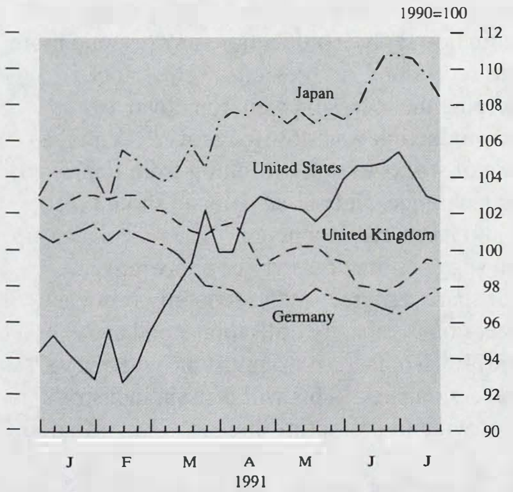
The international environment

- *There is mounting evidence that the North American economies have begun to recover. Following a strong performance in the first quarter of the year, activity growth in Japan and Germany has slowed. Elsewhere in Europe activity remains subdued.*
- *Currency movements have been less dramatic than in the first quarter of the year, although the US dollar continued to appreciate against the EMS currencies during the second quarter. The yen, after falling from the recent peak in February, averaged around its end-March level against the dollar over the second quarter of the year, and strengthened in effective terms, reflecting deutschemark weakness. In July, the US dollar and the yen depreciated in effective terms, while the major ERM currencies strengthened.*
- *Inflation has fallen in the United States and Japan, while inflationary pressures have intensified in Germany.*
- *The US trade deficit narrowed, while Japan's external sector continued to perform strongly. Unification has pushed the German trade account into deficit.*

The divergence in the rates of growth of the major overseas economies has begun to narrow. There is mounting evidence of recovery in the United States and Canada, while growth in Japan and Germany, which had been very strong in the first quarter, has since slowed—though it is nevertheless expected to remain robust over 1991 as a whole. Elsewhere in Europe, economic activity remains weak. Inflation fell in the second quarter in the United States and Japan, while inflationary pressures eased in Canada. In Europe, inflation picked up in Germany, Italy and Spain but was little changed in France.

Effective exchange rates



Currency movements are less dramatic *following the US dollar's strengthening in the first quarter*

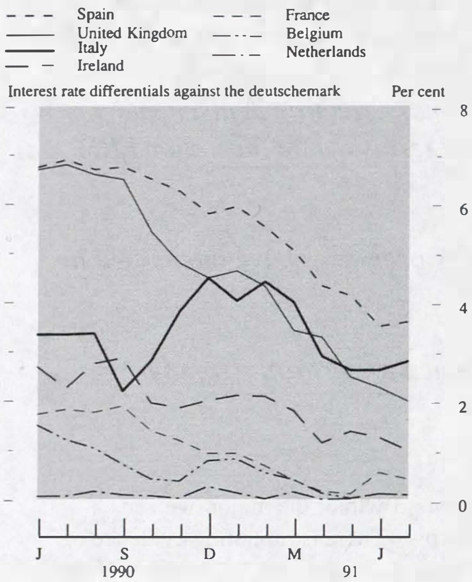
In contrast to the strengthening of the US dollar seen in the first quarter, currency movements in the second quarter were less dramatic. The dollar appreciated against the EMS currencies, as evidence mounted of a recovery in the United States, giving rise to expectations first that the fall in US interest rates had come to an end, and second that US interest rates might rise before long. The dollar was largely unchanged against the yen and fell marginally against the Canadian dollar. The yen gained against the deutschemark, supported by continued tight monetary policy and Japan's position as the only major country running a substantial current account surplus. The yen was little affected by the long anticipated cut in the Official Discount Rate at the beginning of July. Later in the month, the yen and the US dollar depreciated in effective terms, while the major ERM currencies strengthened. Interest rate cuts in Italy and Spain during May, in the United Kingdom in May and July, and in Ireland in July led to a narrowing of interest differentials within the ERM. The issue of convergence in the European Community is considered in greater detail in the note on page 328.

North American economies *are beginning to* **recover**, *while growth in* **Japan and Germany** *has* **slowed**

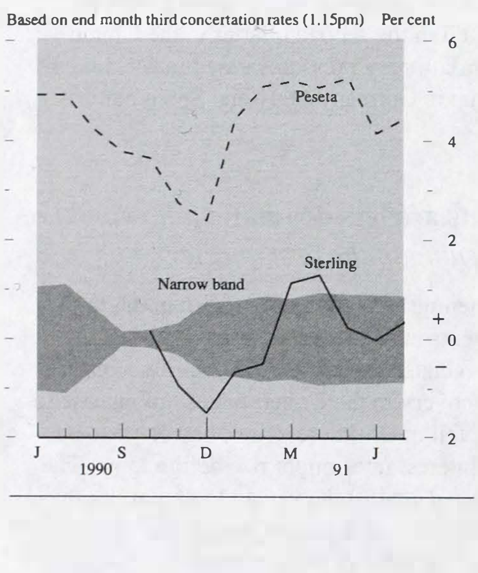
Most activity indicators confirm that the recovery in the United States has begun. While first signs appeared in the housing sector, the business sector has subsequently picked up. In June, the National Association of Purchasing Managers' index rose above the 50% mark that is generally indicative of an expansion in the manufacturing sector, as well as the economy as a whole, and industrial production has risen in recent months. Increases in the production of motor vehicles and parts have underpinned the recent rises in industrial production, and employment has risen in the automobile and construction industries. These sectors were the first to turn down and have been important in leading the economy out of past recessions. The fall in employment in general appears to have ceased, and the length of the average factory working week and the number of overtime hours worked both increased in May and June.

Given the recovery suggested by these indicators, the advance real GNP data—showing a rise of just 0.1% in the second quarter—were much weaker than expected. However, the GNP data understate the strength of domestic demand which is estimated to have risen by around 0.6% in the quarter. The major contributors to growth were private consumption (which accounts for around 60% of GNP, and grew by 0.9%) and housing investment (which also increased by 0.9%), consistent with recent indicators which pointed to a pick-up in these interest-sensitive areas of activity. Business investment declined but to a much lesser degree than in the first quarter, and the inventory rundown continued. The weaker than expected growth in real GNP was primarily owing to a 4.9% surge in imports, about half of which can be attributed to higher oil imports. However, the GNP figures may be revised in subsequent estimates.

ERM interest rate differentials narrow against the deutschemark



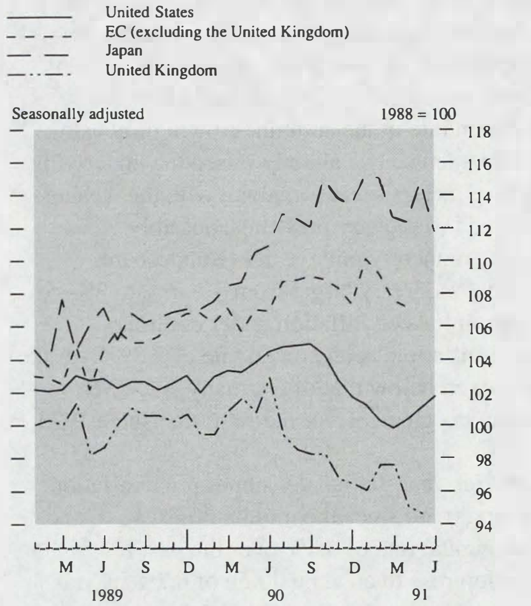
ERM positions



In the post-war period, growth has generally picked up rapidly during the recovery phase in the United States, averaging 6.7% in the first year after the recession. Such rapid growth is unlikely to be achieved this time since consumption and investment growth are likely to be limited by an unwillingness either to increase already high levels of indebtedness or to run down savings ratios further, and by cautious bank lending. Nevertheless, a rise in personal income over the second quarter has led to an increase in consumer spending, and as consumption revives production may respond more quickly than in previous recessions. In previous cycles, stocks involuntarily built up during the recession were run down as demand picked up, and production was slow to recover. With the trend decline in the ratio of stocks to sales, resulting from improved inventory management techniques, increased demand should feed through more quickly into increased production. The recent pick-up in industrial production suggests that this may be happening. However, the margin of spare resources in the economy is not as great as in previous recessions: capacity utilisation stood at 79.3% in June, compared with 71.8% in the last trough at the end of 1982 and 84.3% at the pre-recession peak. This will restrain industry's ability to increase output without prompting an increase in inflation.

First quarter GNP data showed that activity was surprisingly robust in Japan, reflecting strong business investment and an improvement in the external sector. Indicators of activity point to slower growth in the second quarter. Continued tight monetary policy has led to a weakening in personal expenditure, with real household spending in May only marginally up on a year earlier and housing starts substantially below levels recorded at the same time last year. Growth of Japan's broad measure of money stock slowed to a record low of 3.6% over the year to May, before rising slightly to 3.7% in June. The Bank of Japan believes that the money supply is still sufficient for the level of activity. On the corporate side, the Bank of Japan's survey of business expectations, published in June, pointed to an easing of inflationary pressures and a further deterioration in current business conditions. Profits are likely to have declined in the first half of 1991 but are expected to recover in the second half. Growth of capital expenditure is expected to fall to single figures over 1991 as a whole following double digit growth in each of the previous three years.

Industrial production *rises in the* **United States** *but trends lower in* **Japan** *and* **Europe**



The western German economy grew very strongly in the first quarter of the year but latest indicators suggest growth may have slowed since then. Industrial production edged down in April and May, depressed by weaker construction activity, and growth of manufacturing orders has been slowing. However, employment continues to rise and import growth, though moderating, remains strong. Retail sales have risen only slightly in real terms since the one-off boost resulting from unification in July last year, and higher indirect taxes, which came into effect in July this year, can be expected to depress consumer demand further. More significantly, the strong boost from unification is receding, and although public sector expenditures in the east—investment in particular—will continue to fuel demand in Germany as a whole, the tax increases will partly offset this. In eastern Germany, output appears to have steadied in recent months and expectations of a sustained recovery starting around the end of the year have firmed. However, employment prospects remain poor.

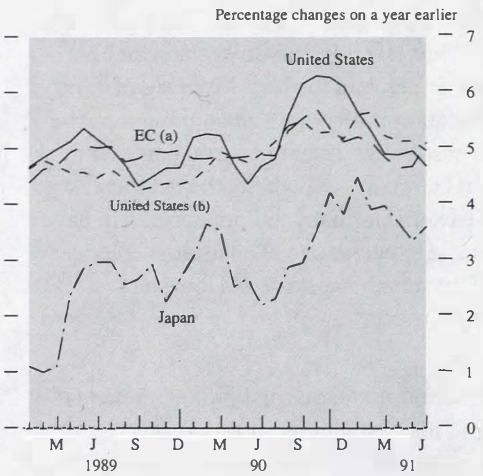
Following a slight fall in the fourth quarter of 1990, marketed GDP was unchanged in France in the first quarter of this year: consumption growth and increased stockbuilding were offset by declining exports. While unification has boosted exports to Germany, weaker activity elsewhere in Europe appears to have offset this. Depressed activity continues to translate into higher unemployment, with the unemployment rate rising to 9.4% of the workforce in June. Continued budgetary restraint, with the automatic stabilisers being partly offset by discretionary tightening, is expected to slow the recovery process.

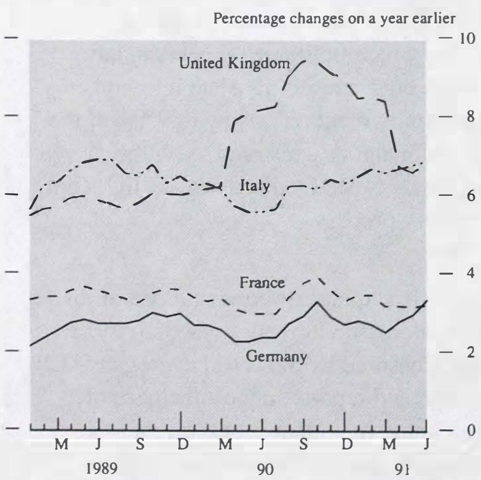
In Italy, real GNP data for the first quarter, showing a rise of just 0.3%, confirmed earlier indicators of relatively weak activity. In Spain, monetary growth (as measured by the broad aggregate ALP) remains above the target range and reports suggest the pace of economic growth picked up in the first quarter of the year, threatening to revive inflationary and current account pressures. At this stage, the main strength looks to have come from non-durable consumption expenditures, while industrial production weakened. In Canada, GDP recorded a further sharp decline in the first quarter of this year (the fourth consecutive quarterly fall), but there are now many signs of recovery. The housing sector has picked up sharply and the monthly production based GDP report shows that real GDP in May was 1.6% above its January trough.

Inflation *falls in the* **United States and Japan,** *while* **inflationary pressures** *intensify in* **Germany**

Consumer price inflation in the United States has receded from the peak rate recorded after last year's rise in the oil price and, at an annual rate of 4.7% in June, is now below the 5% average level of 1989 and the first half of 1990. Although the pace of inflation has slowed considerably over recent months, largely reflecting falling energy prices, the core rate, excluding food and energy, remains stuck around 5%. Subdued wage growth and the dollar's appreciation may point to further falls in inflation, but the extent to which this is later reversed could depend on how rapidly domestic demand picks up. Japan's headline inflation rate rose in June, to 3.6% at an annual rate, but the core rate—excluding food in this case—remained around 3%. Headline inflation has come down from its peak of 4.5% over the year to January, and pressures in the labour market have eased. The unemployment rate remains a little above 2%, while the number of applicants per available position has fallen and wage gains have been moderate.

Consumer price inflation *eases in the* **United States** *and* **Japan,** *while* **German** *inflation has boosted the European average*





(a) Including United Kingdom.
(b) Excluding food and energy.

Consumer price inflation in Germany has been rising steadily since March, and in June stood at an annual rate of 3.5%. Indirect tax increases largely accounted for the rise in the inflation rate to 4.5% in July. Although oil price movements last year are likely to depress the annual inflation rate in the autumn, growth of housing costs and higher pay settlements have already raised the underlying rate of inflation, and these factors seem set, along with the weaker deutschemark, to maintain inflationary pressures, possibly prompting a tightening of monetary policy. The Bundesbank recently tightened its 1991 monetary target from 4%–6% to 3%–5%, signalling its determination to keep inflation under control. France's consumer price inflation, at an annual rate of 3.3% over the year to June, has now moved below that of Germany, even before the impact of the German tax changes, for the first time since 1973.

Despite lower oil prices this year, Italian consumer price inflation has been on a gently rising trend since the middle of last year, and has averaged around an annual rate of 6.8% over the past few months. In Spain, inflation rose to an annual rate of 6.2% in May, after recording 5.9% in each of the previous three months, and remained at this level in June. Higher food prices largely accounted for the rise, and underlying inflation, excluding food and energy, eased further. In both countries, services sector prices continue to provide the main impetus to overall inflation. Consumer prices in Canada grew by 6.3% over the year to June, but the annual rate of inflation overstates markedly the extent of inflationary pressures in the economy, owing to the 2.6% jump in the level of the index in January, caused largely by the introduction of the Goods and Services Tax. Over the latest three month period, consumer prices have grown at an annualised rate of only 2.9%.

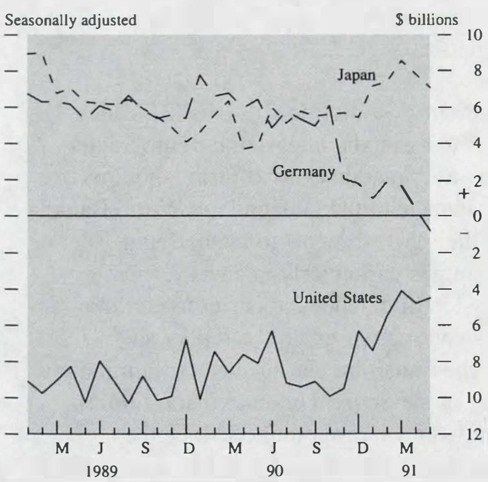
At present, there appear to be few significant upward pressures on producer prices, although there is some evidence that non-oil commodity prices may be around their trough. Metals prices fell again over the second quarter in SDR terms as stocks of many metals remained high, but some limited recovery may occur later in the year as world activity picks up. The price of agricultural non-food products rose in the second quarter, and this may be partly associated with higher motor vehicle production and increased construction activity in the United States. Oil prices were relatively stable during the second quarter as demand and supply were balanced. Future prices will depend to some extent on the lifting of sanctions on Iraqi oil exports.

The United States' **trade performance** *improves, while Japan's trade surplus grows; Germany's trade account moves into deficit*

Weaker domestic demand and competitiveness gains from earlier exchange rate movements reduced the merchandise trade deficit in the United States to $4.1 billion in March, the lowest level since 1983. However, growing demand for capital goods and industrial supplies, linked to the increase in industrial production, and a return to the level of petroleum imports common before the Gulf war, widened the deficit slightly to $4.6 billion in May (although this is still below the first quarter average). Increased imports, resulting from the dollar's appreciation and the prospective recovery, could cause the deficit to widen further. Japan's external sector continued to perform strongly. As the surplus with the United States has narrowed, Japanese companies have increased exports to Europe and South-East Asia. This trend could give rise to renewed protectionist sentiment in Europe.

Bilateral trade flows indicate the importance of intra-community trade in the European Community and, in particular, show the benefit to other EC countries from the boost to German imports following unification. While the United States and Japan did not appear to gain so much during the second half of last year as the rest of the EC (partly as a result of valuation effects due to the relative strength of the deutschemark), imports from the United States and Japan picked up in the first quarter. Rising imports sharply reduced the surplus on Germany's trade account during 1990, and the all-German trade account moved into deficit in May this year. However, the deficit disguises the fact that a significant amount of western German output is being diverted to the east rather than to overseas markets. Elsewhere in Europe, there are signs that the impetus German growth has given to exports may have peaked. In France, there was a surplus on trade with Germany in April for the first time in twenty years, and available data point to a narrowing of the overall trade deficit in the second quarter. In Italy, the trade deficit widened in the second quarter, compared with the same period a year earlier, largely as a result of stronger than expected import growth. At the same time, Spain's trade deficit improved; while exports did not rise as much as expected, import growth was weaker than expected. Canada's trade surplus fell sharply in January, affected by the introduction of the Goods and Services Tax. The surplus has since risen, and in recent months has fluctuated around the average level over the past year.

The **German trade account** *moves into deficit, while the* **US trade deficit** *narrows and the* **Japanese surplus** *remains strong*



Current account *data are distorted by Gulf-related transfers*

One of the prime determinants of the current account balance is the trade balance, but transfers related to the Gulf crisis continue to have a significant impact on current account data in the major economies. Contributions made to the United States moved the US current account from a deficit of $23.4 billion in the final quarter of 1990 to a surplus of $10.2 billion in the first quarter of this year. Excluding Gulf transfers, the deficit narrowed from $27.8 billion to $12.5 billion. Germany's current account slipped into deficit in January and deteriorated sharply in March (to a deficit of

DM 5.3 billion) reflecting Gulf-related payments to the United States. The surplus on the Japanese current account returned to its February level in May following larger surpluses in March and April. The decline in the surplus stemmed from the re-emergence of a deficit on the invisibles account as special factors such as the repatriation of profits for fiscal year 1990 accounting purposes faded. In the process of seasonally adjusting the Japanese current account data, the effect of Gulf-related transfers to the United States in March was smoothed out. France's current account deficit has narrowed in recent months in line with the improved trade performance, while the widening current account deficit in Italy and Spain has largely resulted from growth of interest payments on foreign-held debt.

Economic conditions in the **Soviet Union** *deteriorate*

In 1990 a downturn in all principal economic indicators in the Soviet Union was recorded for the first time since World War II. This deterioration accelerated in the first half of 1991: industrial output is estimated to be 6.2% below the level recorded in the same period last year; the budget deficit in the first quarter exceeded the target for the year as a whole; and the growth of the money supply increased, leading to the possibility of much higher inflation.

The decline in the economy, which stems from the collapse of the central planning system, has made radical reform, encompassing both macro-economic stabilisation and structural reform, more urgent. The task of transforming the Soviet economy to a market economy is enormous given the size of the economy, the unfamiliarity with market mechanisms and the limited nature of reform measures taken to date.

Following the London Economic Summit in July, the G7 leaders confirmed their willingness to assist the integration of the Soviet Union into the world economy. In addition to offering the Soviet Union a special associate status with the IMF and the World Bank, the G7 leaders committed their governments to intensifying technical assistance programmes particularly in energy, food distribution and the conversion of defence industries to civilian output. However, while Western governments can play an important role in assisting the transition, the success will ultimately depend on the commitment of the Soviet Union to market reform. Critical to the success of any reform programme will be the clarification, in the form of a new Union treaty, of the constitutional relationship and allocation of economic powers between the Union and the Republics.

Economic reform *and* **debt reduction** *bring benefits to some economies*

At a time when the Soviet Union, several East European countries and India are encountering external payments difficulties, other developing countries, such as Chile and Mexico, which have made considerable progress in reforming their economies, are beginning to regain access to world capital markets. A number of international bond and equity issues have been successfully floated by the private sector. Yields demanded by investors (the latter include residents of the borrowing countries) are high, reflecting a caution bred by nearly a decade of debt problems. However, high borrowing costs will ration demand. Countries which have negotiated a reduction in excessive external debt burdens and have created a domestic economic structure where there is the prospect that returns on new investment will comfortably exceed financing costs are likely to be more successful in securing access to financial markets. While low levels of domestic investment over the past decade suggest that the potential returns on new investment should be high, the risks remain significant.

Debt reduction operations have contributed to economic and financial recovery in Chile and Mexico. In recognition of the disincentives to reform and new investment posed by excessive external debt burdens, bilateral official creditors (the Paris Club) have agreed to write off 50% (in present value terms) of the debt service obligations of Poland and Egypt. The agreements are, however, to be phased in, and are contingent on satisfactory performance under IMF adjustment programmes and, in Poland's case in particular, matching concessions by banks and other creditors. The London Economic Summit noted that these arrangements should be treated as exceptional cases. The summit also recognised that the poorest, most indebted, countries need very special terms. They agreed on the need for additional debt relief measures, on a case by case basis, going well beyond the relief already granted under Toronto terms. The Summit therefore called on the Paris Club to continue its discussion on how these measures could best be implemented promptly.

Brazil, at odds with its creditors for some time, has now negotiated an arrangement for the clearance of its interest arrears to the banks. Progress in talks to restructure the main body of its bank debt will be a pre-condition for a further IMF agreement.

Convergence in the European Community

Introduction

A high degree of convergence in the economic performances of member states is an essential prerequisite for a move to full economic and monetary union (EMU) in Europe. The potential costs of premature monetary union would be the heavy burdens of adjustment—both to initial differences and subsequent shocks—placed on the real economies of a number of member states, when neither interest rate differentials nor exchange rates would be in a position to adjust.

As the negotiations over EMU have progressed, widespread accord has emerged *at a high level of generality* over the nature of this convergence, although there remains some ambiguity at a more detailed level. Member countries have declared themselves in favour of movement towards EMU being subject to the fulfilment of objective convergence criteria rather than being subject to a predetermined timetable. The principal indicators which have been suggested as criteria of convergence are inflation, interest rates and fiscal positions.

This note outlines the degree of convergence achieved to date on these criteria among the members of the EC, and also discusses the issue of sustainability of convergence. It should be borne in mind, however, that a single statistical measure may not necessarily provide an unambiguous indication of whether or not a particular criterion for convergence has been satisfied; and that many of the statistics themselves are subject to a number of definitional and measurement ambiguities not addressed here.

Nominal convergence

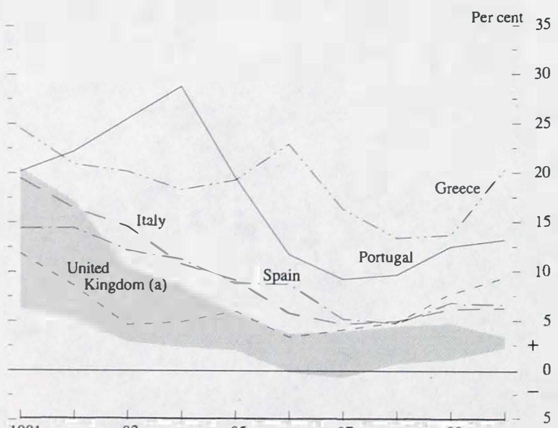
Perhaps the principal aspect of convergence is convergence in inflation rates, without which individual member countries of a monetary union could be exposed to increasing competitiveness problems and, in consequence, output and employment losses. Chart 1a depicts annual consumer price inflation in EC member countries, although this is only one of a number of price series which could be considered. The contraction of the shaded strip in the chart (to around 1.1% in 1990 on an annual average basis) gives *prima facie* evidence of convergence among the original members of the narrow band of the ERM. More recent data, however, suggest there to have been little further progress on convergence over the past twelve months (Chart 1b). Furthermore, inflation rates have tended to increase recently in a number of countries, a development which is incompatible with the objective of convergence on a low rate of inflation.

A second aspect of convergence is short-term interest rates. A monetary union implies a single monetary policy and identical interest rates: but in the *transition* to a monetary union, divergence in monetary policies—and hence interest rates—may be necessary in order to bring about convergence of economic performance. Chart 2a shows the path of interest rates over the past ten years, and the general edging upwards in rates over recent years. Any differentials among interest rates in the EC resulting from capital controls have largely disappeared. Thus, the differentials which remain reflect the aforementioned divergences in policy, together with expectations of currency devaluations associated with factors such as a poor history of inflation performance. The

Chart 1
Consumer price inflation

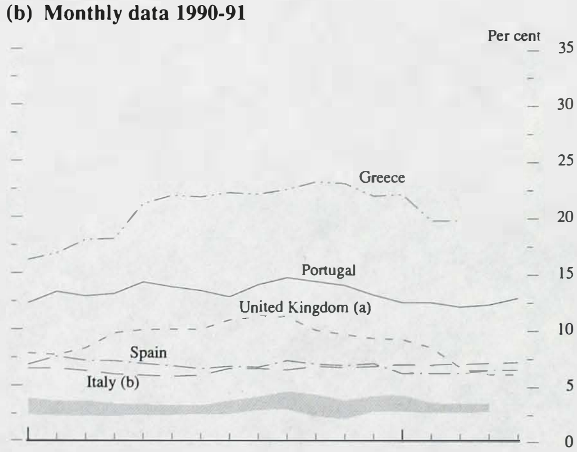
Original narrow band members

(a) Annual data 1981-90



(a) UK figures are the headline retail price index.

(b) Monthly data 1990-91

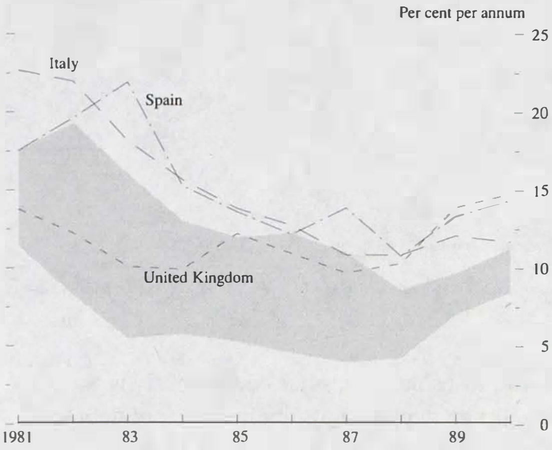


(a) UK figures are the headline retail price index.
(b) Italian figures are the headline cost-of living index.

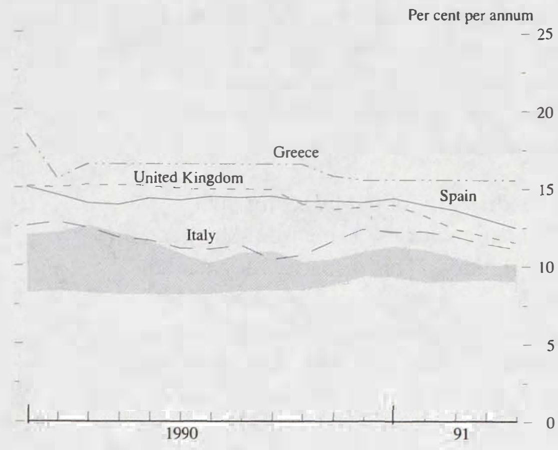
Chart 2
Short-term interest rates (a)

Original narrow band members.

(a) Annual data 1981-90



(b) Monthly data 1990-91



(a) Three-month eurocurrency rates.

hitherto more divergent member countries will need to overcome these risk factors, in particular by developing increasingly credible commitments to the ERM and enhancing the reputations for a firm counterinflationary stance.

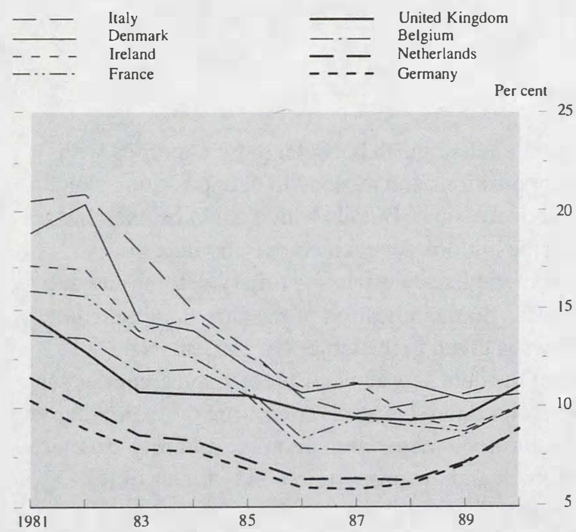
It should be noted furthermore that a narrowing of interest rate differentials over a short period is not a sufficient condition for convergence. This is because short-term interest rates embody the markets' perception of convergence based heavily upon expectations of exchange rate changes. If the authorities are perceived as being committed to maintaining exchange rates in the short run irrespective of the cost of this strategy, then short-term interest rate convergence may not be indicative of convergence in a more fundamental sense and is not in itself a sufficient convergence criterion.

Sustainability

The drifting apart in inflation rates of narrow band members towards the end of last year, following a period of apparently successful convergence, suggests the need for supplementary criteria to judge whether convergence is sustainable. One test would be to require that inflation and interest rates should be within a certain range over a number of years. This would enable some allowance to be made for countries being at different stages in the economic cycle, which could result otherwise in their exhibiting apparent convergence as their paths cross. In addition, there is broad agreement among member states that those countries wishing to move to full monetary union should have demonstrated their ability to remain within the narrow band of the ERM for a reasonable period of time.

Further indicators of sustainability include factors which may act as precursors of *future* inflationary pressures. In this context, convergence requirements could be attached to long-term as well as short-term interest rates. Chart 3 shows the extent to which government bond yields have converged over the past decade. The fulfilment of convergence requirements for long-term interest rates would provide some grounds for expecting that differentials in short-term interest rates would not re-emerge in the future. In fact, the marked convergence in short-term rates during the first half of this year (shown in Chart 2b) has not been matched by a convergence in long-term rates, suggesting that there may indeed be a degree of doubt about the robustness of the convergence in inflation and short-term interest rates. Such doubt in part reflects the substantial disparities which persist in public sector debt burdens and budget deficits (discussed below), and the potential policy problems emanating from them. More generally, it may reflect the market's assessment of the likelihood that a government will become unwilling—perhaps because of increasingly severe unemployment—to continue resisting inflationary pressures. There are concerns, however, that progress towards full

Chart 3
Bond yields

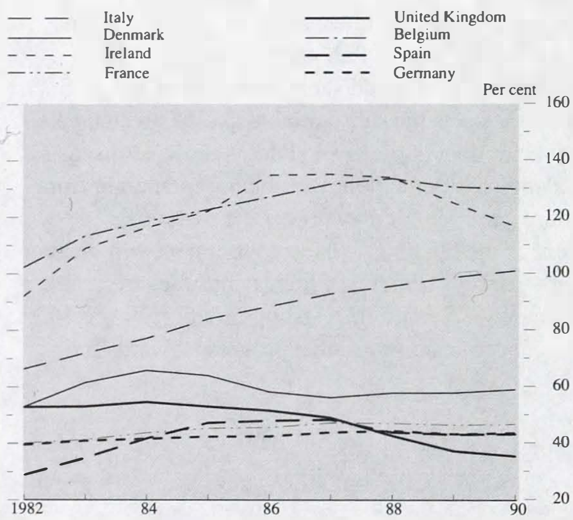


Source: *International Financial Statistics.*

monetary union could lead to the elimination of long-term interest rate differentials for inappropriate reasons. Bond yield differentials should, for reasons of market discipline, persist in a situation of closer union to reflect national governments' differing default risks, and the concern is that the differentials might be eliminated if markets believed that individual countries in extreme difficulties would be bailed out by other member countries. Indeed, the proposed inclusion of a 'no bail out' condition in the Treaty of Rome is intended to counteract these concerns.

Chart 4 illustrates the disparity of public sector debt positions across member countries, as measured by general government debt/GDP ratios. This disparity may tend to create internal tensions, both by generating concerns about crowding-out by less moderate states and also perhaps by increasing the pressure for fiscal transfers. It is by no means clear, however, that full convergence of fiscal positions would be necessary to defuse these tensions; rather, the essential requirement is that no country has a debt/GDP ratio which is excessive, in the sense of being unsustainable. Potentially unsustainable debt positions may threaten to undermine monetary policy discipline and thereby impose upward pressure on inflation; thus, the risk of unsustainability alone may have its costs.

Chart 4
Debt-to-GDP ratios



Source: *OECD Economic Outlook*.

It is important to distinguish between those countries with unstable debt positions and those with debt positions which are large but decreasing. Details which could be examined in assessing the outlook for each country include the components of the fiscal deficits—primary deficits and debt servicing costs. Some indication of the current conjuncture of fiscal flows is given in the table. In particular, the magnitude of the debt servicing costs for some countries may mean that resources are being diverted from more productive uses and in addition—depending upon the maturity structure of the debt stock and the proportion at fixed rates of interest—may render the economy more vulnerable to interest rate shocks. Perhaps key in terms of sustainability

General government financial balances in 1990[a]

	Primary surplus (per cent of GDP)	Debt service (per cent of GDP)	Financial balance (per cent of GDP)	Financial balance (Ecu billions)
	(1)	(2)	(3)	(4)
United Kingdom	2.0	-2.1	-0.1	-1
Denmark	2.0	-3.5	-1.5	-1
France	0.9	-2.6	-1.7	-16
Germany	0.1	-2.1	-2.0	-23
Ireland	4.7	-7.0	-2.3	-1
Spain	-1.0	-2.4	-3.4	-13
Netherlands	-0.7	-4.9	-5.6	-12
Belgium	3.8	-9.7	-5.9	-9
Italy	-1.5	-9.2	-10.7	-92
Greece	-6.8	-12.0	-18.8	-10

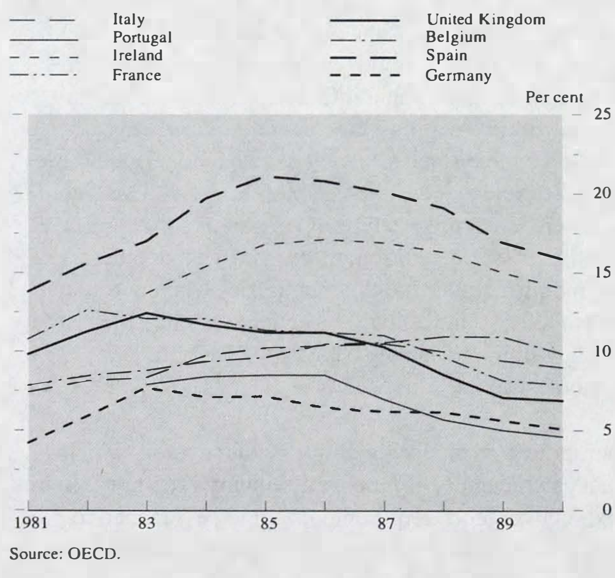
Source: *OECD Economic Outlook*.

(a) The general government financial balance (column 3) is defined as the sum of the primary balance (column 1) and debt service payments (column 2).

are primary surpluses/deficits, since continuously high primary deficits augment the outstanding stock of debt and thereby exacerbate the existing problem. A lasting reduction in the stock of debt requires the maintenance of appropriate primary surpluses over a number of years.

In addition to long-term interest rates and fiscal positions, the durability of nominal convergence will be dependent upon an adequate degree of market flexibility. Market flexibility implies the ability of an economy to maintain a good performance over the longer term, including its capacity to adjust to external shocks. Such ability is likely to be undermined by persistent economic imbalances, such as current account deficits or unemployment. For example, a reduction in inflation which was achieved at the expense of higher unemployment might prove politically or financially unacceptable over an extended horizon. What is deemed unacceptable in one country may be tolerable in another, however, making it difficult to formulate an explicit and straightforward criterion for unemployment convergence. Nevertheless, it seems questionable whether the levels and national disparities of the magnitude exhibited in Chart 5 could be explained in terms of either differences in national

Chart 5
Unemployment rates



Source: OECD.

tolerance levels or differences in the rates of unemployment compatible with non-accelerating inflation, suggesting unemployment to be an important indicator of the potential fragility of inflation convergence.

Conclusion

The requirement of sustainability in the convergence process supports the case for convergence to be firmly established prior to monetary union. The alternative approach of progress being subject to a fixed timetable may tend to result in *ex post* ('crash') convergence measures, which could risk jeopardising the position of all member states.

The charts above have demonstrated that a degree of convergence has been taking place over recent years in the areas of inflation and interest rates—although there remain some prominent exceptions. But the evidence from other indicators—such as public debt and unemployment—suggests that greater and more durable convergence will be needed before the European Community can progress safely to full monetary union.