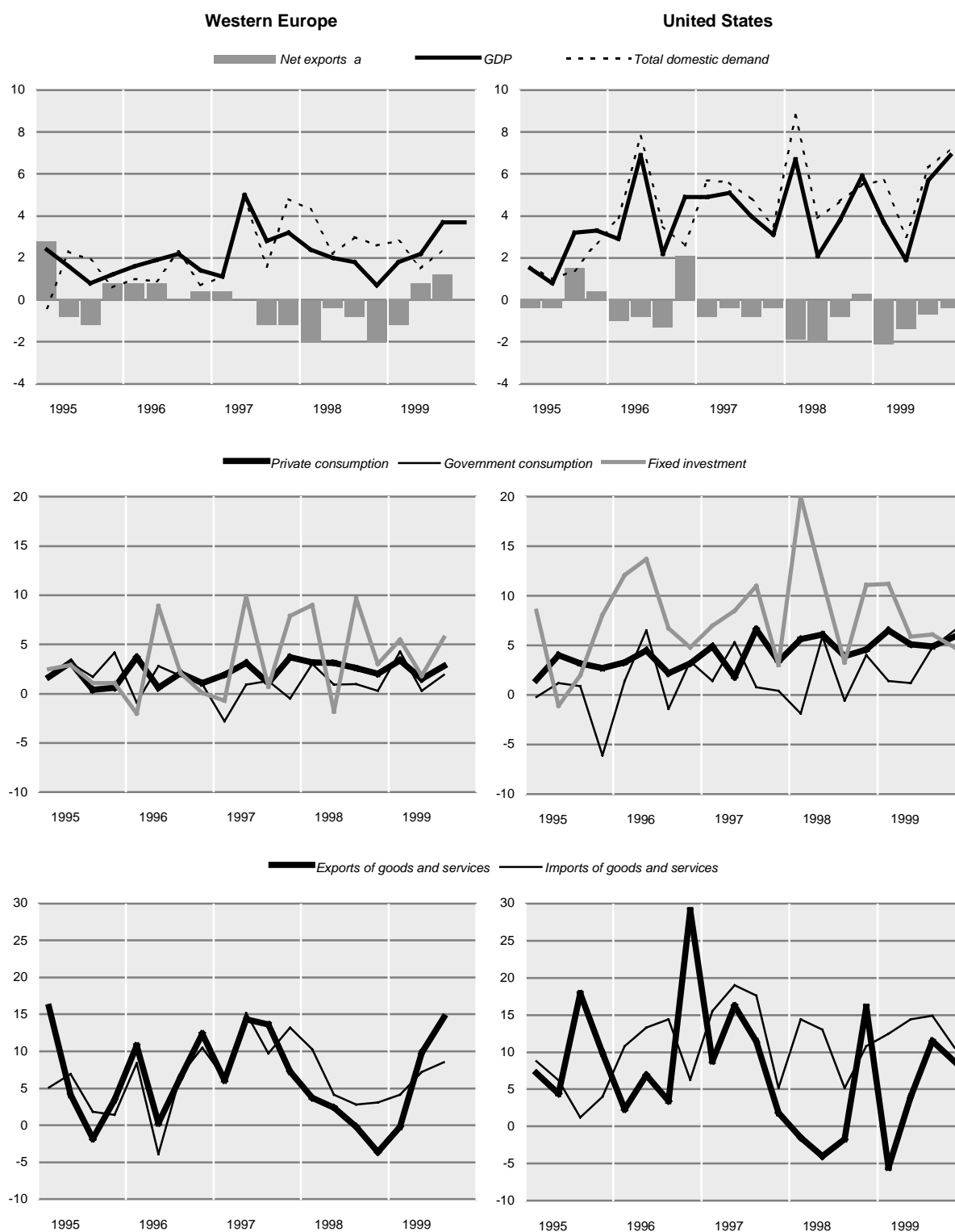
³⁹ There was also a pronounced decline in interest rates in Italy in the run-up to EMU, but the potential stimulus to demand seems to have been more than offset by restrictive fiscal policy and the adverse effects of the Asian crises.

Outside the *euro area*, the six-year expansion in the United Kingdom ended in the final quarter of 1998, when real GDP stagnated compared with the preceding period. But fears that the economy might move into recession did not materialize; instead, economic activity gathered considerable momentum in the course of 1999, provoking a renewed tightening of monetary policy in the second half of 1999, which continued in early 2000. Among the remaining economies, rapid growth in Greece, Iceland and Sweden contrasts with the more sluggish performance in Denmark, Norway and Switzerland. In Greece, the government aims to join EMU at the beginning of 2001, a formal application being submitted in early March 2000. Stringent fiscal consolidation led to a fall in the general government deficit to some 1.5 per cent of GDP in 1999, down from 7.4 per cent in 1996. Among the other Mediterranean countries, there was continued strong growth in Cyprus and Malta.⁴⁰ In contrast, real GDP fell in Turkey in 1999, largely a consequence of the earthquake in the Marmara region in August. In Israel, economic activity picked up in the course of 1999, partly reflecting the improved export performance associated with the more favourable global economic developments.

⁴⁰ Economic developments in Cyprus and Malta are analysed in special country notes in sect. 2.3 below.

CHART 2.2.4

Quarterly changes in real GDP and main demand components in western Europe and North America, 1995-1999
 (Percentage change over preceding quarter, seasonally adjusted at annual rates)



Source: National statistics.

Note: Data for western Europe cover 13 countries (Austria, Belgium, Denmark, Finland, France, Germany, Italy, the Netherlands, Norway, Spain, Sweden, Switzerland and the United Kingdom).

^a Contributions to GDP growth (percentage points).

TABLE 2.2.2

Annual changes in major components of demand in western Europe and North America, 1998-1999
(Percentage change over preceding year)

	Private consumption		Government consumption		Gross fixed investment		Changes in inventories ^a		Total domestic demand		Exports		Imports		Net exports ^a	
	1998	1999	1998	1999	1998	1999	1998	1999	1998	1999	1998	1999	1998	1999	1998	1999
Western Europe	2.9	2.5	1.4	1.6	5.5	4.3	0.5	-0.1	3.5	2.5	5.8	3.1	8.7	5.0	-0.8	-0.5
4 major countries	2.8	2.5	0.7	1.3	5.1	4.5	0.5	-	3.2	2.6	5.2	2.7	8.9	5.4	-0.9	-0.8
France	3.6	2.3	1.1	1.7	6.1	7.0	0.4	-0.4	3.9	2.6	6.9	3.6	9.5	3.3	-0.4	0.2
Germany	2.3	2.1	0.5	0.2	1.4	2.3	0.7	0.4	2.5	2.2	7.0	4.2	8.5	7.1	-0.3	-0.7
Italy	2.3	1.7	0.7	0.6	4.1	4.4	0.6	0.4	2.9	2.5	3.3	-0.4	9.1	3.4	-1.3	-1.0
United Kingdom	3.2	4.0	0.7	3.4	10.8	5.2	-	-0.7	4.1	3.4	2.4	2.6	8.8	7.1	-2.1	-1.7
17 smaller countries	3.2	2.7	2.7	2.2	6.1	3.9	0.5	-0.3	4.1	2.3	6.9	3.8	8.3	4.1	-0.5	0.1
Austria	1.5	2.3	2.0	0.3	6.8	3.3	-0.1	0.2	2.7	2.3	8.7	4.0	6.9	4.1	0.7	-0.1
Belgium	3.8	2.0	1.4	2.3	3.7	6.0	0.8	-1.1	4.1	1.8	4.2	2.9	6.3	2.2	-1.2	0.6
Cyprus	6.3	1.8	7.7	2.1	1.8	0.6	1.5	-0.8	6.7	0.8	-1.8	5.3	4.2	-2.1	-3.3	3.7
Denmark	3.5	0.9	3.0	1.4	6.9	1.5	0.4	-0.9	4.6	0.3	1.4	3.4	6.4	0.7	-1.8	1.0
Finland	4.6	2.8	1.5	0.3	7.8	4.8	0.8	-0.8	5.4	1.7	9.3	7.0	8.5	3.3	1.1	1.9
Greece	2.2	2.6	2.1	-	8.0	7.5	-0.3	-0.1	3.1	3.3	4.2	6.2	1.9	5.1	0.3	-0.2
Iceland	11.0	6.7	3.7	3.4	22.8	0.1	0.3	-	12.0	4.8	3.0	8.5	22.4	5.1	-6.7	1.0
Ireland	7.4	7.7	5.9	4.3	15.9	11.8	0.4	-1.3	9.4	6.6	20.5	14.5	23.2	14.5	0.6	1.7
Israel	3.6	3.7	2.0	3.5	-4.0	1.5	-0.9	2.5	0.8	5.4	6.3	7.4	1.7	14.3	1.2	-4.2
Luxembourg	2.3	3.3	2.8	2.5	1.5	7.8	0.2	-	2.4	3.7	9.9	6.1	8.3	5.5	3.0	1.6
Malta	2.2	6.3	-3.8	-0.3	-4.0	0.3	-1.0	0.6	-1.4	4.3	8.1	5.0	2.5	4.5	4.6	0.3
Netherlands	4.1	4.2	3.3	2.6	5.2	5.8	0.2	-0.4	4.3	3.8	6.4	4.7	7.7	5.3	-0.3	-0.1
Norway	3.1	2.1	3.7	2.5	8.1	-7.0	0.9	-0.6	5.4	-0.8	0.5	0.6	9.1	-3.6	-2.9	1.6
Portugal	5.8	4.5	3.3	3.3	9.7	6.7	-	-0.5	6.3	4.3	7.8	4.2	14.3	7.0	-3.3	-1.7
Spain	4.1	4.3	2.0	1.6	9.2	8.8	0.1	0.2	5.0	5.0	7.1	6.7	11.1	11.5	-1.0	-1.3
Sweden	2.4	4.1	2.2	1.8	9.4	8.1	0.3	-0.5	3.8	3.6	7.3	5.2	10.4	5.0	-0.5	0.5
Switzerland	2.3	2.2	-0.2	0.3	4.4	3.7	1.7	-0.1	4.1	2.1	4.6	4.4	9.4	5.3	-2.0	-0.5
Turkey	0.1	-2.0	5.0	5.5	-2.4	-8.6	1.1	-0.4	0.7	-3.7	10.5	-5.0	2.2	-8.0	2.2	1.2
North America	4.7	5.1	1.3	2.5	10.0	8.3	-	-0.3	5.2	5.0	2.7	4.1	11.1	11.6	-1.1	-1.1
Canada	2.8	3.2	1.7	1.0	3.6	9.3	-0.4	0.1	2.2	4.0	8.2	9.7	5.8	9.7	1.0	0.2
United States	4.9	5.3	1.3	2.6	10.6	8.2	0.1	-0.4	5.5	5.1	2.2	3.6	11.6	11.8	-1.3	-1.3
Total above	3.8	3.8	1.3	2.1	7.7	6.3	0.2	-0.2	4.4	3.8	4.2	3.6	9.9	8.3	-0.9	-0.8
Japan	-0.5	1.2	1.5	1.3	-7.4	-0.7	-0.6	-	-3.1	0.6	-2.5	1.8	-7.6	5.1	0.5	-0.3
Total above, including Japan	3.1	3.4	1.4	1.9	5.3	5.2	0.1	-0.2	3.2	3.3	3.2	3.3	7.1	7.8	-0.7	-0.7
<i>Memorandum items:</i>																
European Union	3.1	2.8	1.2	1.5	5.9	5.1	0.4	-0.1	3.6	2.9	5.6	3.5	9.0	5.8	-0.8	-0.6
Euro area	3.1	2.6	1.2	1.1	4.7	5.0	0.5	0.1	3.5	2.8	6.4	3.5	9.2	5.6	-0.6	-0.5

Source: OECD national accounts and national statistics.

Note: All aggregates exclude Israel.

^a Percentage point contribution to annual GDP growth.

Against a background of stronger output growth, developments in the *labour markets* in 1999 were rather favourable. In western Europe, total employment rose by about 1¼ per cent, slightly less than in 1998 (table 2.2.4) but masking a general improvement in the course of the year. There are quite sizeable intercountry differences in employment growth, reflecting to a more or less large degree the differing strength of cyclical growth forces and the stage of the business cycle. In various countries, labour market reforms have improved the match between the demand and supply of labour, and increased wage flexibility, in combination with generally moderate wage growth, has probably also contributed to the higher demand for labour. Employment growth in most of the smaller economies continued to outpace job creation in the four major economies by a large margin. Indeed, the

performance of the majority of the smaller economies compares favourably with the performance of the United States economy in recent years. Incomplete data suggest that the upturn in manufacturing output in the course of 1999 was only partly reflected in higher employment levels, the major exceptions being Finland, France, Ireland, the Netherlands and Spain. In general, most of the employment gains in 1999 were in the services sector, with buoyant demand for certain business services leading to pronounced labour shortages, notably in the field of information technology. (The latter was also partly related to the efforts to ensure compliance of EDP systems with the perceived Y2K problem.)

The cyclical upturn was accompanied by further declines in unemployment. The standardized unemployment rate in western Europe fell to 8.4 per cent in the fourth

TABLE 2.2.3

Contribution of major demand components to annual changes in real GDP in western Europe and the United States, 1998-1999
(Percentage points)

	Western Europe		European Union		Euro area		United States	
	1998	1999	1998	1999	1998	1999	1998	1999
Private consumption	1.7	1.5	1.8	1.6	1.7	1.4	3.2	3.5
Government consumption	0.2	0.3	0.2	0.3	0.2	0.2	0.2	0.4
Gross fixed investment	1.1	0.8	1.1	1.0	1.0	1.0	2.0	1.7
Final domestic demand	3.0	2.6	3.2	3.0	2.9	2.7	5.5	5.6
Changes in inventories	0.5	-0.1	0.4	-0.1	0.5	0.1	0.1	-0.4
Total domestic demand	3.5	2.5	3.5	2.9	3.4	2.8	5.5	5.2
Net exports	-0.8	-0.5	-0.8	-0.6	-0.6	-0.5	-1.3	-1.3
Exports	1.9	1.1	1.9	1.2	2.1	1.3	0.3	0.4
Imports	2.7	1.6	2.7	-1.9	2.8	1.8	1.6	1.7
GDP	2.7	2.0	2.7	2.3	2.8	2.3	4.3	4.1

Source: UN/ECE secretariat.

quarter of 1999, its lowest level since the second quarter of 1992 (chart 2.2.5). The average annual unemployment rate was 8.7 per cent for 1999 (table 2.2.5). In the euro area, the unemployment rate was 9.6 per cent in January 2000, down from 10.4 per cent in the same month of the preceding year. The average figures nevertheless mask some persistent structural weaknesses which appear to be difficult to correct. Youth unemployment (as a percentage of persons in the labour force aged 15-24) was still very high at 16.8 per cent in the European Union in December 1999, although it had fallen from 18.9 per cent at the beginning of the year. There has also been a decline in the long-term unemployment rate since 1997, but it was less than the fall in the total,⁴¹ and the long-term unemployed still accounted for nearly half of total unemployment in the European Union in late 1999. In other words, the long-term unemployed have benefited much less than other groups from the improvement in cyclical conditions. This points to the importance of ensuring a sustained recovery which, in combination with structural reforms designed to increase labour market flexibility, should create a better environment for a more broadly based improvement in the labour markets. This applies especially to the euro area, where the adjustment burden of asymmetric shocks will fall disproportionately on the labour markets given that the exchange rate is no longer available as an instrument of national policy.

Evidently, increased labour market flexibility will also have a cost, namely an unfavourable impact on income distribution and on social cohesion.⁴² Throughout the 1990s, the general tendency has been for a tightening of access to unemployment benefits, a policy designed to encourage workers to seize existing job opportunities,

even if they involve significant personal adjustment costs. The tighter restrictions concern the duration and level of benefits, and the minimum period of work experience that entitles the claimant to receive unemployment benefits.⁴³ The European Union agreed the basic principles of a labour market strategy at the Jobs Summit in Luxembourg in 1997, which were confirmed at the 1999 Cologne Summit. These are to increase worker employability, foster entrepreneurship, improve firms' and workers' capacity to adapt to a changing environment, and to promote equal opportunities.⁴⁴ In line with these principles, several countries (Belgium, Denmark, Greece, Italy, Netherlands, Spain, Sweden) introduced fiscal incentives in 1999 – largely in the form of reduced employers' social security contributions – to support the demand for labour. Other countries have special programmes that target young persons (e.g. France) and the long-term unemployed by providing training and/or granting tax credits to firms. A more controversial move to stimulate the demand for labour has been the introduction of the mandatory 35-hour work week in France at the beginning of 2000 (see box 2.2.1). In Germany, sluggish employment growth in 1999 reflected not only the weak cyclical momentum in the first half of the year but also the phasing out of a number of active labour market measures in the eastern part of the country.

Consumer price inflation in the euro area started to edge upwards in the second half of 1999 (chart 2.2.6). This rise, however, is not reflected in the average annual inflation rate (HICP) which was unchanged from 1998 (table 2.2.6). In February 2000, the annual inflation rate was 2 per cent, which is the upper limit of the

⁴¹ Over the period 1997Q1-1999Q4, the total unemployment rate tended to fall, on average, by some 0.2 percentage point per quarter, compared with a decline of 0.1 percentage point for the long-term unemployment rate. This difference is likely to be partly due to special government schemes designed to combat unemployment among the younger generation.

⁴² J. Flynn, "Structural differences between the US and the euro area", *Central Bank of Ireland Bulletin*, Winter 1999, p. 82.

⁴³ OECD, *Benefits Systems and Work Incentives* (Paris), 1999.

⁴⁴ These may be partly conflicting goals. Reducing the minimum wage for young people (as in the Netherlands) will tend to increase their employability, but at the same time it affects the equal opportunity principle, because of age discrimination. For a more detailed analysis of the concept of "employability" see B. Gazier, "Employability: concepts and policies", European Commission, *Employment Observatory*, Policies Nos. 67/68, Autumn/Winter 1999, pp. 36-46.

TABLE 2.2.4

Total employment in western Europe and North America, 1996-1999
(Percentage change over previous year)

	1996	1997	1998	1999 ^a
Western Europe	1.0	0.4	1.6	1.3
4 major countries	0.1	0.4	0.9	0.9
France	0.3	0.3	1.2	1.5
Germany	-0.8	-0.8	0.4	0.3
Italy ^b	0.5	0.4	1.1	1.1
United Kingdom ^c	0.9	2.0	1.2	1.0
17 smaller countries	2.3	0.5	2.6	2.0
Austria	-0.7	0.3	0.6	0.7
Belgium ^c	0.3	0.8	1.2	1.4
Cyprus	1.0	-0.2	1.2	0.8
Denmark	1.4	2.1	2.1	0.5
Finland	1.4	3.3	2.0	2.3
Greece	1.3	-0.4	1.5	0.7
Iceland ^b	2.4	2.9	2.0	2.3
Ireland ^d	3.7	3.8	8.3	6.4
Israel	2.4	1.4	1.6	3.1
Luxembourg	2.9	3.2	4.3	5.0
Malta ^e	1.0	0.5	0.4	0.8
Netherlands ^b	2.0	3.4	3.0	2.5
Norway	2.1	2.9	2.3	0.1
Portugal	0.5	1.9	2.4	1.7
Spain	1.3	2.8	3.6	3.3
Sweden	-0.6	-0.6	1.3	2.3
Switzerland	0.3	-0.3	1.2	0.5
Turkey	5.6	-2.5	2.8	1.7
North America	1.4	2.2	1.6	1.7
Canada	1.2	1.9	2.8	2.7
United States ^f	1.4	2.2	1.5	1.5
Total above	1.2	1.2	1.6	1.5
Japan	0.5	1.1	-0.6	-0.9
Total above, including Japan	1.1	1.2	1.2	1.1
Memorandum items:				
European Union	0.4	0.8	1.4	1.3
Euro area	0.2	0.6	1.4	1.4

Source: National statistics; OECD, *National Accounts Detailed Tables*, Vol. II, 1999 and *OECD Economic Outlook*, No. 66, December 1999 (Paris); UN/ECE secretariat estimates.

Note: All aggregates exclude Israel. Unless otherwise indicated, data refer to the annual average number of persons employed, i.e. no adjustment is made for part-time workers. Comparisons with previous years are limited due to changes in methodology in Israel and Spain (1996).

^a Provisional.

^b Full-time equivalent data.

^c June.

^d Mid-April estimates.

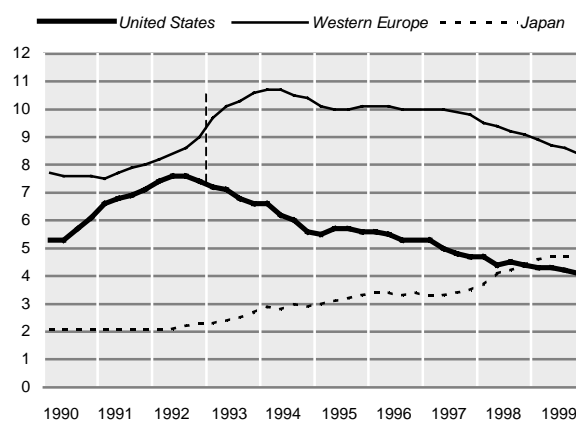
^e End of year.

^f Full-time equivalent employees plus the number of self-employed workers (unpaid family workers are not included).

(asymmetric) inflation target of the ECB. In the main, the upturn since the second half of 1999 reflected the pass-through of the sharp rise in oil prices and the general upward pressure on import prices due to the depreciation of the euro. Labour cost pressures, however, remained relatively moderate. But the rise in non-energy commodity prices has also added to the pressure for higher prices. At the producer level, these pressures were reflected in a

CHART 2.2.5

Unemployment rates in industrialized countries, 1990-1999
(Per cent of civilian labour force, quarterly average, standardized rate)



Source: National statistics; OECD, *Quarterly Labour Force Statistics*, No. 4, 1999, *Main Economic Indicators*, various issues and *OECD Economic Outlook*, No. 66, December 1999 (Paris); UN/ECE secretariat estimates.

Note: The average unemployment rate for western Europe does not include data for east Germany before 1993.

rapid rise of intermediate goods prices, which in January 2000 were 7.4 per cent higher than in the same month of 1998. In contrast, final goods prices rose by less than 1 per cent over the same period, which points to the limited scope for raising prices in the face of intense competitive pressures. These are also reflected in the still modest rate of core inflation: the consumer price index excluding food and energy was only 1.2 per cent higher in February 2000 than a year earlier. The downward pressure of increased competition on prices was especially notable in the services sector where liberalization has led to large price cuts for telecommunication products. Similarly, the liberalization of the electricity market in several countries has lowered the price of electricity, a development which has partly offset the impact of higher oil prices on the overall inflation rate. There continue to be sizeable differences between the countries of the euro area, a reflection of both cyclical and structural factors: in February 2000, inflation ranged from 1.5 per cent in France and the Netherlands to 4.6 per cent in Ireland. More generally, the tendency for price level convergence associated with the longer-term process of convergence of real per capita incomes across countries will imply that the inflation rate in countries with below average real incomes will tend to be higher than in the other countries (Balassa-Samuelson theorem).

Outside the euro area, inflationary pressures have also remained generally moderate. In the United Kingdom, the strong pound and intense competition in the manufacturing and retail sectors led to a fall in goods prices in the second half of 1999. This contrasts with continued large increases in the prices of services, reflecting the buoyancy of demand as well as cost pressures stemming mainly from rising labour costs. In Greece, tight monetary policy contributed to a marked

TABLE 2.2.5

Standardized unemployment rates ^a in western Europe and North America, 1996-1999
(Per cent of civilian labour force)

	1996	1997	1998	1999 ^b
<i>Western Europe</i>	10.0	9.9	9.3	8.7
<i>4 major countries</i>	10.0	10.1	9.7	9.2
France	12.4	12.4	11.7	11.0
Germany	8.9	9.9	9.4	9.1
Italy	11.7	11.7	11.9	11.4
United Kingdom	8.2	7.0	6.3	6.1
<i>17 smaller countries</i>	10.1	9.7	8.8	7.9
Austria	4.4	4.5	4.7	4.4
Belgium	9.7	9.4	9.5	9.0
Cyprus ^c	3.1	3.4	3.3	3.7
Denmark	6.8	5.6	5.1	4.5
Finland	14.6	12.6	11.4	10.2
Greece	9.6	9.8	10.7	10.4
Iceland	4.4	3.9	2.8	1.9
Ireland	11.6	9.8	7.7	6.5
Israel	6.7	7.7	8.5	8.9
Luxembourg	3.0	2.8	2.8	2.8
Malta ^c	4.4	5.0	5.1	5.3
Netherlands	6.3	5.2	4.0	3.1
Norway	4.9	4.1	3.3	3.1
Portugal	7.3	6.8	5.1	4.6
Spain	22.2	20.8	18.8	15.8
Sweden	9.6	9.9	8.3	7.0
Switzerland	4.7	5.2	3.9	2.8
Turkey	6.0	6.4	6.3	6.6
<i>North America</i>	5.8	5.4	4.9	4.6
Canada	9.6	9.1	8.3	7.6
United States	5.4	4.9	4.5	4.2
Total above	8.2	7.9	7.4	6.9
Japan	3.4	3.4	4.1	4.7
Total above, including Japan	7.4	7.2	6.9	6.5
<i>Memorandum items:</i>				
European Union	10.8	10.6	9.9	9.2
Euro area	11.6	11.5	10.9	10.0

Source: National statistics; OECD, *Quarterly Labour Force Statistics*, No. 4, 1999, *Main Economic Indicators*, various issues and *OECD Economic Outlook*, No. 66, December 1999 (Paris); UN/ECE secretariat estimates.

Note: All aggregates exclude Israel.

^a Adjusted to achieve comparability between countries, except for Cyprus, Iceland, Israel, Malta, Switzerland and Turkey.

^b Provisional.

^c End of year.

decline in the inflation rate in the course of 1999. The "headline" inflation rate was 2.6 per cent in February 2000; revised data show that this was the ninth consecutive month in which inflation was in line with the price stability criterion⁴⁵ for EMU membership. In Israel, tight monetary policy was mainly responsible for the decline in the rate of inflation to 1.3 per cent in December 1999, down from 8.6 per cent a year earlier and the lowest monthly increase in over 20 years.

⁴⁵ This requires a country to have an average rate of inflation (over a period of one year) before EMU membership that does not exceed by more than 1.5 percentage points the average in the three best performing countries.

In the euro area, the current account surplus fell to about 0.75 per cent of GDP in 1999, down from 1 per cent in 1998. This largely reflects a smaller merchandise trade surplus due in turn to the rise imports triggered mainly by the depreciation of the euro against the dollar and robust domestic demand. In the United Kingdom, buoyant domestic demand led to a further large increase in the merchandise trade deficit, while at the same time there was a smaller surplus on the income account. The net result was that the current account deficit rose to some 1.5 per cent of GDP in 1999, up from 0.1 per cent in 1998.

(ii) North America

(a) Recent macroeconomic developments

In the *United States*, the economic expansion entered its 108th month in February 2000 – starting from a cyclical trough in March 1991, this has been the longest upswing on record.⁴⁶

Economic growth accelerated markedly in the second half of 1999, reflecting in the main the combined impact of faster rates of inventory accumulation and export growth in the presence of continued robust growth of private consumption and business fixed investment (chart 2.2.4). The result was that real GDP rose by 4.1 per cent in 1999, the third consecutive year in which annual growth exceeded 4 per cent.

Against a background of improved foreign demand, manufacturing activity strengthened in the second half of 1999, and for the year as a whole increased by 4¼ per cent, down from 4.9 per cent in 1998. Within the average, there was a much stronger growth of durable than non-durable goods. But there still appears to be relatively large margins of slack in the manufacturing sector. Capacity utilization rates edged upwards only slightly in the course of the year (chart 2.2.3), reflecting the continuing strong growth of capacity which in December 1999 was estimated to be some 4.5 per cent larger than a year earlier.⁴⁷

⁴⁶ The previous longest expansion (from trough to peak) lasted 106 months, from February 1961 to December 1969, but this included a period during which economic activity was driven by expenditure on the Vietnam war. NBER, *US Business Cycle Expansions and Contraction* (www.nber.org). Revised national accounts data show that the last economic contraction, which started in the second quarter of 1990 and ended in the first quarter of 1991, was slightly more shallow than previously estimated. As a result, real GDP fell by only 0.2 per cent in 1991 compared with 1990, whereas the old data showed a decline of 0.7 per cent. In a similar vein, the average growth rate of the current expansion between the first quarter of 1991 and the second quarter of 1999 is now estimated at 3.5 per cent against the previously published figure of 3.1 per cent. E. Seskin, "Improved estimates of the national income and product accounts for 1959-1998. Results of the comprehensive revision", *Survey of Current Business*, December 1999, pp. 15-43.

⁴⁷ Utilization rates in December 1999 were about 1 percentage point below the long-term average for the period 1967-1998 and some 4 percentage points below their previous peak in 1988-1989.

BOX 2.2.1

The statutory 35-hour work week in France

In France, a legal provision was introduced in 1981 which fixed the statutory working week at 39 hours. Overtime was limited to a maximum of 130 hours per worker per year and the minimum premium on overtime work was equivalent to 25 per cent of the normal hourly wage. In the face of high and persistent unemployment throughout the 1990s the French government decided to adopt a new worksharing scheme to increase the demand for workers. The so-called “*Loi Aubry*” of 13 June 1998 reduced the statutory working week to 35 hours. For firms with more than 20 employees this provision entered into force at the beginning of 2000; for all other companies this will be the case as of 1 January 2002. The *legal* statutory working week in France will thus be the lowest among all the industrialized countries.

The law obliges employers to negotiate with workers’ representatives over the effective reduction in working time, but it leaves the outcome open: a reduction may effectively take place, or, in the event that there is no agreement on reducing current normal working hours, employees must be paid the premium wage for hours in excess of 35 per week. The law has also introduced financial incentives (reduced monthly social security contributions for a period of five years) for firms that reduce working time prior to the legal deadlines but maintain the current work force or even add to it.

In the face of growing concerns about the potential adverse impact on the competitiveness of firms, a supplementary law was adopted on 19 January 2000, which limits the overtime wage premium on weekly hours exceeding 35 but below 39 to 10 per cent (instead of 25 per cent) during a one-year transition period. It was also decided that the limit of 130 overtime hours per employee per year would not apply for the two years following the official deadlines. For firms that reduce working time after 1 January 2000, the law provides for substantial reductions in employers’ social contributions on wages up to a maximum of 1.8 times the minimum wage.¹ There is no provision for the level of *weekly* wages: whether they fall in proportion to the reduction in working hours will depend on the outcome of the negotiations. This does not apply, however, to the 2 million workers who are paid the minimum wage rate (SMIC) and who are entitled to a constant weekly wage.

In general, academic research is not very optimistic about the ability of mandatory work time reductions to foster higher levels of employment.² Broadly speaking, in the presence of fixed costs per worker a reduction in actual working time which is to be followed by a corresponding increase in the number of persons employed will *ceteris paribus* lead to higher unit labour costs. This, in turn, could lead to a substitution of capital for labour. Alternatively, the rise in costs may reduce the optimum level of output for firms with an associated reduction in factor demand. Evidence for offsetting effects (productivity increases associated with reduced pressure on workers or the introduction of additional shifts) is not clear-cut.

The ability of the 35-hour scheme to stimulate employment depends to a large extent on the downward flexibility of the wage rate which, combined with the reduction in hours, implies a rather large fall in weekly wages. The fact that, so far, workers have rarely accepted a proportional reduction in weekly wages suggests that they do not seem to prefer the possibility of increased leisure to the extent assumed by the proponents of the 35-hour working week. In fact, according to the government, weekly labour compensation was unchanged in 87 per cent of the agreements on working time reduction concluded so far. This implies a mechanical *increase* in hourly wage rates in these firms by 10 per cent. In 1999, average hourly wages increased by 3.4 per cent and it has been pointed out that the introduction of the 35-hour week is largely responsible for this.³ Obviously, unless offset by productivity gains, this increase in the cost of labour services will tend to restrain labour demand.

According to the French Ministry for Employment and Solidarity,⁴ some 23,200 firm level agreements had been signed on reduced working time by January 2000. These agreements cover almost 2.7 million employees. There were 14,200 such agreements for firms with 20 and more employees. According to INSEE, there are some 100,500 companies with 20 and more employees (in February 2000), with a total employment of some 12 million persons.⁵ These figures suggest that a large majority of enterprises so far has chosen to cope with the increase in wage costs due to increased overtime and to postpone or to abstain from the introduction of reduced work hours.

The government estimates that by 19 January 2000, the first Aubry Law had created 137,000 new jobs,⁶ equivalent to a reduction in the unemployment rate by some 0.5 percentage points. It is difficult, however, to separate the direct employment effect of the reduction in hours from the impact of the fiscal incentives introduced to promote the worksharing schemes. These fiscal incentives could by themselves be sufficient to create additional jobs in some firms.

¹ The scheme will be financed by new environmental and profits taxes.

² R. Hart, *Working Time and Employment* (London, Allen and Unwin; 1987), F. Contensou and R. Vranceanu, *Working Time. Theory and Policy Implications* (Cheltenham, Edward Elgar, 2000).

³ Banque de France, *Bulletin*, No. 72, December 1999 and “Divorce entre salaire horaire et mensuel”, *Le Figaro*, 24 March 2000.

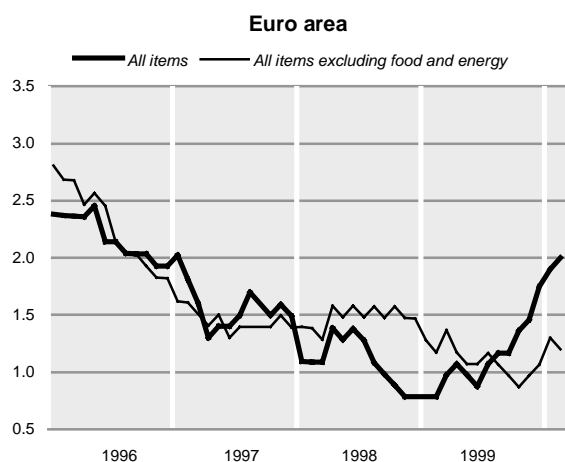
⁴ “Réduire la durée du travail pour l’emploi. Bilan au 19 Janvier 2000”, Ministère de la Solidarité et de l’Emploi (Paris) (www.35h.travail.gouv.fr).

⁵ INSEE Enterprise Database SIRENE (www.sirene.tm.fr).

⁶ The method consisted of comparing employment growth in those firms that implemented shorter hours with employment growth in firms of

CHART 2.2.6

The Harmonized Index of Consumer Prices of the euro area, January 1996-February 2000
(Percentage change over same month of preceding year)



Source: Eurostat.

Note: Tobacco and alcohol are also excluded from the "All items excluding food and energy" index.

Private consumption in 1999 continued to be supported by further gains in real disposable incomes, reflecting in turn a combination of increases in real hourly earnings and employment. Against this backdrop, consumer confidence remained strong and in January 2000 reached its highest level in the 32-year history of this index (chart 2.2.2). In addition, spending was stimulated by favourable lending terms and by further increases in wealth due to rising share prices and house prices.⁴⁸ This is also mirrored in a further decline of the household savings ratio which was only 1.9 per cent of disposable incomes in the final quarter of 1999, down from 3.5 per cent a year earlier.⁴⁹ The debt burden (the ratio of total debt service payments to family income has risen above its previous record level in 1989.⁵⁰ Government spending also contributed to higher output

⁴⁸ Rising share prices have not only raised the net worth of households but have also lowered the cost of equity capital for firms, which has stimulated private business investment. The combined wealth effect of rising asset prices may have added some 1 percentage point per annum to the average annual increase in real GDP by 4 per cent since 1996. A. Greenspan, "Technology and the economy", remarks made before the Economic Club of New York, 13 January 2000 (www.bog.frb.fed.us/boarddocs).

⁴⁹ The recent revisions of the United States national accounts have led to an upward revision of personal savings largely on account of the reclassification, from the government to the personal sector, of savings associated with government employee retirement plans. But the downward trend has remained unchanged. On previous data, the savings ratio fell from a peak of 9 per cent in 1982 to 0.5 per cent in 1998. The revised data show a fall from 10.9 per cent to 3.7 per cent over the same period. See chap. 7 below.

⁵⁰ "Recent changes in U.S. family finances: results from the 1998 survey of consumer finances", *Federal Reserve Bulletin*, Vol. 86, No. 1, January 2000, p. 25.

TABLE 2.2.6

Consumer price indices in western Europe and North America, 1996-1999
(Percentage change over previous year)

	1996	1997	1998	1999
Western Europe	2.4	1.7	1.3	1.2
4 major countries	2.3	1.6	1.1	1.1
France	2.0	1.3	0.7	0.6
Germany	1.2	1.5	0.6	0.7
Italy	4.0	1.9	2.0	1.7
United Kingdom	2.5	1.8	1.6	1.4
16 smaller countries	2.5	1.9	1.6	1.7
Austria	1.7	1.2	0.8	0.5
Belgium	1.7	1.5	0.9	1.2
Cyprus	2.9	3.6	2.2	1.7
Denmark	2.0	1.9	1.4	2.0
Finland	1.1	1.2	1.4	1.3
Greece	7.9	5.4	4.6	2.4
Iceland	2.1	1.8	1.4	2.1
Ireland	2.1	1.2	2.2	2.5
Israel	11.3	9.0	5.4	5.2
Luxembourg	1.2	1.4	1.0	1.0
Malta	2.5	3.2	2.2	2.1
Netherlands	1.4	1.9	1.8	2.0
Norway	0.7	2.6	1.9	2.1
Portugal	2.9	1.9	2.3	2.1
Spain	3.5	1.9	1.8	2.2
Sweden	0.8	1.9	1.0	0.5
Switzerland	0.8	0.5	0.1	0.8
Turkey	79.8	84.8	86.2	64.9
North America	2.9	2.2	1.5	2.2
Canada	1.6	1.6	0.9	1.7
United States	3.0	2.3	1.6	2.2
Total above	2.6	2.0	1.4	1.8
Japan	0.1	1.8	0.6	-0.3
Total above, including Japan	2.3	2.0	1.3	1.5
<i>Memorandum items:</i>				
European Union	2.4	1.7	1.3	1.3
Euro area	2.1	1.6	1.1	1.1

Source: National statistics and Eurostat.

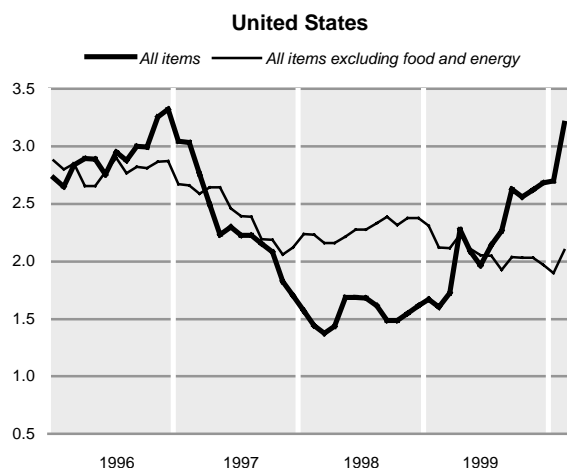
Note: Harmonized Index of Consumer Prices for the 15 member countries of the European Union and for Iceland and Norway. Consumer price index according to national definition for other countries. All aggregates exclude Israel and Turkey.

levels in 1999. Fixed investment in equipment, notably information and communications technology and software remained one of the main driving forces of economic growth. Residential investment slowed down in the second half of the year under the impact of rising mortgage rates while outlays on business structures fell in each quarter of 1999.

Export growth strengthened in the second half of the year, the restraining effects of the strong dollar being offset by the revival of demand in western Europe and other regions of the world economy. On the other hand, buoyant domestic demand led to continued rapid growth of imports. Changes in real net exports subtracted 1.3 percentage points from annual economic growth in 1999, the same as in 1998 (table 2.2.3). The merchandise trade deficit rose to \$347 billion, up from \$247 billion in 1998.

CHART 2.2.7

Consumer price indices in the United States,
January 1996-February 2000
(Percentage change over same month of preceding year)



Source: Bureau of Labor Statistics.

Combined with another decline in the surplus in services and the deficit in transfers, this translated into the current account deficit of some \$339 billion in 1999, equivalent to about 3.7 per cent of GDP and 1.2 percentage points more than in 1998.

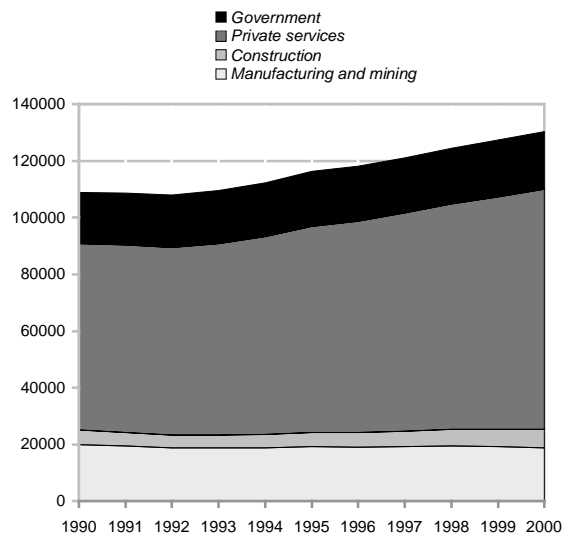
A striking feature of the United States economy is the moderate inflation in the face of very tight labour markets. Core inflation remained broadly stable at 2 per cent during 1999, and continued to do so in the first two months of 2000 (chart 2.2.7). This compares with an overall inflation rate rise of 3.2 per cent in February 2000, the difference being solely due to the impact of the sharp rise in oil prices. Labour cost pressures remained moderate in the face of strong productivity growth. Hourly compensation in the non-farm business sector in the final quarter of 1999 was 4.3 per cent higher than the same period of 1998, but unit labour costs were only 0.7 per cent higher. This average outcome, however, is strongly influenced by favourable developments in the durable goods sector of manufacturing (see below).

Rapid economic expansion led to further substantial gains in employment in 1999. For the year as whole it increased by 1.5 per cent (table 2.2.4). The gains have continued in early 2000, although there was a slowdown in non-farm payrolls in February. As in previous years, most of the additional jobs were in the services sector,⁵¹ where employment rose by 2.8 per cent in the 12 months to January 2000. Increased construction activity also led to some rise in employment, but on the whole the number of persons employed outside the service sectors has remained broadly stable (chart 2.2.8). The decline in

⁵¹ These gains were largely concentrated in transportation and communications, computer services and engineering and management.

CHART 2.2.8

Employment in non-farm sectors in the United States,
January 1990-January 2000
(Thousands)



Source: United States Bureau of Labor Statistics (www.bls.gov/ceshome.htm).

manufacturing employment in 1998 petered out in the course of 1999, and although there were small gains in January 2000 (compared with the preceding month), mostly in construction related activities, it was still 1.2 per cent lower than a year earlier. The rise in total employment increased the employment/population ratio⁵² to a record level of 64.8 per cent in January 2000.

The unemployment rate reached a 30-year low of 4 per cent in January 2000, but increased slightly to 4.1 per cent in February. The high rate of turnover in the United States labour market is illustrated by the fact that only 12 per cent of the unemployed in January 2000 were without a job for six months or more. The average unemployment rate, however, masks a much higher rate of youth unemployment: for persons aged 16 to 19 it was 12.6 per cent in January.⁵³ The combination of very low unemployment and moderate inflation is widely seen as a feature of the so-called "new economy" but it is also associated with a decline in the so-called non-accelerating inflation rate of unemployment (NAIRU).⁵⁴

In *Canada*, the cyclical upturn continued strongly in the course of the year, supported by consumer demand and fixed investment. Against a background of rising employment and real income gains, household confidence strengthened markedly. Business investment

⁵² More precisely, the ratio of persons employed to the number of persons aged 16 and above. "Employment situation, January 2000", *Bureau of Labor Statistics News* (stats.bls.gov/newsrels.htm).

⁵³ Ibid.

⁵⁴ See the following subsection.

was stimulated by the prospect of improved sales and by rising capacity utilization rates. Exports benefited from the strength of demand in the United States, the major trading partner, but also from the strengthening recovery in overseas markets. Exports helped to sustain activity in the manufacturing sector, while primary industries were stimulated by the rise in commodity prices in the course of 1999. In sum, real GDP rose by 4.2 per cent in 1999, up from 3.1 per cent in 1998. Rising prices for energy and services put upward pressure on the inflation rate, but this was partly offset by the dampening effect of a stronger exchange rate on import prices.

(b) The United States: the “new economy” and the decline of the NAIRU

The performance of the United States economy over the past two decades has been impressive. Abstracting from the short and mild recession from summer 1990 to spring 1991, the economy has been on an upward trend since the autumn of 1982. This “long boom” has more recently attracted particular attention not only because of its unique combination of very robust output growth, moderate inflation⁵⁵ and very high degrees of labour utilization but also because of a pronounced strengthening of productivity growth. All this has occurred against the background of sustained and buoyant business investment in information and communications technology and important advances in other areas such as biotechnology. This conjunction of circumstances has led to the presumption that the economy has been subject to an intensified Schumpeterian “process of industrial mutation”⁵⁶ which is altering the basic relations underlying the functioning of the economy.⁵⁷ The upshot is the paradigm of a “New Economy”, which is characterized by higher trend growth rates of productivity and potential output.⁵⁸ As the United States has been leading this innovation process among the industrialized economies, the latter can possibly expect, with a lag, to undergo a similar experience, provided they can replicate the essential pre-conditions.

⁵⁵ J. Taylor, “Monetary policy and the long boom”, *Federal Reserve of St. Louis Review*, Vol. 80, No. 6, pp. 3-11. Taylor argues that a more aggressive response of monetary policy to increases in inflation in the 1980s and 1990s compared with the 1960s and 1970s has been a key factor in this performance.

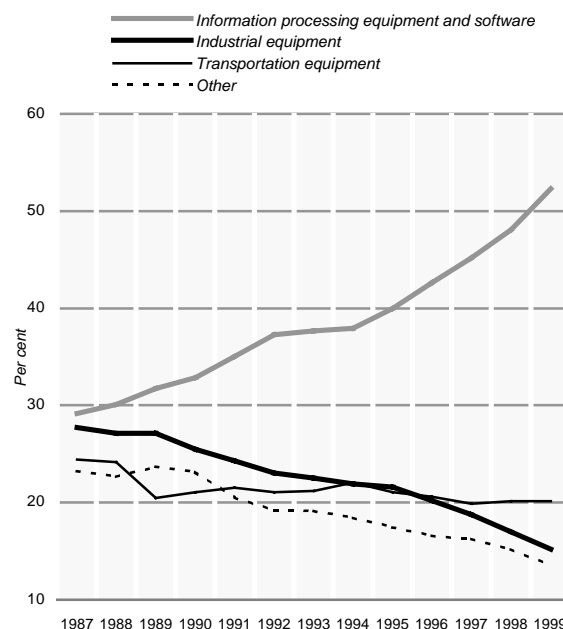
⁵⁶ J. Schumpeter, *Capitalism, Socialism and Democracy* (New York, Harper & Brothers, 1942), chap. 7. These mutations, in turn, are the outcome of a process of “creative destruction”.

⁵⁷ One of the main proponents of this view is Mr. A. Greenspan, the Chairman of the Governors of the Federal Reserve Board: “... important technological changes have been emerging in recent years that are altering, in ways with few precedents, the manner in which we organize production, trade across countries and deliver value to consumers.” A. Greenspan, “Is there a new economy?”, remarks made at the Haas Annual Business Faculty Research Dialogue, University of California at Berkeley, 4 September 1998; for a more recent statement see, “Technology and the economy”, op. cit.

⁵⁸ Claims that inflation and the business cycle are dead are not considered as part of the “new economy” – they are rather expressions of “irrational exuberance”.

CHART 2.2.9

Changes in the asset composition of United States business investment in equipment and software, 1987-1999
(Percentage shares)



Source: United States Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business* (Washington, D.C.), January 2000.

Note: Non-residential investment expenditures at chained (1996) dollars. The use of chain-type quantity and price indices implies that the sum of chained dollar values for the detailed components can differ from total expenditures for years other than the base year (1996).

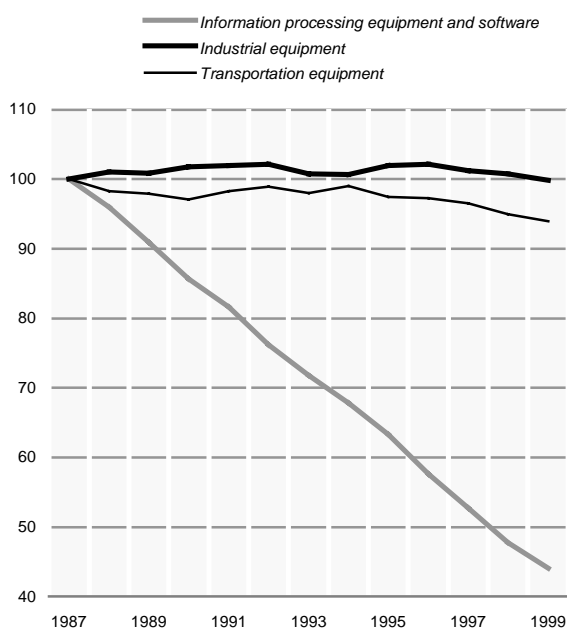
The main proximate cause for the emergence of the “new economy” is seen to be the accelerated diffusion of increasingly efficient information and communications technology in the economy. In fact, the share of information processing equipment in total real business investment in equipment and software rose to more than 50 per cent in 1999, up from some 30 per cent at the beginning of the decade (chart 2.2.9). This boom in spending on computers and related equipment reflects also a sharp decline in the relative price of these investment goods (chart 2.2.10): between 1990 and 1999 it fell by nearly 50 per cent, an average annual decline of some 7 per cent. From the firms’ vantage point, this fall in prices translated into lower user costs for these investment goods and a corresponding increase in the desired stock of these assets. This stimulus has contributed to, but was also accentuated by, the strong growth performance of the United States economy as a whole.

The effects of the increasingly pervasive use of information and communications technology have been to allow a more flexible use of factor inputs and, more generally, a more efficient organization of the production and distribution processes.⁵⁹ This, in turn, has led to

⁵⁹ Typical examples are “just-in-time” production and significant reductions in lead times for the production of capital equipment.

CHART 2.2.10

Changes in the relative price of investment goods, 1987-1999
(Indices, 1987=100)



Source: United States Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business* (Washington, D.C.), January 2000.

Note: Ratios of chain-type price indexes for non-residential investment goods to the price index for GDP.

improved productivity. The rationalization of production processes has also been spurred by the increased competition associated with the increased supply flexibility of domestic firms and the increased liberalization of international markets. The increasing importance of the internet for commercial transactions between businesses and between consumers and businesses is also a potential source of competitive pressures by lowering search costs, reducing barriers to market entry and shortening the supply chain, with attendant downward pressures on profit margins and productive inefficiencies.⁶⁰

For quite some time, however, it has been hard to find evidence that computers do in fact have a tangible impact on output and productivity growth.⁶¹ This paradox prompted the ironic remark that “you can see the computer age everywhere but in the productivity statistics.”⁶² The main explanation suggested for this is that computers have for some time remained a relatively

⁶⁰ S. Wadhvani, Member of the Monetary Policy Committee, Bank of England, “The impact of the internet on United Kingdom inflation”, speech at the London School of Economics, 23 February 2000 (www.bankofengland.co.uk).

⁶¹ S. Onliner and D. Sichel, “Computers and output growth revisited: How big is the puzzle?”, *Brookings Papers on Economic Activity*, 2:1994 (Washington, D.C.), pp. 273-317.

⁶² R. Solow, “We’d better watch out”, *New York Times Book Review*, 12 July 1987, p. 36.

small factor of production, accounting for only 2 per cent of the nominal net capital stock of the business sector in the United States in 1993.⁶³ But since the mid-1990s there has indeed been a striking increase in productivity growth (chart 2.2.11 and table 2.2.7). In the manufacturing sector, there was evidence for stronger gains already in the period 1990-1995, but productivity growth accelerated markedly in 1995-1999 to a rate significantly higher than in 1960-1973, i.e. the period before the productivity slowdown. At the same time, there is, however, a striking failure of productivity growth to improve in the non-durables manufacturing sector.⁶⁴ In other words, all of the acceleration in manufacturing productivity is accounted for by the durables sector. One possible explanation for the failure of productivity growth to pick up in the non-durables manufacturing sector could be the rather sluggish activity in this sector in the 1990s. Output in this sector rose at an annual rate of only 1 per cent over the period 1995-1999, compared with 4.9 per cent for total manufacturing. To the extent that there is a positive linear relationship between labour productivity growth and the rate of output growth (Verdoorn Law), slow output growth does not produce the potential productivity gains associated with scale economies (static and dynamic) and capital deepening. In fact, rapid output growth will tend to be associated with increased fixed investment, i.e. the introduction of more efficient machinery and equipment, which, in turn, will raise labour productivity.⁶⁵ Another factor reducing incentives to raise the capital-labour ratio could be the abundance of unskilled immigrant labour, which puts downward pressure on wages.

It has been estimated that computers have made a larger contribution to output growth in the second half of the 1990s compared with previous periods.⁶⁶ In the period 1996-1998 computers accounted for about 35 per cent of the total contribution of fixed capital to output growth, significantly more than in preceding periods (table 2.2.8). The more conspicuous feature, however, is the sharp rise in the growth contribution of multifactor productivity since 1995, which accounts for half of the acceleration in growth compared with 1990-1995. It may be surmised that this component, which is calculated as a residual, also captures the efficiency gains associated with the rapid diffusion of information technology.⁶⁷ The larger contribution of computers to output and productivity growth in more recent years could reflect the increasing maturity of computer technology and the progress made in

⁶³ S. Onliner and D. Sichel, op. cit., p. 314. This small share reflects the very short service lives of computers because of their rapid obsolescence.

⁶⁴ This aggregate comprises industries such as food, textiles, clothing, leather and chemicals.

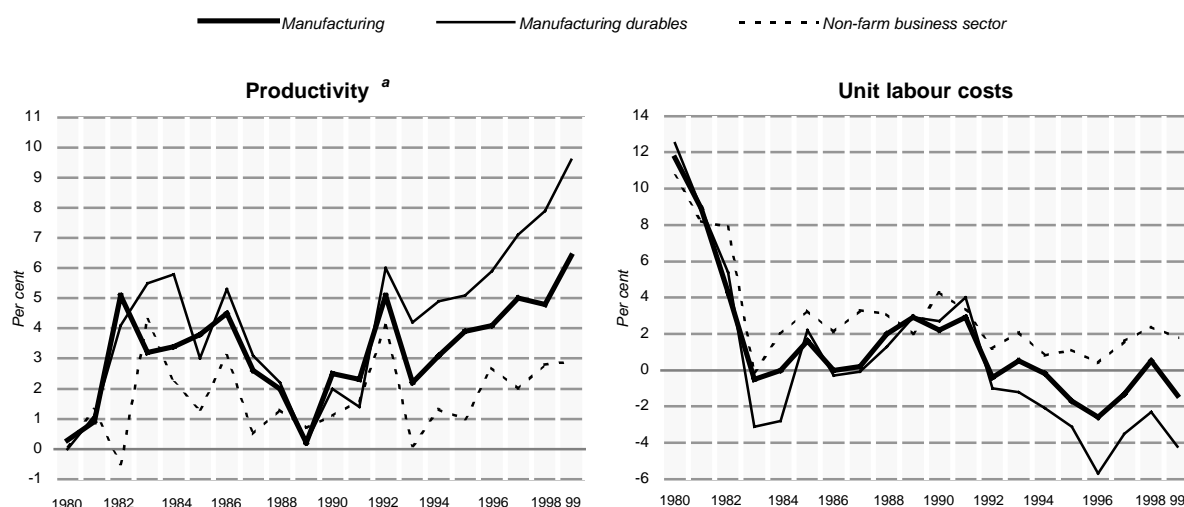
⁶⁵ W. Salter, *Productivity and Technical Change* (Cambridge, Cambridge University Press, 1960).

⁶⁶ D. Sichel, “Computers and aggregate economic growth: an update”, *Business Economics* (Washington, D.C.), April 1999, pp. 18-24.

⁶⁷ Ibid.

CHART 2.2.11

Changes in productivity and unit labour costs in the United States economy, 1980-1999
(Percentage change over preceding year)



Source: United States Bureau of Labor Statistics (www.bls.gov/ceshome.htm).

^a Output per hour.

adapting the production process to the characteristics of the new information technology. This is also reflected in the increasingly dynamic commercialization of this technology and the sharp decline in its relative price. An historical analogy to this development is the lag between the invention of the dynamo and the subsequent gradual process of diffusion of electric motors in industry.⁶⁸

The view that computers have played an important role in the recent improvement in labour productivity, however, has been challenged. It has been argued that only 0.3 percentage point of the actual growth in output per hour in the non-farm private business sector by 2.2 per cent between 1995 QIV and 1999 QI reflects a true structural acceleration.⁶⁹ The remainder is accounted for by a cyclical effect (0.3 percentage point), improved statistical methods for measuring price deflators which imply a higher rate of output growth (0.4 percentage point), and the underlying trend over the period 1972-1995 (1.1 percentage points). These estimates suggest that there was no structural acceleration in productivity growth for the non-farm non-durable sector as a whole (table 2.2.9). In contrast, there was a considerable acceleration in trend productivity growth in durable manufacturing, which, in turn, is entirely accounted for

by the sector producing computers. But the direct implication of this is, nevertheless, that the overall improvement in productivity growth translates into an increase in potential GDP growth (the “speed limit”) to a rate of about 3 per cent per annum. Until recently this rate was estimated at 2.3 per cent per annum, for the period 1990 QIII to 1996 QIII.⁷⁰ The failure for any significant improvement in productivity growth to occur outside the durable manufacturing sector is, however, puzzling. This pertains notably to the services sector, which accounts for the bulk of output produced in the economy. The problem of measuring the output of services is well-known and there is the possibility of an increasingly large downward bias in current estimates. This would, *ceteris paribus*, imply that the United States economy is currently growing even faster than suggested by the official statistics. But it could be that the impact of information technology on services productivity is not yet showing up because the sector is still in the process of adapting to the new technology. The potential competitive pressures associated with new tools (such as the internet) on distribution, wholesale and retail activities and financial services are only gradually trickling down to the company level, but it can be expected that the impact on aggregate labour productivity will become more clearly visible in the medium term.⁷¹

A key factor which determines for how long an economy can grow faster than its potential “speed limit” is the margin of spare capacity, notably the reserves of

⁶⁸ P. David, “Computer and dynamo. The modern productivity paradox in a not-too-distant mirror”, OECD, *Technology and Productivity* (Paris), 1991, pp. 315-347. There are, of course, limits to this analogy, partly because of the specific characteristics of information as an economic commodity, which “make direct measurement of its production and allocation very difficult and reliance upon market processes very problematic.” *Ibid.*, p. 336.

⁶⁹ R. Gordon., “Has the ‘new economy’ rendered the productivity slowdown obsolete?” (revised version, 14 June 1999), paper presented at a Productivity Growth Workshop, Federal Reserve Bank of St. Louis, 8 October 1999 (www.stls.frb.org/research/workshop).

⁷⁰ *Economic Report of the President*, transmitted to Congress February 1997 (Washington, D.C.), 1997, pp. 85-87.

⁷¹ Morgan Guarantee Trust Company, *World Financial Markets*, 14 January 2000, pp. 15-16.

TABLE 2.2.7

Changes in productivity and unit labour costs in the United States, 1960-1999
(Average annual growth rates)

	Total non-farm business	Manufacturing		
		Total	Durables	Non-durables
Output per hour				
1960-1973	3.0	3.0	3.5	2.8
1973-1990	1.4	2.4	2.6	2.0
1990-1999	2.0	4.1	5.8	2.3
1990-1995	1.6	3.3	4.3	2.3
1995-1999	2.6	5.1	7.6	2.3
Unit labour costs				
1960-1973	2.6	2.1	1.5	2.2
1973-1990	5.5	4.5	4.3	5.1
1990-1999	1.6	-0.4	-2.1	1.6
1990-1995	1.7	0.2	-0.7	1.2
1995-1999	1.6	-1.2	-3.9	2.1

Source: United States Bureau of Labor Statistics.

TABLE 2.2.8

Contributions to the growth in real gross output in the United States private non-farm business sector
(Percentage points)

	1980-1989	1990-1995	1996-1998
Computer hardware	0.22	0.17	0.35
Other capital	1.03	0.57	0.71
Labour input	1.52	1.15	1.92
Multifactor productivity	0.32	0.26	1.25
Total output growth	3.1	2.1	4.2

Source: D. Sichel, "Computers and aggregate economic growth: an update", *Business Economics* (Washington, D.C.), April 1999, table 2.

TABLE 2.2.9

Decomposition of productivity growth in the United States, 1995QIV-1999QI
(Percentage points at annual rates)

	Non-farm business	Durable manufacturing	Non-farm non-durables
Actual growth	2.2	6.8	1.5
<i>of which:</i>			
Cyclical effects	0.3	0.2	0.3
Trend 1972 QII-1995 QIV	1.1	3.1	0.8
Improved price measurement ...	0.4	0.4	0.4
True structural acceleration	0.3	3.1	-0.1

Source: R. Gordon, "Has the 'new economy' rendered the productivity slowdown obsolete?" (revised version, 14 June 1999), paper presented at a Productivity Growth Workshop, 8 October 1999 (www.stls.frb.org/research/workshop), table 4.

Note: Output per hour. Differences between actual growth and the sum of components are due to rounding.

unemployed labour at a given point in time. In fact, a striking feature of recent United States economic performance has been the behaviour of inflation in the presence of increasingly tight labour markets. Viewed in a longer-term perspective, a low unemployment rate of 4

per cent, as was attained in early 2000, would have been expected to be associated with an upturn in the rate of inflation. Thus, when the United States unemployment rate fell below 4 per cent in the second half of the 1950s, inflation rose to 3.5 per cent; when it fell below 5 per cent in the 1960s, inflation also rose. But, in contrast with the past, the decline in unemployment to very low levels in the current expansion has not been accompanied by significant upward pressures on the inflation rate (chart 2.2.12).

In the traditional theoretical framework, inflation depends on the tightness of the labour market. Excess demand in the goods market spills over to the labour market, leading to rising wages and, assuming price setting power on the part of firms, to rising prices. More graphically, whenever there is excess demand in the goods and labour markets, prices and wages will chase each other up a price-wage spiral until a new equilibrium is reached. In this process lower than normal unemployment entails higher inflation, and vice-versa. The negative relationship between unemployment and changes in inflation, traditionally known as the *Phillips curve*,⁷² implies that there is a natural rate of unemployment which is associated with a stable rate of inflation. This "non-accelerating inflation rate of unemployment" is better known under the acronym NAIRU.⁷³

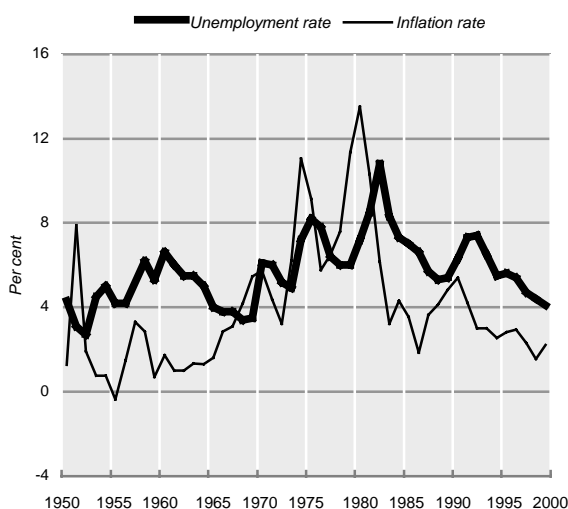
Chart 2.2.13 presents a simple scatter diagram of the relationship between changes in the inflation rate and the unemployment rate in the United States over the period 1970-1999. While the downward sloping regression line clearly indicates the existence of a negative relationship between the two variables, the ample dispersion of the points around the line suggests that factors other than unemployment have also contributed to the variations in inflation. In any case, the point where the regression lines cross the zero horizontal axis is an estimate of the NAIRU – its value is 6.3 per cent. This is in line with typical estimates of the NAIRU of some 6 to 6¼ per cent made in the early 1990s. In principle, therefore, inflation should have been on an upward tendency for quite some time in the United States. Moderate inflation partly reflects the impact of special factors such as the strong

⁷² The pioneering papers are: A. Phillips, "The relation between unemployment and the rate of change of money wage rates in the United Kingdom, 1861-1957", *Economica*, Vol. 100, 1958, pp. 283-299; P. Samuelson and R. Solow, "Analytical aspects of anti-inflation policy", *American Economic Review*, Vol. 50, No. 5, 1960, pp. 177-194. For a modern explanation see R. Layard, S. Nickell and R. Jackman, *Unemployment. Macroeconomic Performances and the Labour Market* (Oxford, Oxford University Press, 1991).

⁷³ In contrast to the traditional Keynesian view, the monetarist/new-classical school argues that inflation is a purely monetary phenomenon and thus independent of the tightness of the labour market. For the theoretical background see M. Friedman, "The role of monetary policy", *American Economic Review*, Vol. 8, No. 1, 1968, pp. 1-17; R. Lucas, "Some international evidence on the output-inflation trade-offs", *American Economic Review*, Vol. 63, No. 3, 1973, pp. 326-334; T. Sargent and N. Wallace, "'Rational' expectations, the optimal monetary instrument, and the optimal money supply rule", *Journal of Political Economy*, Vol. 83, No. 2, 1975, pp. 241-254.

CHART 2.2.12

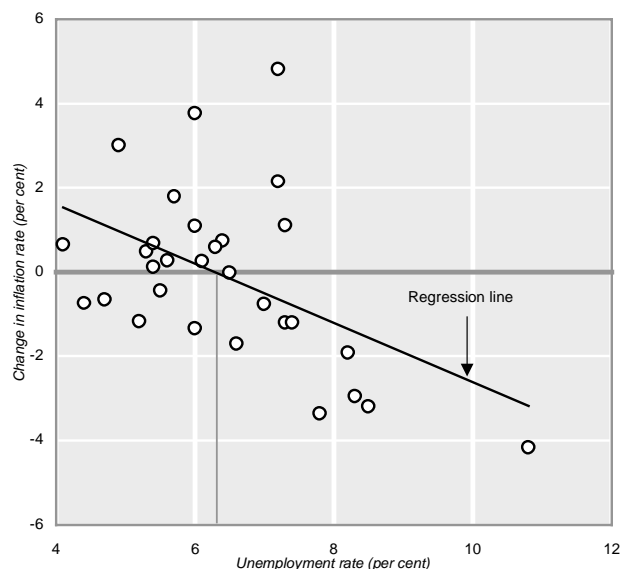
Inflation and unemployment rates in the United States, 1950-2000
(Percentages)



Source: United States Bureau of Labor Statistics. Inflation rate based on the CPI (base year 1982); unemployment rates refer to end of year.

CHART 2.2.13

Inflation and unemployment rates in the United States, 1970-1999
(Percentages)



Source: United States Bureau of Labor Statistics. Inflation rate based on the CPI (base year 1982); unemployment rates refer to end of year.

appreciation of the dollar and weak commodity prices, notably the sharp fall in oil prices, in the wake of the Asian crisis. But the persistent combination of low inflation with very low unemployment has been linked especially to the supply shocks associated with the “new economy” and longer-term structural changes which have

lowered the NAIRU. Recent estimates suggest that the NAIRU appears to have fallen to some 5 to 5.5 per cent.⁷⁴

To some extent this fall in the NAIRU has been associated with increased competitive pressures (reflected in the squeeze on margins and wage restraint) and productivity gains associated with the “new economy”. Evidently, the gains originating in the recent improvement in productivity performance will not have a long-term impact on the NAIRU. The favourable short-term effects reflect the lagged response of wage claims to unanticipated gains in productivity. If these gains persist then the “aspiration wage” of workers will be increased accordingly,⁷⁵ although this adjustment process can be quite drawn out. In the interim, this constellation implies wages below market clearing rates and an excess demand for labour.

But there are other longer-term factors, which have probably led to a more permanent decline of the NAIRU:

- The share of young workers in the working age population has fallen as a consequence of the ageing of the baby-boom generation (chart 2.2.14).⁷⁶ Unemployment rates of teenagers and young adults have tended to be much higher than for adult workers, a fact which is related to the hiring behaviour of firms, which prefer “experienced” workers to newcomers in the market. As a consequence, a reduced share of young workers in the labour force leads mechanically to a lower unemployment rate;
- Improvements in the education level of the labour force over recent decades have increased the employability of workers.⁷⁷ It has been estimated

⁷⁴ The basic method of estimating the NAIRU consists in building an inflation equation, wherein variations in inflation are explained by actual unemployment and various supply shock variables (such as food and energy prices). The NAIRU may be easily inferred from the constant term and the unemployment coefficients. For recent NAIRU estimates, see e.g. R. Murphy, “Accounting for the recent decline in the NAIRU”, *Business Economics*, Vol. 34, No. 2, 1999, pp. 33-38; R. Gordon, “The time-varying NAIRU and its implications for economic policy”, *Journal of Economic Perspectives*, Vol. 11, No. 1, 1997, pp. 11-32; R. Gordon, “Foundations of the Goldilocks economy: supply shocks and the time-varying NAIRU”, *Brookings Papers on Economic Activity*, 2:1998 (Washington, D.C.), pp. 297-333; D. Staiger, J. Stock and M. Watson, “The NAIRU, unemployment and monetary policy”, *Journal of Economic Perspectives*, Vol. 11, No. 1, 1997, pp. 33-49; J. Stiglitz, “Reflections on the natural rate hypothesis”, *Journal of Economic Perspectives*, Vol. 11, No. 1, 1997, pp. 3-10.

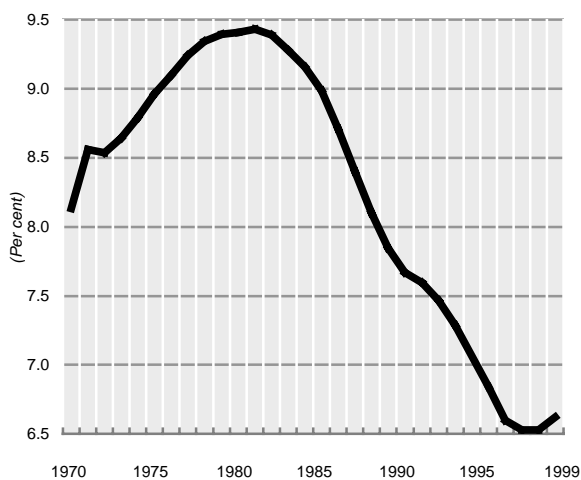
⁷⁵ R. Murphy, op. cit.; J. Stiglitz, op. cit.

⁷⁶ J. Stiglitz, op. cit.; L. Katz and A. Krueger, “The high pressure U.S. labor market of the 1990s”, *Brookings Papers on Economic Activity*, 1:1999 (Washington, D.C.), pp. 1-65.

⁷⁷ The general tendency of Americans to be more educated is well documented by the National Center for Education Statistics. In 1997, 82 per cent of the population 25 years old and over had completed high school and 24 per cent had completed four or more years of college. This represents a significant increase from 1980, when 69 per cent had completed high school and 17 per cent had four years of college. National Center for Education Statistics, “Digest of education statistics, 1998” (nces.ed.gov/pubs99).

CHART 2.2.14

Percentage of persons aged 20-24 in total resident population in the United States, 1970-1999
(Percentages)



Source: United States Department of Commerce, Bureau of the Census. Current Population Reports (www.census.gov/population/estimates).

that in the absence of this effect, the unemployment rate would have been higher by 1.7 percentage points compared with its actual value;⁷⁸

- The fading of trade union power may have contributed to wage moderation which, in turn, could have raised the demand for labour.⁷⁹ Trade union membership in the United States private business sector has declined steadily over the years. As union workers generally obtain higher wage rates than equivalent non-unionized workers, wage pressures might therefore have been diminished. The reduced unionization rate could be related to the recent waves of deregulation in major industrial sectors (such as trucking, railroad, airlines and telecoms).⁸⁰ Another factor that might have contributed to moderate wage claims is the significant inflow of immigrant workers, both legal and illegal, who are, in general, paid below the standard rates;⁸¹
- Labour reallocation between sectors, motivated by various exogenous shocks, is likely to have been an

⁷⁸ E. Phelps and G. Zoega, "The rise and downward trend of the natural rate", *American Economic Review*, Vol. 87, No. 2, 1997, pp. 283-289.

⁷⁹ J. Stiglitz, op. cit.; L. Katz and A. Krueger, op. cit.; R. Gordon, 1997, op. cit.

⁸⁰ J. Peoples, "Deregulation and the labour market", *Journal of Economic Perspectives*, Vol. 12, No. 3, 1998, pp. 111-130.

⁸¹ There are now 26 million legal immigrants in the United States, almost 10 per cent of the total population. Official estimates from the Census Bureau suggest that there are also around 5 million illegal immigrants. "United States: immigrant labour", *Oxford Analytica*, 17 February 2000; "The great American jobs machine", *The Economist*, 15 January 2000; G. Tapinos, "Illegal immigrants and the labour market", *Observer*, No. 219, 1999, pp. 35-37.

important determinant of the frictional component of the unemployment rate. The cross-sectoral dispersion of employment growth rates, which often serves as a proxy for this reallocation, has been on a declining trend (box 2.2.2). It appears that the massive introduction of information technology in the past decade has produced less labour reallocation than earlier shocks (such as the oil shocks of the 1970s or the deregulation waves of the mid-1980s);

- Increased worker mobility and a better matching between the supply and demand for skills in the labour market may have contributed to improved labour flexibility and efficiency in labour allocation. This is tantamount to a reduction in frictional unemployment. It can be partly related to new methods of targeting workers for reemployment (Worker Profile and Reemployment Services Programme) and the spreading of temporary help agencies during the 1990s, which helped to reduce search costs and the costs of changing employment.⁸² The increased publication of help-wanted information on the internet should also allow for a more efficient match between job seekers and vacancies, which will also put downward pressure on the NAIRU;⁸³
- It has also been argued that the marked rise in the incarceration rate from 0.2 per cent of the adult population in 1970 to 0.9 per cent in 1998 has depressed the unemployment rate. Assuming that "those in jail tend to have been unemployed prior to being arrested", this would explain as much as one fifth of the reduction in the unemployment rate over this period.⁸⁴

The "unemployment equation" estimated in box 2.2.2 is an attempt to assess the contribution of some of these factors to the recent reduction in United States unemployment.⁸⁵

The fact that in the 1990s the NAIRU has been falling is, of course, good news for the unemployed and for the United States economy as a whole. From a policy point of view, if the link between the unemployment rate and future inflation were strong and precise, then changes in the unemployment rate would be an important indicator for the conduct of monetary policy. Thus, if

⁸² A detailed analysis of the development of this sector is provided by M. Esteveao and S. Lach, *The Evolution of the Demand for Temporary Help Supply Employment in the United States*, NBER Working Paper, No. 7427 (Cambridge, MA), December 1999.

⁸³ S. Whadwani, op. cit.

⁸⁴ L. Katz and A. Krueger, op. cit.

⁸⁵ The standard approach was pioneered by R. Barro, "Unanticipated money growth and unemployment in the United States", *American Economic Review*, Vol. 67, No. 2, 1977, pp. 101-115 and extended by D. Lilien, "Sectoral shifts and cyclical unemployment", *Journal of Political Economy*, Vol. 90, No. 4, 1982, pp. 777-793.

BOX 2.2.2

An "unemployment equation" for the United States economy

The decline of the United States unemployment rate can be examined more thoroughly by estimating an unemployment equation for the period 1970-1997. The dependent variable is the unemployment rate (UNEMP) as of 31 December of each year. The explanatory variables are (i) DINFL, the first difference in the inflation rate as a proxy for unexpected inflation (which is assumed to follow a random walk); (ii) SIGMA, the cross-sectoral variance of the employment growth rates, weighted by the employment share of the sector in total employment; (iii) PROSH, the "unexpected productivity shock", calculated as the difference between the actual annual variation in labour productivity (output per hour in the non-farm business sector) and a Hodrick-Prescott trend; (iv) YOUNG, the proportion of persons aged 20 to 24 in the total resident population. The estimated equation which gave the best results is as follows:

$$UNEMP_t = 0.53 + 0.36UNEMP_{t-1} - 0.25DINFL_t + 0.08SIGMA_t - 0.40PROSH_t + 0.38YOUNG_t$$

(0.44) (2.74) (2.85) (2.78) (3.46) (2.20)

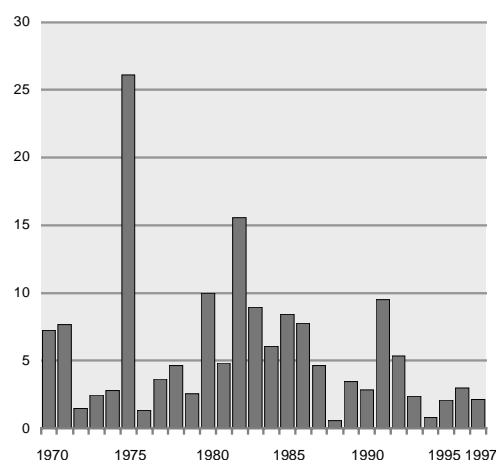
The figures in brackets below the estimated coefficients are t-statistics. The fit of the model is good (R^2 (adj.) = 0.74) and the hypothesis of second order autocorrelation is rejected (Breusch-Godfrey test). The data used in this box were taken from the United States Bureau of the Census, United States Bureau of Labor Statistics and the OECD, *National Accounts* (Paris), 1999.

The results suggest that the United States unemployment rate exhibits some inertia, with current unemployment depending on one period lagged unemployment. This means basically that the costs of changing employment are not negligible, even in the highly "flexible" United States labour market. The significant coefficient on SIGMA indicates that labour reallocation had a strong influence on the unemployment rate. It follows that the small dispersion in sectoral employment growth rates after 1992 would also account for reduced unemployment rates (as shown in chart A). The significant coefficient on the productivity variable PROSH corroborates the expected negative relationship between stronger than expected productivity growth and unemployment. In 1998 and 1999, the very high annual productivity growth rates (close to 3 per cent) were above the trend values; the cumulative effect would account for a reduction in the unemployment rate by some 0.2 percentage points in 1999. Finally, the significant coefficient on the variable YOUNG supports the hypothesis that demographic changes have contributed to the decline in unemployment. The decline of the proportion of young persons in the total population by 3 percentage points between 1980 and 1997 may have lowered the (steady state) unemployment rate by some 1.8 percentage points. Finally, the estimates suggest that a 2 percentage point inflation shock will alter the current unemployment rate by some 0.5 percentage point.

The model can also be used to estimate the "natural rate of unemployment" associated with the absence of inflation shocks. The method consists in setting to zero the coefficient on DINFL and then recalculating the unemployment series. Chart B represents the actual unemployment rate (UNEMP), the natural rate (UNAT) and its trend value (HPUNAT). The latter was calculated by applying a Hodrick-Prescott filter to the natural rate series. The trend values peaked in 1980, when it was 7.3 per cent; it had fallen to 5 per cent by 1997.

CHART A

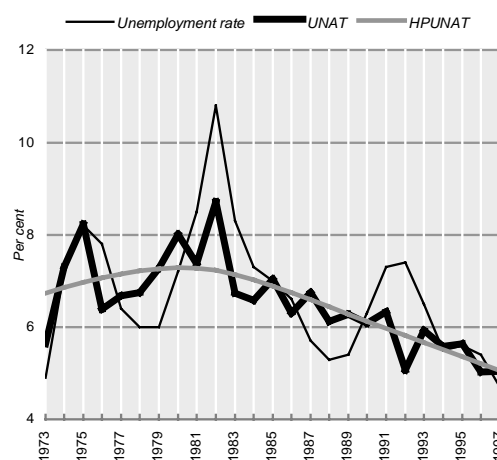
Cross-sectoral dispersion in United States employment growth rates, 1970-1997
(Variance)



Source: OECD, *National Accounts* (Paris), 1999; UN/ECE secretariat calculations. Primary data correspond to the nine main sectors of activity (i.e. agriculture, mining, manufacturing, electricity gas and water, construction, trade, transport, finance and business services, community and personal services).

CHART B

The rise and fall of the United States natural rate of unemployment, 1973-1997
(Per cent)



Source: UN/ECE secretariat calculations.

unemployment falls below the NAIRU, the monetary authorities would increase interest rates in an attempt to reduce the excess demand in the economy before inflation accelerates. Estimates of the NAIRU, however, are not sufficiently precise for it to be a reliable predictor of inflationary pressures.⁸⁶ The implication is that the NAIRU has not proved to be very useful in the conduct of monetary policy over the past decade or so and that there is a need for more research to better understand the determinants of inflation in the short run.

(iii) Monetary conditions

Monetary conditions in the western market economies changed in the course of 1999 and in early 2000 towards a tightening of monetary policy. In the euro area, increases in short-term interest rates have partly offset the expansionary effects of the depreciation of the exchange rate. In contrast, in the United Kingdom and the United States, higher interest rates have accentuated the restraining effects on demand of their strong currencies.

In the *euro area*, the stance of monetary policy began to be tightened in November 1999. The main refinancing rate was increased by 0.5 percentage point, to 3 per cent, thus fully reversing the reduction in April. The ECB argued that the move was designed to contain the medium-term risks to price stability against a backdrop of strengthening economic growth, rising oil prices, a rapid expansion of credit to the private sector and a growth of money supply significantly above the reference value of 4.5 per cent.⁸⁷ This policy was continued in early February and in mid-March 2000, when the main refinancing rate was raised successively by a quarter of a percentage point to 3.5 per cent. In addition to the factors already noted, this decision also reflected concerns about the sizeable depreciation of the euro and its potential inflationary impact on domestic inflation via rising import prices,⁸⁸ but it may be surmised that concerns about investors' confidence in euro-denominated financial assets also played a role.

In a similar vein, in the *United Kingdom*, strong growth in domestic demand and increasing pressures in the labour market and on productive capacity led to fears that inflation would rise above the 2.5 per cent inflation target. Consequently, there was a progressive tightening of monetary policy between September 1999 and early February 2000, the repo-rate being increased in stages by a full percentage point to 6 per cent.

In the *United States*, the continued economic expansion at a rate above the trend rate of output growth and increasingly tight labour markets have raised

concerns about the increasing risk of upward pressures on costs and prices. As a result, the Federal Reserve has reversed the easing of monetary policy which occurred in the second half of 1998 in response to the threats of international financial turbulence: the target for the federal funds rate was raised in three steps from 4.75 per cent to 5.5 per cent between June and November 1999, and in early February 2000 there was a further increase to 5.75 per cent.

As a result of the tightening of policy, short-term interest rates have edged upwards. In the euro area, three-month EURIBOR were, on average, some 3.5 per cent in February 2000, nearly one percentage point more than their recent low of 2.6 per cent in May 1999 (chart 2.2.15). In the United States, short-term rates rose, on average, to 6 per cent in February 2000, up from 4.9 per cent 12 months earlier. As a result, the spread between nominal short-term rates in the United States and the euro area fell to 2.5 percentage points, the smallest it has been since June 1996 (chart 2.2.15).

Seen in a longer-term perspective nominal short-term interest rates are still quite low in the euro area. This also holds for real short-term rates, which were only 1.4 per cent in January 2000, about 1 percentage point lower than in the same month of 1999 (chart 2.2.15). Real short-term rates in the United States were about 3.3 per cent in January 2000, broadly unchanged from a year earlier.

In the international bond markets, there was a considerable increase in long-term interest in 1999 and the rise continued in early 2000. In the United States, this tendency started in early 1999 and accelerated in the second half of the year (chart 2.2.15). To some extent this reflected the rise in inflationary expectations associated with the improving outlook for the global economy, but the reversal of capital outflows from emerging markets, notably in Asia, after financial crises in 1997-1998 has also played a role. Yields on 10-year treasury bills averaged at some 6.5 per cent in February 2000, 2.5 percentage points more than in the same month of 1999. Since late January 2000, there has been a striking inversion of yields at the long end of the maturity spectrum, with yields on 30-year treasury bills falling below that for 10-year bills. In early March, the difference was about a quarter of a percentage point. This feature is largely associated with the large federal budget surplus and the reduced supply of 30-year treasury bills (a reflection of debt repayment), which has driven up their prices (and lowered their yields).

In the euro area, there was little upward pressure on long-term yields in the first half of 1999, and as a result a sizeable spread emerged, of some 1.4 percentage points, between yields on dollar and euro-denominated bonds in mid-1999. But this decoupling was not sustained in the second half of 1999, when long-term rates in the euro area rose faster than in the United States. This reflected partly the strengthening of economic activity in the euro area and a rise in the risk premium on account of the increased uncertainty of investors about future inflation,

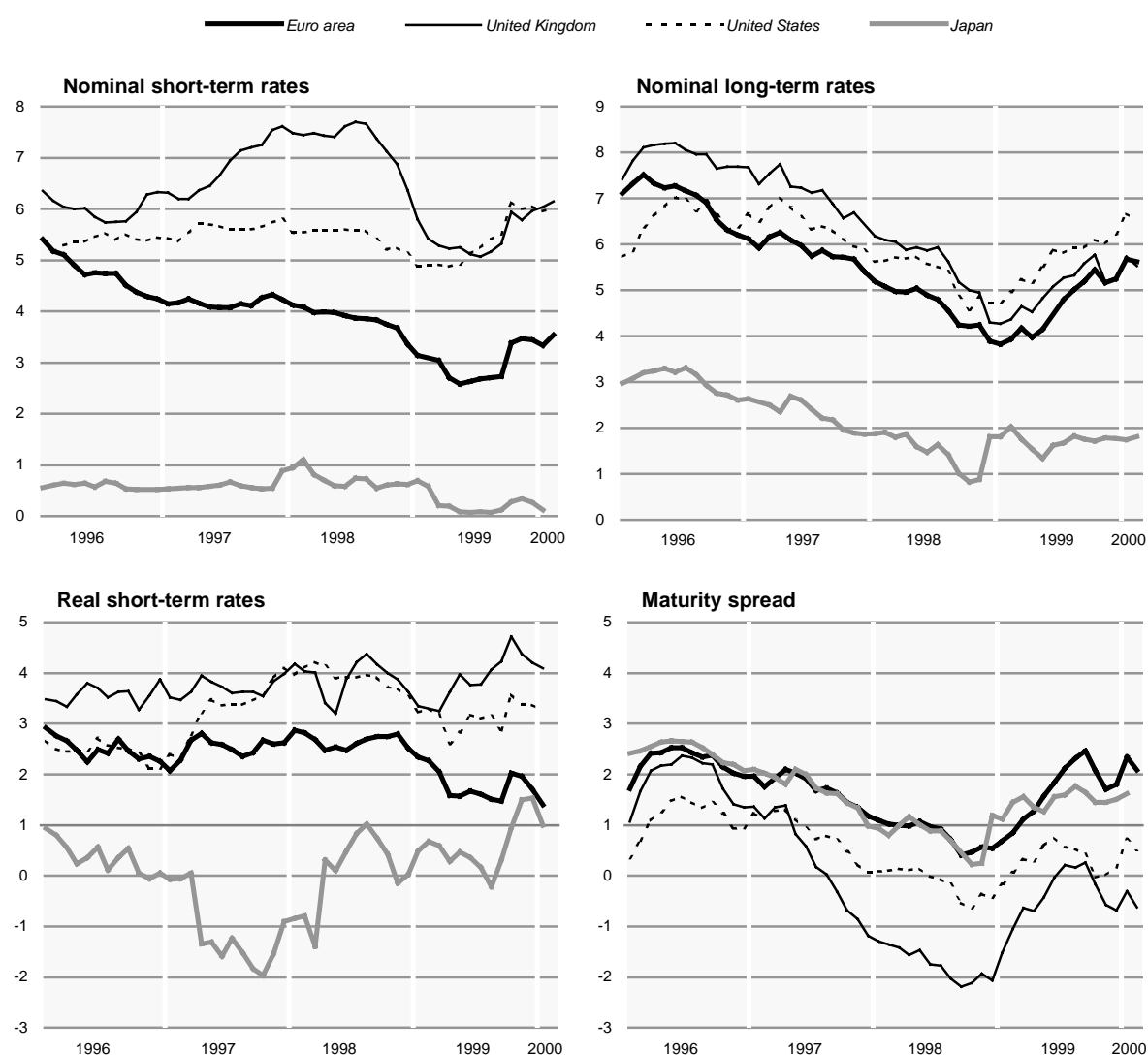
⁸⁶ In statistical terms, the central estimates of the NAIRU were found not to be very precise. A recent estimate for 1994 was for a range (corresponding to the 95 per cent confidence interval) from 4.8 per cent to 6.6 per cent. D. Staiger, et al., op. cit.

⁸⁷ ECB, *Monthly Bulletin*, November 1999, pp. 5-6.

⁸⁸ ECB, *Monthly Bulletin*, February 2000, p. 5

CHART 2.2.15

Nominal short-term and long-term interest rates, January 1996-February 2000
(Average monthly rates, per cent per annum)



Source: National statistics; OECD, *Main Economic Indicators* (Paris), various issues; European Central Bank; *Financial Times*, various issues.

Note: Short-term rates: three-month money market rates. Long-term interest rates: yields on 10-year government bonds. Maturity spread: long-term interest rates less short-term interest rates. Long-term interest rates for the euro area are GDP-weighted averages of national rates. The same holds for short-term interest rates before 1999. Real short-term interest rates are calculated as the difference between nominal interest rates and the corresponding month inflation rate.

but there was also a spillover from monetary tightening in the United States. In December 1999, long-term euro rates had risen to 5.3 per cent and the margin below United States yields had narrowed to 1 percentage point. In February 2000, the average 10-year bond yield was 5.6 per cent, 0.9 percentage point lower than in the United States. These were the highest 10-year yields since autumn 1997.

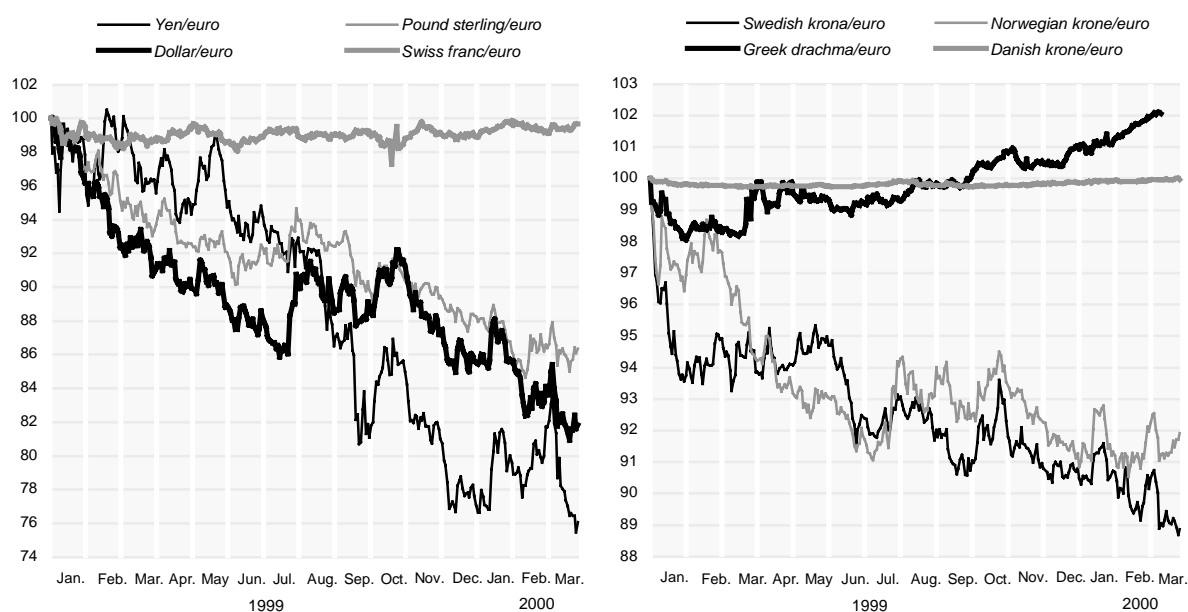
Real long-term interest rates (nominal rates less the contemporaneous inflation rate) were about 3.5 per cent in the euro area in January 2000, about half a percentage point lower than 12 months earlier. There was no significant tendency for real long-term interest rates to rise in the United States in 1999: they were 3.8 per cent in

January 2000, close to their long-term average for the period 1990-1999. In general, both short- and long-term interest rates are still relatively low in the euro area and the United States.

The change in inflationary expectations, and associated anticipations of a tightening of monetary policy, is reflected in the steepening of the yield curve (approximated by the difference between long-term and short-term interest rates) in the euro area in 1999. (This tendency was temporarily distorted by the rise in short-term rates around the turn of the year reflecting the increased risk premium associated with the expected Y2K problem.) The average spread of 2.1 percentage points in the euro area was still rather small in February

CHART 2.2.16

Euro reference exchange rates, January 1999-March 2000
(Indices, 4 January 1999=100)



Source: European Central Bank.

Note: Daily rates from 4 January to 15 March 2000.

2000, although it was 1.2 percentage points higher than 12 months earlier (chart 2.2.15). In general, this illustrates the accommodating stance of monetary policy. In the United States, the yield curve was very flat in early 2000, as it was throughout 1999, and partly reflects the tightening of monetary policy.

In the foreign exchange markets, the more or less steady depreciation of the euro against the dollar in the course of 1999 continued in early 2000 (chart 2.2.16). In fact, in late January the euro was being traded for the first time at below one dollar, and continued to be so throughout most of the period to mid-March; by that time it had depreciated by some 18 per cent against the dollar as compared with the average rate of the first five trading days in January 1999. The weakness of the euro, to a large degree, is probably related to the persistent difference in cyclical strength between the United States and the euro area and the associated interest rate differential in favour of dollar-denominated financial assets. This is also reflected in the large net outflow of capital from the euro area. The yen and the pound sterling have also appreciated markedly against the euro (chart 2.2.16). Within the ERMII,⁸⁹ the Greek drachma was revalued by 3 per cent against the euro in mid-January 2000. This was designed to maintain downward pressure on the inflation rate which, in turn, is part of the

effort to join EMU. The nominal effective exchange rate of the euro⁹⁰ fell by some 10.5 per cent in the 12 months to January 2000. Over the same period, the dollar appreciated in effective terms by 1.2 per cent. This contrasts with a much stronger effective appreciation of the pound sterling (by 9 per cent) and the yen (by 12.5 per cent). In real effective terms, the appreciation of the dollar was somewhat larger (by about 5 per cent) and much weaker (only 2.2 per cent) for the yen (chart 2.2.17).

(iv) The short-term outlook

(a) The baseline

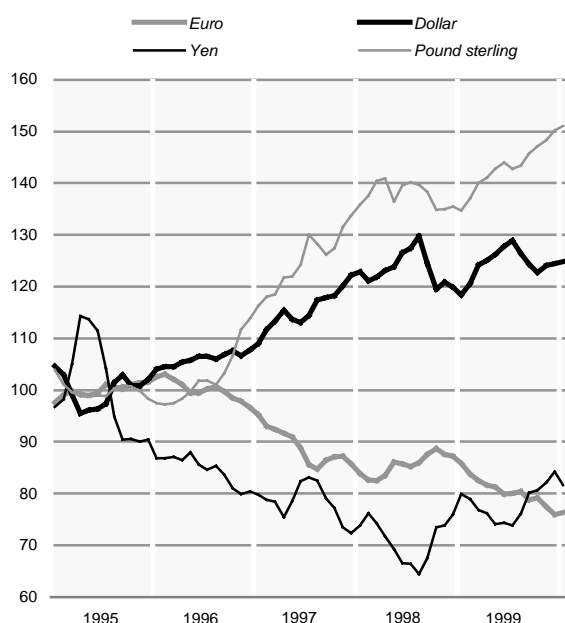
Against a background of improving economic conditions in other regions of the world economy, the short-run economic outlook for western Europe and North America is now quite favourable. In western Europe, the cyclical recovery is expected to gain further momentum in the course of 2000, with real GDP currently forecast to increase by slightly more than 3 per cent in 2000 (table 2.2.1). This would be the largest increase since 1990, when there was a growth rate of 3.4 per cent. In fact, in the absence of the downside risks discussed below and a somewhat stronger rate of growth than currently expected in Germany and Italy, the outcome could be even better, possibly closer to 3.5 per cent. Performance in the euro and non-euro areas of

⁸⁹ This is the exchange rate mechanism which replaced the European Monetary System (EMS) and links currencies of EU member states outside the euro area to the euro. Only Denmark and Greece are currently participating in ERMII.

⁹⁰ As calculated by the IMF.

CHART 2.2.17

Real effective exchange rates, January 1995-January 2000
(Indices, 1995=100)



Source: IMF, *International Financial Statistics* (Washington, D.C.), March 2000.

Note: Based on relative unit labour costs. The real effective exchange rate for the euro before January 1999 is based on the so-called "synthetic euro", i.e. a trade-weighted average of the bilateral exchange rates of the participating EMU countries against the dollar using their national conversion rates vis-à-vis the euro. For more information see the source.

western Europe is expected to be similar. In the United States, the consensus of forecasts is for the cyclical expansion to slow down from the high rates of the final two quarters of 1999. Average annual growth in 2000 could still be some 4 per cent, which includes, however, a significant statistical carry-over effect from 1999.⁹¹ Broadly the same outlook is forecast for Canada. These forecasts imply a significant narrowing of the growth differential between North America and western Europe in 2000. This benign scenario could continue into 2001, especially if the cyclical upturn in the various regions of the world economy leads, via the foreign trade channel, to a mutually reinforcing process of economic growth.

In *western Europe*, the main factor behind the strengthening recovery is likely to be the more rapid expansion of exports. Apart from rising intraregional trade, this largely reflects the stronger demand from emerging markets and developing countries where the rate of economic expansion is also forecast to accelerate. Such a favourable export performance will contribute to

⁹¹ If GDP were to stagnate at the level attained in the final quarter of 1999 this alone would ensure an annual growth rate of 2.1 per cent in 2000. The corresponding carry-over effect was 1.7 percentage points in 1998. The weaker cyclical momentum in western Europe compared with the United States in the course of 1999 is reflected in a carry-over effect of only about 1/4 percentage points into 2000.

the strengthening of domestic demand. Private consumption will be supported by rising real incomes, in turn the result of further gains in employment and higher real wage rates. Business investment should be stimulated by rising capacity utilization rates and improved sales prospects. Changes in stockbuilding will also make a small contribution to higher output growth. The stronger growth of domestic demand, however, will lead to a rising demand for imports and the change in real net exports should be broadly neutral in its effect on economic growth in 2000. (In 1999 net export subtracted half a percentage point from GDP growth.) Among the four major economies, France and the United Kingdom are likely to develop the strongest cyclical momentum, but growth is also accelerating in Germany and Italy, where the business climate improved markedly in early 2000. Italy, nevertheless, is expected to continue to grow more slowly than most of the other west European countries. The rate of economic expansion will remain quite strong in the smaller west European economies.

Higher levels of economic activity in western Europe will not only feed through to employment but should also lead to a further decline of the unemployment rate. Inflation is expected to pick up slightly, a main underlying assumption being that the rise in oil prices will peter out in the spring and possibly be partly reversed later on in the year. Growth in labour costs are expected to remain relatively moderate and to be largely offset by productivity gains. Fiscal policy is set to maintain a broadly neutral stance, but many forecasters expect that the cyclical upturn will lead to a further gradual tightening of monetary policy both in the euro area and in the United Kingdom in order to meet the established inflation targets.

In the *United States*, robust private consumption and business fixed investment are likely to remain the mainstays of economic growth, partly supported by continuing positive wealth effects. Exports are expected to strengthen as a result of the more favourable international economic environment. A slowdown in employment growth and less favourable financing conditions associated with the tightening of monetary policy, however, should tend to dampen household expenditures and fixed investment. Import demand should remain strong but the changes in real net exports is likely to be considerably less of a drag on domestic activity in 2000 than in the two preceding years. In view of the continuing strength of economic growth, the unemployment rate should stay close to 4 per cent. Inflationary pressures are still expected to remain rather moderate, given the assumptions about developments in the oil markets and that increases in productivity should continue to largely offset increases in labour costs. The slowdown in the rate of expansion in the course of 2000 should bring the growth of demand somewhat closer to the lower rate of potential output growth. This gradual transition of the economy towards a "soft landing" has already been forecast for the last few years, but the continuing strength of the cyclical upturn has been systematically underestimated.

(b) *The risks*

There remain, however, a number of downside risks which, if not contained, could lead to less favourable or even quite bad outcomes. A major uncertainty hanging over the international economy is the future direction of oil prices and its effects on inflation and growth. In the United States, the rate of expansion may not slow down sufficiently in time to avoid overheating. Important downside risks, moreover, continue to be attached to the possibility of a sharp downward correction of the high level of United States stock prices and to the sustainability of the record United States current account deficit.

In general, the national growth forecasts embody the assumption of stable or falling oil prices in the course of 2000. It is true that because of a much reduced energy intensity and oil dependency a given percentage increase in oil prices now has a much less adverse economic impact than at the time of the first and second oil price shocks in the 1970s. But a sustained and large rise in oil prices, nevertheless, can still have relatively significant inflationary consequences and, via their adverse effects on real incomes and the terms of trade, can dampen economic growth.⁹² Future developments in the oil markets will be shaped by the outcome of the OPEC meeting scheduled for end of March 2000.

The fact that the United States economy has been continuing to expand at a high rate is a major factor behind the general improvement in the global economic outlook. The persistent growth of demand in excess of the estimated growth of potential output in the presence of what is now a very tight labour market, however, has increased concerns about the increasing risk of rising inflationary pressures. Such concerns have been accentuated by the significant and direct inflationary consequences of the rise in oil prices, although core inflation has remained remarkably low given the advanced stage of the business cycle. The broader question is whether the rate of expansion can be slowed down sufficiently to avoid overheating and a hard landing. This will partly depend on the effects of the monetary tightening already in the pipeline and on the ability of the Federal Reserve to anticipate more or less correctly future inflationary pressures. The decision, on 21 March 2000, to raise the target for the federal funds rate by a quarter of a percentage point to 6 per cent continued the progressive tightening of monetary policy which started in June 1999. Since then the target for the federal funds rate has been raised by a cumulative 1¼ percentage points, but the earlier increases have failed so far to have a visible impact on the rate of economic expansion. This suggests that the stance of monetary policy is still broadly neutral.

The objective of achieving a “soft landing” for the United States economy is complicated by the high level

of share prices, which are generally reckoned to be significantly overvalued. The wealth effect associated with rising share prices has helped to boost private sector spending in the past few years. Any shock that would cause a sharp and sustained fall in share prices can therefore be expected to have adverse consequences on domestic spending and activity levels. This would also have adverse spillover effects on equity markets and economic activity in western Europe and other parts of the world economy. A possible risk is that the monetary authorities will underestimate the future rate of inflation and could therefore be forced eventually to act more abruptly to tighten the stance of monetary policy. Under these circumstances, equity markets would probably no longer display the striking behaviour where higher short-term interest rates trigger further increases in share prices, as they did again in mid-March. Such non-traditional responses may be a pointer to the increasing importance of pure speculation in driving the stock market. This appears to hold notably for so-called technology stocks, which account for a substantial proportion of the overall increase in share prices and the associated wealth effect.

In such a speculative environment buyers are guided by self-fulfilling expectations of rising share prices, assuming that they are able to correctly anticipate the point at which they can still sell at a profit.⁹³

In this context there are also increasing concerns about the potential effects on stock market volatility of the massive and recent increase in household borrowing to purchase equities. This so-called “margin debt” reached a record \$243.5 billion in January 2000, an increase of some 33 per cent compared with three months earlier. This level of borrowing was equivalent to 2.6 per cent of GDP in 1999. Relative to the value of stocks, margin debt rose to its highest level in at least 18 years.⁹⁴ In the event of a pronounced fall in share prices, households would be faced with the need to reduce their margin debt (triggered by “margin calls”) because the extent of borrowing is proportional to the value of the collateral, i.e. the value of stocks. This process, in turn, would put further downward pressure on equity prices

⁹³ For a theoretical framework in which increases in short-term interest rates lead to higher share prices in the context of a “near-rational bubble” see V. Reinhart, “Equity prices and monetary policy in the United States”, in BIS, *The Role of Asset Prices in the Formulation of Monetary Policy*, Conference Papers, Vol. 5 (Basle), March 1998, pp. 280-299. In this model, an exogenous shock may lead to a widening gap between fundamental and market values. The basic mechanism is that the increase in short-term rates is tantamount to a higher rate of return on a competing asset, i.e. three-months treasury bills. But given the expectations of future capital gains on equity, the perverse feature is for higher short-term rates to drive up equity prices further to give investors the requisite higher return. In economic theory, a ‘rational bubble’ characterizes a situation in which the price of a given asset increases systematically, driven by self-fulfilling expectations of future price increases, and independent of its fundamental value. Such rational expectations concerning other people’s “irrational exuberance” may take into account the non-zero probability that the bubble will burst at some time in the future. O. Blanchard and S. Fischer, *Lectures on Macroeconomics* (Cambridge, MA, MIT Press, 1992), chap. 5.

⁹⁴ WEFA, *U.S. Financial Markets Outlook* (Eddystone, PA), 21 February 2000.

⁹² OECD *Economic Outlook*, December 1999 (Paris), pp. 8-9.

and could also involve a tightening of bank lending standards (“credit squeeze”). In such circumstances the risk of a downward spiral of debt reduction and falling stock prices is clear although difficult to quantify.

It is generally acknowledged that the United States current account deficit has reached a size which is unsustainable.⁹⁵ For how long the present situation can last, will depend on the continued willingness of foreign investors to hold dollar-denominated financial assets. This, in turn, will depend on the assessment of the risks related to the deterioration of the United States net foreign asset position and the expected returns of holding assets denominated in dollars compared to assets denominated in other currencies, notably the euro and the yen. Any sudden and large change in investor sentiment could trigger a run on the dollar and therefore a major shift in the pattern of exchange rates among the three main currencies. A marked depreciation of the dollar would force a more resolute tightening of United States monetary policy and higher interest rates than currently expected, with concomitant adverse effects on economic growth. This, in combination with a marked appreciation of the euro, would also have negative effects on Europe.

It can also be assumed that the strengthening of economic growth in the world economy will lead to a general increase in the global demand for capital. This has already put upward pressure on long-term interest rates, but this tendency could become stronger in the course of 2000. This in turn could lead to a more pronounced slowdown in the growth of United States domestic demand than is currently anticipated. The economic slowdown itself, however, could also affect the confidence of investors in the continued strength of the United States economy; the associated reduction in profit expectations could therefore stimulate a larger outflow of capital.

In *western Europe*, the crucial policy issue is to ensure that the current recovery can be sustained at a robust rate of growth over the medium term. Only if they have confident expectations of sustained and robust growth will firms be willing to significantly step up their demand for labour and their propensity to invest. The positive experience of the smaller economies in recent years suggest that significant progress towards the goal of full employment will require not just structural reforms but also a sustained growth of GDP by at least 3 per cent.⁹⁶ Such a performance can also be expected to trigger a significant increase in fixed investment required to enhance capacity and to create more jobs.

Inflationary pressures in western Europe and notably the euro area are still very low. Although the inflation rate edged upward to the ceiling of the ECB’s target in February 2000, the consensus of forecasts⁹⁷ is that average inflation will remain below the ceiling of 2 per cent in 2000 and 2001, a view which also appears to have been shared by the ECB in late 1999.⁹⁸ This assessment contrasts with the recent tightening of monetary policy in the euro area. Core inflation has remained very low, there is ample slack in labour markets, and intensive competitive pressures are still putting downward pressure on profit margins and prices. The ECB now appears to be more concerned about the possibility of second-round effects of the sharp rise in oil prices on wages and consumer prices in the course of 2000. It is difficult to judge to what extent this also holds for the “consensus forecasts” – but they also appear to embody the assumption of a moderate tightening of monetary policy in the course of 2000. Although monetary conditions are still seen to be accommodative, albeit to a lesser degree than in 1999, an overly cautious orientation of monetary policy risks, however, placing an unnecessary restraint on the cyclical upturn.

2.3 Two small island economies: Cyprus and Malta

Cyprus and Malta are two small island economies in the Mediterranean. They gained independence from the United Kingdom only a few decades ago, Cyprus in 1960 and Malta in 1964. Given the small size of their domestic markets, they are strongly dependent on foreign trade and direct investment as engines of economic growth. Given their geographical position and climate, both also rely heavily on tourism as a source of domestic incomes. The two countries differ not only in size, but also in their degree of openness and their living standards as measured by GDP per capita (table 2.3.1).

Both countries have developed close ties with the European Union. Malta concluded an Association Agreement as early as 1970, which led to a rapid expansion of trade with the Union and contributed significantly in attracting a substantial amount of FDI. Cyprus concluded an Association Agreement in 1972, the principal motive for which was to ensure continued free access of Cyprus’ agricultural exports to the United Kingdom, which joined the EEC in 1973.⁹⁹

Cyprus and Malta both applied for EU membership in 1990 and accession negotiations are currently under way. In the case of Cyprus, they started in the spring of 1998. These negotiations have been taking place against the background of renewed efforts to find a political

⁹⁵ For a general discussion of this issue see C. Mann, *Is the U.S. Trade Deficit Sustainable?*, Institute for International Economics (Washington, D.C.), 1999.

⁹⁶ A similar point is made in item 1.2 of the “Document of the Portuguese Presidency of the European Union” (Lisbon), January 2000. This document was prepared for the Lisbon European Council special summit to be held on 23-24 March 2000 and outlines the strategic goals of future EU policy.

⁹⁷ Consensus Economics Inc., *Consensus Forecasts* (London), 13 March 2000.

⁹⁸ ECB, *Monthly Report*, December 1999, p. 6.

⁹⁹ Cyprus, as a member of the Commonwealth, had free access to the United Kingdom market, which accounted for some 65 per cent of its total agricultural exports in the early 1970s.

TABLE 2.3.1

Comparison of economic indicators for Cyprus and Malta, 1998

	Cyprus	Malta
Population (millions)	0.75	0.38
Area (sq. km)	9 251	316
GDP per capita (EU=100)		
At current dollars	63.8 ^a	42.7
At current PPPs	78.5 ^a	..
Degree of openness ^b	47.7	90.8

Source: National statistics; Eurostat; OECD.

^a Excluding the economy in the northern part of the island.

^b Arithmetic average of imports and exports of goods and services as a per cent of GDP.

settlement for the Cyprus problem.¹⁰⁰ The Helsinki European Council of December 1999, which also accepted Turkey as a candidate for EU membership, appears to have removed such a settlement as a precondition for Cyprus' EU accession. But it is expected that "progress towards accession and towards a just and viable solution of the Cyprus problem will naturally reinforce each other."¹⁰¹

In the case of Malta, a change of government in 1996 led to the suspension of the application for EU membership which had been made in 1990. A subsequent change in government, following early elections in September 1998, led to a revival of Malta's application in February 1999. The Helsinki European Council of December 1999 approved the opening of accession negotiations also with the so-called "second-wave" candidates including Malta. These negotiations started in February 2000.

It is too early to speculate on the timing of accession, which also depends on progress with internal reforms of the European Union itself, but both countries hope to join in early 2003. The main economic benefits expected from EU membership are that the free movement of goods and services and the associated competitive pressures will lead to a more efficient allocation of resources and that increased inflows of FDI will help to accelerate the development of the economies. Evidently, European Union structural funding, e.g. for the improvement of the physical infrastructure and human capital formation is also expected to promote economic development.

¹⁰⁰ In response to the invitation of the United Nations Secretary-General, the political representatives of the Greek Cypriots and the Turkish Cypriots started so-called proximity talks in December 1999, which are expected to be resumed in May 2000. The objective is "to prepare the ground for meaningful negotiations leading to a comprehensive settlement". United Nations Security Council, *Report of the Secretary-General on the United Nations Operations in Cyprus* (for the period from 10 June to 29 November 1999), S/1999/1203, 29 November 1999, item 15.

¹⁰¹ European Commission, "1999 regular report from the Commission on Cyprus' progress towards accession" (Brussels), p. 15.

The purpose of this short note is to provide a brief overview of the economic structures of these small economies, the main current economic problems and some of the adjustment problems associated with EU accession.

(i) Cyprus

Cyprus has achieved rapid economic growth almost throughout the entire period 1960-1999, but the main driving forces behind this performance have changed over time. At the time of independence in 1960, the economy was largely dependent on agriculture. In the 1970s and the early 1980s the manufacturing sector was the main engine of growth. This largely reflected the expansion of labour-intensive industries, which benefited from comparative cost advantages. In the late 1970s the manufacturing sector accounted for about 20 per cent of total output, twice the share of agriculture. During the 1980s and 1990s, tourism and other services, notably finance and business services, became the main source of economic growth, resulting in declining shares of both the primary and secondary sectors in total output. Thus, manufacturing accounted for only some 10 per cent of gross value added in 1998, about the same as restaurants and hotels and only about half the share of finance and other business services (table 2.3.2).

In fact, since the mid-1970s Cyprus has become an offshore centre for many companies, mainly from Europe, that provide financial, legal, accounting, maritime and other services, and which have been attracted by favourable tax treatment. The revenues generated by offshore companies have risen rapidly during the 1990s and corresponded to some 4.5 per cent of GDP in 1998. The tourist industry has also expanded rapidly since the mid-1970s, becoming a major source of economic growth. The share of this sector (hotels and restaurants) in GDP does not fully reflect its significant impact on activity in other sectors, notably construction, retail and wholesale trade, and communications. Including these indirect effects, tourism accounted for some 20 per cent of GDP and 15 per cent of total employment in 1998. The tourist industry faces fierce price competition from other Mediterranean countries and efforts are being made by the government to cope with these problems, *inter alia*, by upgrading tourist services.

Cyprus and the EU (EEC) signed a Customs Union agreement in 1987, which covered 80 per cent of their trade. In the first phase (1988-1997) there was a gradual abolition of Cypriot duties and quantitative restrictions on industrial products originating in the EU, with exceptions for some sensitive products.¹⁰² Cyprus also adopted the Common External Tariff for the same products covered by the agreement. EU duties on a number of agricultural products (mainly fruit and vegetables) originating in

¹⁰² The EEC abolished duties on industrial products originating in Cyprus in 1977.

TABLE 2.3.2

Cyprus: real gross value added by main economic activity,
1990 and 1998
(Percentage shares)

	1990	1998
Primary sector ^a	7.4	5.8
Secondary sector ^b	27.0	20.6
Manufacturing	15.0	10.9
Tertiary sector	53.0	60.2
Wholesale, retail trade	12.0	12.6
Restaurants, hotels	9.9	9.4
Transport, storage and communication	9.4	10.4
Finance, insurance, real estate, business services	16.0	19.8
Community, social and personal services	5.7	8.0
Government services	11.9	12.5
Total	100	100

Source: Statistics and Research Department, Ministry of Finance.

^a Agriculture, forestry, fishing, mining and quarrying.

^b Manufacturing, electricity, gas and water, construction.

TABLE 2.3.3

Cyprus: direction of merchandise trade, 1992 and 1998
(Percentage shares)

	Exports ^a		Imports	
	1992	1998	1992	1998
European Union	44.2	40.4	52.8	55.1
United Kingdom	20.8	15.5	11.3	11.4
Greece	9.5	10.4	6.8	8.2
Italy	1.9	1.0	9.7	9.4
Middle East	38.5	23.7	4.4	4.5
Eastern Europe	8.5	25.9	8.3	7.3
Other	8.8	9.9	34.5	35.1
United States	1.7	2.0	8.4	12.6
Total	100	100	100	100

Source: Statistics and Research Department, Ministry of Finance.

^a Includes re-exports and ship stores.

TABLE 2.3.4

Cyprus: macroeconomic indicators, 1995-1999

	1995	1996	1997	1998	1999
Real GDP ^a	6.1	2.0	2.5	5.0	4.5
Consumer prices ^a	2.6	2.9	3.6	2.2	1.7
Employment ^a	3.4	1.0	-0.2	1.2	0.8
Unemployment rate ^b	2.6	3.1	3.4	3.3	3.7
Current account balance ^c	-1.9	-5.3	-4.0	-6.6	-3.0
Government financial balance ^c	-1.0	-3.4	-5.3	-5.6	-5.0
Government debt ^c	51.7	53.3	57.7	60.1	62.1

Source: Statistics and Research Department, Ministry of Finance.

^a Percentage change over preceding year.

^b Per cent of civilian labour force.

^c Per cent of GDP.

Cyprus were gradually abolished during the first phase. During a second phase (1998-2001/2002) it was planned to eliminate all remaining restrictions and that Cyprus would join the Common Agricultural Policy. These

matters have now become part of the accession negotiations with the EU.

The expansion of services was associated with large increases in labour costs throughout the economy,¹⁰³ which eroded the competitiveness of the low productivity, labour-intensive manufacturing industries (notably textiles, clothing and leather) as well as agriculture. Competitive pressures facing the manufacturing sector have intensified with the completion of the first phase of the Customs Union and the improved price competitiveness of Asian products and exports of manufacturing goods were on a declining trend during the 1990s. In the face of the poor performance of the manufacturing sector, the government has recently adopted a framework for a new industrial policy, which involves, *inter alia*, incentive schemes to promote the development of high-tech industries, to attract FDI and, more generally, to improve the export competitiveness of domestic firms.

The European Union is the main trading partner of Cyprus, accounting for some 40 per cent of exports and 55 per cent of imports in 1998 (table 2.3.3). Within the EU, the United Kingdom, Greece and Italy are not only the main destinations for exports but also the main sources of imports. The transition economies, especially Russia, have become quite important markets for exporters in the 1990s, the main counterpart to this being the declining relative importance of the Middle East. Re-exports¹⁰⁴ mainly carried out by "offshore" companies, accounted for some 60 per cent of total merchandise exports in 1998 and have been larger than domestic exports since 1993.

Cyprus' recent macroeconomic performance has been mixed (table 2.3.4). Following a marked slowdown in 1996-1997, economic growth picked up again, partly reflecting a fiscal stimulus. This boosted consumption and offset falling exports in 1998. Strong economic growth in 1999 was mainly due to an increase in tourism; the growth of consumption expenditures slowed down and fixed investment remained weak. Inflation has continued to fall to very low rates. Unemployment edged slightly upward on account of weak activity in agriculture and industry, but it is still relatively low.¹⁰⁵ The current account deficit rose to a high level of about 6.5 per cent of GDP in 1998, to a large extent the result of excess domestic demand and weak export competitiveness. Large surpluses on the invisibles balance were more than offset by sizeable merchandise trade deficits. The

¹⁰³ Wage bargaining in the various sectors has been strongly oriented to the average productivity gains for the whole economy as a basis for a minimum increase, in addition to automatic cost of living adjustments (COLA).

¹⁰⁴ The major goods traded in this category are alcoholic beverages, consumer electronic goods and cigarettes, which are destined for the Middle East and eastern Europe.

¹⁰⁵ The tight labour market, especially for some sectors of the economy, has attracted a growing number of foreign workers to Cyprus. It is estimated that their total number is about 30,000 (including legal and illegal workers), approximately 10 per cent of the labour force.

smaller deficit in 1999 reflects improved earnings from tourism and reduced import demand due to the weaker growth of consumption. There has also been a significant deterioration in government finances, mainly because of spending. Given the size of the budget deficit, the government has had to rely increasingly on foreign financing. The cumulative effect of large budget deficits is mirrored in a marked increase in public debt. The government has proposed a range of measures to restrain expenditure growth and to raise tax revenues in order to consolidate public finances and meet the Maastricht fiscal criteria. These measures were partly approved by parliament in late 1999, but a decision on the proposed increase in VAT,¹⁰⁶ the main potential source of additional revenue, is still pending.

Faced with large and rising external and domestic imbalances ("twin deficits") the central bank has tightened liquidity conditions. The scope for restrictive monetary policy, however, is restrained by the existence of an official ceiling of 9 per cent on the lending rate of commercial banks.¹⁰⁷ Given that actual lending rates were already at 8 per cent, the central bank decided to impose ceilings on private sector credit at the end of 1998.¹⁰⁸ But the target was missed, partly because the central bank does not have complete control over the large number of small cooperative credit institutions, which had a market share of 35 per cent in 1998. The exchange rate of the Cyprus pound has been pegged since 1992, first to the ECU and from the beginning of 1999 to the euro with a narrow fluctuation margin of $\pm 2\frac{1}{4}$ per cent. Tight capital controls have allowed monetary policy to support domestic demand in the past but the scope for this in the future is set to disappear with the abolition of controls.

There are a number of sensitive sectors of the economy that need special treatment during the course of negotiations, or require radical structural reform before accession to the EU. In general there is a need for technological and organizational upgrading and to enhance competitiveness across all sectors of the economy in order to contain adjustment costs. Considerable costs are also involved in the field of legislation and institutions, which have to be aligned to the *acquis communautaire*.¹⁰⁹ Of major economic importance will be the introduction of a unified tax rate for both the local and offshore activities. The abolition of the preferential tax treatment of the

offshore sector will not only affect the competitiveness of Cyprus in attracting such companies but could also have adverse repercussions on government revenues and other sectors of the economy. But there are, of course, other important reasons (geographical location, climate, quality of infrastructure and human capital), which also influence these location decisions. Other sectors that will require liberalization and harmonization are telecommunications, air transport and the cooperative sector. As regards the financial sector, plans are for capital controls to be completely abolished by 2002; and for interest rates to be liberalized from the beginning of 2001. Both measures will lead to intensified competition in the protected commercial banking sector.

*The economy of the Turkish Cypriot zone*¹¹⁰

In the northern part of Cyprus, the prevailing currency has been the Turkish lira since 1974, which has entailed that the high rate of Turkish inflation has spilled over to the region. Major export goods are citrus and clothing, and most of this trade is with Turkey. The main focus of recent economic policy has been to develop further the tourism sector. Some 80 per cent of tourists in recent years came from Turkey. GDP per capita amounted to about \$4,150 in 1998, compared with \$13,800 in the rest of the island. The public sector budget has been largely in deficit over the past 25 years, but has been financed by grants and credits from Turkey.

(ii) Malta

The Maltese economy is characterized by a dual nature, namely a protected domestic-oriented sector and an open export-oriented sector. The former sector comprises state and non-state controlled monopolies, particularly utilities, as well as small, mostly manufacturing firms, producing goods and services for the domestic market and the majority of which have so far been largely protected from external competition.¹¹¹ The export-oriented sector is composed mostly of manufacturing firms set up with foreign direct investment (FDI) as well as the tourist sector which is dominated by Maltese-owned capital and which over the years has acted as the motor of the Maltese economy. It may be surmised that the high level of protection of the domestic-oriented sector has probably diverted an important amount of resources from the export-oriented sector, and has thus limited economic growth.

The role of services in the economy has strengthened over time. Private market services accounted for some 33 per cent of total employment¹¹² in 1999, up from some 27 per cent in 1990 (table 2.3.5).

¹⁰⁶ The government proposed to raise the VAT rate from the current 8 per cent to 10 per cent, the medium-term target being to move gradually to the minimum standard rate of 15 per cent in the European Union.

¹⁰⁷ This ceiling was introduced by law in 1944.

¹⁰⁸ Another reasons for not raising interest rates could have been the anxieties of borrowers that the forthcoming financial liberalization would entail higher interest rates, an impression which the authorities may have not wanted to raise at this stage.

¹⁰⁹ The Planning Bureau estimates that the total cost to the Cypriot public sector of harmonization with the European Union (legislation, institutions and standards) may amount to a cumulative 13 per cent of GDP in 1999, corresponding to some 3 per cent of GDP per annum over the period 1999-2002. Only a small part of this will be financed by European Union funds designed to facilitate preparation for membership. Planning Bureau, *Economic Review* (Nicosia), 1998 (in Greek).

¹¹⁰ Nothing in this subsection should be deemed to imply any endorsement or acceptance by UN/ECE of any boundaries or political status other than those accepted by the United Nations.

¹¹¹ In 1989, the authorities replaced quantitative restrictions and outright bans on imports by a system of protective levies imposed in addition to customs duties.

¹¹² Data on GDP by main economic activity are only available at current prices.

TABLE 2.3.5

Malta: employment by economic sector, 1990 and 1998
(Percentage shares)

	1990	1998
Private sector	56.5	60.2
Agriculture, fisheries	2.5	1.8
Quarrying, construction, oil drilling	4.2	4.0
Manufacturing	22.9	21.4
Market services	26.9	33.0
of which:		
Wholesale, retail trade	10.1	11.1
Insurance and real estate	1.0	1.0
Hotels and catering establishments	5.8	6.3
Banks and financial institutions	–	1.3
Community and business services	4.0	7.1
Public sector	43.5	39.7
of which:		
General government	20.6	22.2
Companies with public majority shares	8.2	6.8
Temporary employees ^a	6.5	3.6
Total	100	100
<i>Memorandum item:</i>		
Number of persons employed	127 196	137 387

Source: Ministry for Economic Services, Economic Planning Division, *Economic Survey*, January-September 1999 (Malta), November 1999; direct communication from the Central Office of Statistics.

Note: Data refer to December of the corresponding year.

^a Apprentices and trainees, pupil workers, student workers.

This reflects both growth in the traditional Maltese service industry, particularly tourism and market services, and a steady expansion of “new” activities such as financial services, transshipment activities from the Malta Free Port and ship registration.

One of the growing service sectors is the Malta Free Port. Its main activities are transshipment, storage and blending of petroleum products, and storage and warehousing of commodities. Financial Services is another important sector that Malta is seeking to develop¹¹³ and which is fast becoming a growing source of income not only for the country but for a substantial number of professionals working in the legal and financial sectors. The importance of tourism for the Maltese economy is shown by the fact that in 1998, income from tourism amounted to 21.3 per cent of the value of exports of all goods and services while its share in total employment was 6.3 per cent. The multiplier effect of the sector on the rest of the economy is substantial.

The share of manufacturing activity in the economy has declined over the past decade (table 2.3.5). Within manufacturing, the importance of electrical and non-electrical machinery and rubber production has been on

¹¹³ The Malta International Business Authority was originally established in 1988 to encourage the development of an “offshore” financial centre. But the legal distinction between “on shore” and “off shore” was removed in 1994. The promotion and regulation of the domestic financial services and insurances sector was put under the responsibility of the Malta Financial Services Centre.

the increase. The ship repair and ship building sector continues to drain public finances, despite attempts over the past decade to restructure it.¹¹⁴ Overall this activity continues to make a negative contribution to GDP. Despite massive labour shedding over the past decade, the yards’ profitability has still not materialized. The shipbuilding and ship repair sectors in Malta have featured prominently in the European Commission’s reports on Malta’s membership application, particularly because the high level of state aid they receive conflicts with the EC’s competition rules. During the bilateral screening sessions with the Commission on Malta’s adoption of the *acquis communautaire*, the Maltese representatives have emphasized that when formal accession negotiations commence the government will be requesting special derogations from EU regulations for a transitional period after membership.¹¹⁵

The European Union is Malta’s most important trading partner.¹¹⁶ About half of total exports went to the EU in 1999, which, in turn, supplied nearly 70 per cent of its imports (table 2.3.6). Up to the beginning of the 1980s, clothing dominated Maltese exports, but since then the share of electronic goods has increased to become the leading export product. This change in the composition of exports also helps to explain the changes in the direction of trade – an increasing importance of markets in North America and Asia – that have occurred in the 1990s.

The Maltese economy has continued to enjoy rapid economic growth significantly above the west European average in recent years (table 2.3.7), but this performance masks a persistently weak rate of fixed investment. Private consumption was the mainstay of growth in 1999 and changes in real net exports made only a small positive contribution to growth. The inflation rate fell to 2.1 per cent in 1999, the lowest in the 1990s and at the same time the deficit on the current account continued to decline, although it is still quite high. Robust economic growth was accompanied by increased employment, but this was less than the increase in labour supply. As a result, the unemployment rate edged up to 5.3 per cent in 1999. For the past decade, the main challenge in the labour market has been the need to reduce public sector employment, which still accounted for some 40 per cent of total employment in 1999. Public sector employment increased markedly in the mid-1980s when the economy went into recession. The number of persons employed in this sector has started to fall only slowly since 1994.

¹¹⁴ The yards were nationalized in 1968 and handed over to workers’ control in 1975. Against the background of continued losses, the authorities put an end to workers’ self management in 1997 and passed legislation that ensured a government majority in decision-making.

¹¹⁵ Malta-EU Information Centre, *Press Statement*, 10 November 1999.

¹¹⁶ This is also reflected in the exchange rate policy. Since 1989, the Maltese lira has been pegged to a basket of currencies comprising the ECU (now the euro), the dollar and the pound sterling. The weight of the euro in this basket is 56.8 per cent, the remaining 43.2 per cent being equally shared between the two other currencies.

TABLE 2.3.6

Malta: direction of merchandise trade, 1990 and 1999
(Percentage share)

	Exports ^a		Imports	
	1990	1999 ^b	1990	1999 ^b
Europe	84.7	50.6	82.2	69.0
European Union	80.4	49.8	77.5	68.0
Italy	37.3	5.0	32.6	17.3
Germany	21.3	12.8	11.7	11.6
France	7.3	16.6	7.2	10.9
United Kingdom	9.6	8.5	14.9	19.1
Africa	5.8	3.3	3.6	2.5
America	3.9	22.2	4.7	9.8
Oceania	0.1	0.1	0.3	0.6
Asia	5.2	20.5	9.1	18.1
Other ^c	0.3	3.3	-	-
Total	100	100	100	100

Source: Ministry for Economic Services, Economic Planning Division, *Economic Survey*, January-September 1999 (Malta), November 1999.

^a Domestic exports.

^b January-September.

^c Ships and aircraft.

TABLE 2.3.7

Malta: macroeconomic indicators, 1995-1999

	1995	1996	1997	1998	1999
Real GDP ^a	6.2	4.0	4.8	3.1	4.8
Consumer prices ^a	4.0	2.5	3.2	2.2	2.1
Employment ^a	3.8	1.0	0.5	0.4	0.8
Unemployment rate ^b	3.7	4.4	5.0	5.1	5.3
Current account balance ^c	-11.0	-10.7	-6.1	-5.6	-3.5
Government financial balance ^c	-3.1	-9.2	-10.0	-12.0	-8.6
Government debt ^c	66	73	79	80	..

Source: Ministry for Economic Services, Economic Planning Division, *Economic Survey*, January-September 1999 (Malta), November 1999.

^a Percentage change over preceding year.

^b Per cent of civil labour force.

^c Per cent of GDP.

A matter of concern in recent years has been the deterioration of public sector finances. The government budget deficit amounted to some 12 per cent of GDP in 1998. Fiscal measures to raise revenue and curb expenditure led to a reduction in the deficit to some 8.5 per cent of GDP in 1999 (table 2.3.7). Government debt¹¹⁷ rose to a level corresponding to 80 per cent of GDP in 1998. The root causes of the crisis in the public finances can be identified on both the revenue and expenditure sides of the balance. On the expenditure side, state aids and subsidies to non-competitive, state-controlled industries, particularly ship-repair and ship-building, an excessively large government sector, a growing social security deficit, and the inadequate cost-effectiveness of government financed works, have all taken their toll. Due to overemployment in the public sector, wage increases for

¹¹⁷ Including the debt of the non-financial public institutions controlled by the governments.

government employees lead immediately to significant increases in government spending. On the revenue side, tax evasion is the most important problem, although controls are gradually becoming more stringent. Another important problem is that of uncollected tax arrears, largely reflecting disputes about tax assessments. These arrears corresponded to some Lm162 million (or 10 per cent of GDP) at the end of 1998. Only about one third of this figure is considered recoverable by the Inland Revenue Department.¹¹⁸ The government has introduced a number of austerity measures (increases in direct and indirect taxes) in the budget for 2000 designed to support the required consolidation of public finances, but the main task remains to address the structural problems on the expenditure side. The current target is to reduce the budget deficit to 3.9 per cent of GDP by 2004.

The revival of Malta's EU membership application has accentuated the need for the restructuring of the protected, domestic-oriented manufacturing industries. This process is now in full swing. From October 1999, Malta began to remove the remaining trade barriers, an exercise planned to be completed by 2003. The government provides financial aid for the restructuring process through the Institute for the Promotion of Small Enterprises created in 1997. Part of the proceeds from the privatization programme were also used for this purpose. EU membership will also require liberalization outside the manufacturing sector, for example, in telecommunications. These developments will certainly provide the economy with a shake-up which should result in more competitive pricing as the monopolies and captive markets make way to a competitive environment. A privatization programme began in 1988, but it was sporadic and with no apparent plan of what its aims were or how it was to be executed. The publication of a white paper at the end of 1999 has been instrumental in narrowing the focus and discussion of this important aspect of economic policy.¹¹⁹ Restructuring and privatization will certainly have adverse consequences in the labour market in the short and medium term unless economic growth accelerates to take up the slack.

Privatization, the opening up of the economy and the preparations for EU membership (and for the earlier envisaged free trade area) have also led to the expansion of a regulatory framework to ensure adequate supervision and monitoring of markets. This has also involved the setting up of a number of new institutions, *inter alia*, to regulate the competition law, to promote industrial development, to ensure a better utilization of Malta's limited land space and to enhance the protection of the environment. The powers of the central bank have been gradually increased, making it more independent from direct government control. There is also an institutional forum for consultations between trade unions and employers on industrial relations and wages and incomes policy.

¹¹⁸ Department of Information, *Auditor General's Report for 1998* (Malta), p. 120.

¹¹⁹ Among the major entities earmarked for privatization in the immediate future are the Malta International Airport and the Malta Free Port (Operating Company).