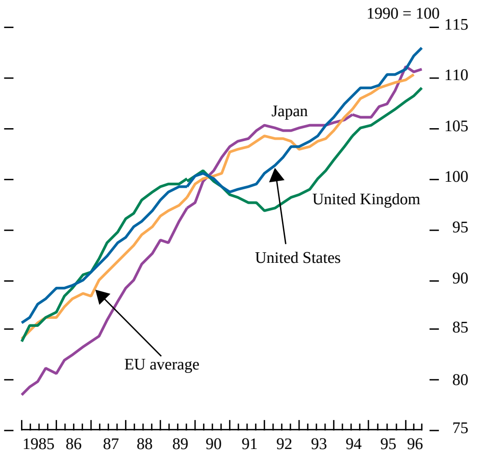
The international environment

The main news since the previous Quarterly Bulletin *is:*

- *The buoyant US economy slowed in the third quarter, mainly because of lower consumer spending, but picked up again in the fourth quarter.*
- *The slowdown in Europe may have troughed in mid-1996. GDP growth in Germany, France and Italy was quite strong in the third quarter, largely led by exports. But it was boosted by temporary, special factors and domestic demand remained weak.*
- *The slow recovery in Japan continued in the third quarter. There, too, the external sector has offset falls in domestic demand.*
- *Inflation remained low, reflecting the large output gaps in several continental European countries and in Japan. Inflation in the United States has been surprisingly low.*
- *Several European countries cut official interest rates in November and December. But in the G3 countries, interest rates were left unchanged in the fourth quarter. All major industrial countries plan to tighten fiscal policy in 1997.*
- *Ten-year government bond yields fell further over the fourth quarter as a whole, but started rising during December.*
- *Global trends in world growth and trade have been favourable, with a convergence of growth in most regions. In particular, growth seems to have stabilised at a sustainable level in the dynamic Asian economies, and increased in the transition economies of Central and Eastern Europe.*

Chart 1
Real GDP levels



Overview

During the past four or five years, growth in the United States has been consistently strong, but it has been weaker and more volatile in Japan and Europe (see Chart 1). In the United States, the key issue is whether the economy has slowed towards its sustainable rate of growth or if the Q3 slowdown was temporary. In much of Europe and in Japan, the question is whether the fragile recoveries in 1996 will be sustained, particularly in view of fiscal contraction.

In the United States and Europe, the drag on growth caused by lower rates of stock accumulation may have ended in the second half of 1996, with positive implications for growth in 1997. The major economies benefited in the second half of 1996 from earlier reductions in short-term real interest rates, from better corporate profitability and from continued low inflation. The wider international picture also improved; the emerging market economies grew strongly on average last year, while fears of overheating in Asia lessened, and Latin America recovered from the Mexican crisis. Japan and most EU countries aim to tighten fiscal policy in 1997. While that should improve performance over the

Monetary policy in transition—the case of Central Europe

Maintaining the purchasing power of the currency, whether internally (price stability) or externally (exchange rate stability), is the formal final goal of monetary policy in all the central European transitional countries. But closer inspection suggests that this goal is pursued differently across countries. Although all have succeeded in reducing inflation since the early 1990s, the goal of low inflation appears to have been pursued most successfully in the Czech and Slovak Republics and Slovenia. By 1996, inflation in those countries had fallen to 10% per year or less. By contrast, inflation in Poland and Hungary has remained at 20%–30% per year. The Czech and Slovak Republics have pursued fixed nominal exchange rates (within a corridor since early 1996), while Slovenia adopted a managed float. By contrast, the Hungarian and Polish currencies have been progressively devalued over the past three years by means of ‘crawling pegs’ in an attempt to limit real exchange rate appreciation. So inflation has been reduced to the lowest rates in countries which have not devalued their currencies to try to maintain competitiveness.

Price inflation, exchange rate depreciation and real GDP growth 1993 Q2–96 Q2

	Czech Republic		Hungary		Poland		Slovak Republic		Slovenia	
Exchange rate system	Fixed band		Crawling band (a)		Crawling band		Fixed band		Managed float	
Depreciation of domestic currency (%) (b)	-3.8		41.4		36.7		6.1		20.5	
Increase in consumer prices (%) (c)	30.7	*8.5*	91.2	*24.0*	109.7	*20.9*	34.0	*6.1*	51.5	*10.8*
Increase in consumer prices, US dollar terms (%)	35.7		12.0		32.7		25.9		20.4	
Increase in real GDP (%) (d)	13.1		5.7		19.1		20.0		11.8	
Increase in foreign currency reserves (US dollar billions) (e)	10.3	*12.5*	5.0	*9.9*	14.2	*17.5*	3.1	*3.3*	1.0	*1.7*

Data source: IMF, International Financial Statistics.

(a) Adjustable peg pre-March 1995.
(b) Against US dollar; - means appreciation.
(c) Figures in *italics* show price inflation in the year to 1996 Q2.
(d) Between 1993–96, IMF estimates.
(e) Foreign currency reserves excluding gold; figures in parentheses show the stocks outstanding in 1996 Q2.

The final goal of price stability in Poland and—along with exchange rate stability—in Hungary, appear to be longer-term aims. Poland used strong measures to halt inflation at the beginning of the 1990s. But a gradualist approach is now being pursued because of concerns about short-run losses in trade competitiveness and output. In Hungary, too, there has been a short-run conflict between the pursuit of low inflation through high interest rates and a strong exchange rate, and the adverse consequences of these on the budget and trade deficits respectively.

Has the decline of inflation made a noticeable difference to the rate of economic growth?

The evidence from across the former Communist bloc is that a sustained recovery of real output has only occurred once inflation has been brought down to rates below about 50% per year.[1] Relatively low and stable inflation appears to have been an important precondition for the strong output growth of the past few years in Central Europe; and high and/or volatile inflation may explain why output is still falling in most of the former Soviet Union. However—as shown in the table—a comparison of the central European economies shows no simple relationship, positive or negative, between inflation and output growth in recent years. In Poland, GDP growth

(1) See, for example, S Fischer, R Sahey and C Vegh (1996), ‘Stabilisation and growth in transition economies: the early experience’, *Journal of Economic Perspectives*, Volume 10.

medium term by reducing long-term real interest rates, it is not clear to what extent there may be negative effects on demand in the short term. These may be more likely as many countries are pursuing fiscal retrenchment at the same time. The outlook depends on the effects of fiscal policy retrenchment and the response of monetary policy.

Growth in the major six (M6) overseas economies was 0.7% in the third quarter.[1] But that probably overstates underlying activity because growth in France and Italy was boosted by temporary special factors. These have unwound in the fourth quarter, lowering growth in these two countries. In Germany, fourth quarter GDP will have been depressed by the effect of the cold weather on construction.

(1) GDP growth in the United States, Japan, Germany, France, Italy and Canada weighted by trade shares with the United Kingdom.

has been among the highest in the region, but so has the rate of inflation. On the other hand, Slovakia has reduced inflation to the lowest rate in the region (6% per year by mid-1996) while output growth is the fastest. Lower inflation is still likely to be an important factor in stimulating longer-term economic growth but, for such relatively small cross-country differences in inflation rates, it is probably less important than differences in the speed of structural reform, the scale of the previous decline in output and the initial economic conditions at the outset of reform (eg government and external debts).

Exchange rate stability versus price stability?

The balance of payments has been a key concern of monetary and economic policy in the region in recent years. In 1994 and 1995, the concern was that overall external surpluses were too large, resulting in too much monetary growth. According to the latest official data, these large surpluses were attributable mainly to massive private capital inflows into the Czech Republic and Hungary and strong net export growth in Poland and Slovakia. All these countries adjusted their fixed exchange rates regimes to reduce short-term speculative capital inflows. Hungary widened its intervention band from +/- 1.25% to +/- 2.5% in December 1994, while Poland went further by widening its crawling band in two steps in the first half of 1995 from +/- 0.5% to +/- 7% and undertaking a 6% revaluation of the zloty at the end of 1995. Although the Czech and Slovak Republics maintained their fixed central rates, they also introduced exchange rate corridors, of +/- 7.5% and +/- 5% respectively, in 1996. This added flexibility was successful in deterring further speculative inflows.

By 1996, large external surpluses had given way to falling current account positions (except in Hungary). That has raised questions about the appropriate level of nominal exchange rates and whether devaluation was asked for. Measures of competitiveness in most countries, however, suggest that real exchange rates are still below equilibrium levels. Moreover, actual real exchange rates may need to appreciate if equilibrium real rates are appreciating as a result of fast improvements in regional productivity.(2)

One explanation for the recent deterioration in current accounts in the Czech Republic, Poland, Slovakia and Slovenia is the sharp upturn in domestic spending—fuelled in some countries by earlier sizable capital inflows—combined with a general slowdown in spending in Western Europe and capacity constraints in domestic production. In addition, current account deficits in transition countries can be viewed partly as the expected counterpart to capital inflows from abroad to help finance investment and economic growth.

Fixed exchange rate systems have helped many transitional countries, including the Czech and Slovak Republics, reduce inflation to modest rates. However, it may prove difficult to reduce inflation to Western European rates in the near future unless exchange rate appreciation is permitted. A fixed nominal exchange rate may result in the convergence of price inflation in the tradable sector on Western European rates but non-tradables, including most services, do not face the same competitive pressures.

Strong productivity growth in manufacturing—the main tradables in transitional countries—permits large real wage increases in the tradable sector without necessarily leading to large price increases (above those in Western Europe). But if real wages rise as fast in the non-tradable sector, where productivity growth is lower, prices in that sector—and consumer prices in aggregate—will increase more quickly than in the EU.(3) This suggests that the final monetary policy goals of price and exchange rate stability are not always compatible.

(2) See L Halpern and C Wyplosz 'Equilibrium exchange rates in transition economies', *IMF Working Paper 96/125*, November 1996.
(3) The Balassa-Samuelson effect.

Table A
Contributions to US GDP growth(a)

Quarter-on-quarter contributions

	1995	1996		
	Q4	Q1	Q2	Q3
Domestic demand	-0.2	0.8	1.3	0.8
Stockbuilding	-0.3	-0.3	0.1	0.4
Investment	0.1	0.4	0.3	0.4
Government	-0.1	0.0	0.3	0.0
Consumption	0.2	0.6	0.6	0.1
Net trade	0.2	-0.3	-0.2	-0.3
GDP	0.1	0.5	1.1	0.5

(a) Contributions may not sum due to rounding.

Growth in the United States slowed in the third quarter, but probably picked up in the fourth

In the United States, GDP grew by 0.5% in the third quarter, a slowdown from the strong growth in the second quarter (see Table A). That was mainly attributable to a slowdown in consumption growth, particularly of durable goods, which was unexpected and hard to explain. Recent indications suggest that consumption rebounded in the fourth quarter: retail sales were strong in October and November and industrial production rose in November. Consumer confidence was high, and large capital gains accrued on equities. Housing starts also rose strongly in November, and mortgage applications for new home purchases rose sharply. Employment data for December were strong, leaving the unemployment rate at 5.3%. Though the data

Chart 2
GDP growth in Germany, France and Italy

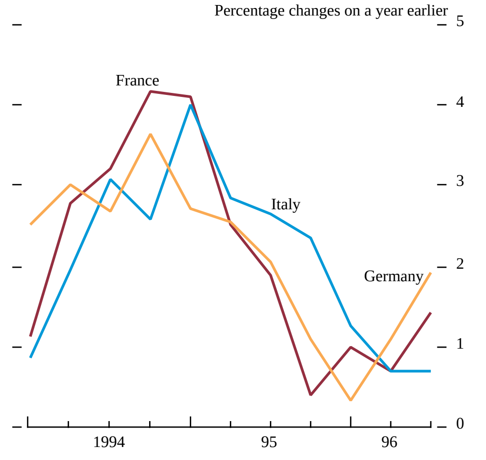


Table B
Contributions to German GDP growth(a)

Quarter-on-quarter contributions

	1995	1996		
	Q4	Q1	Q2	Q3
Domestic demand	0.2	-0.4	1.2	0.0
Stockbuilding	0.3	0.3	-0.9	-0.5
Investment	-0.2	-1.2	1.5	0.1
Government	0.1	0.1	0.2	0.2
Consumption	-0.1	0.4	0.3	0.1
Net trade	-0.1	0.0	0.3	0.8
GDP	0.1	-0.4	1.5	0.8

(a) Contributions may not sum due to rounding.

Table C
Contributions to French GDP growth(a)

Quarter-on-quarter contributions

	1995	1996		
	Q4	Q1	Q2	Q3
Domestic demand	-0.9	0.6	0.3	0.6
Stockbuilding	-0.7	-0.8	0.7	-0.3
Investment	-0.1	-0.2	0.0	0.2
Government	0.1	0.1	0.1	0.1
Consumption	-0.2	1.5	-0.5	0.6
Net trade	0.4	0.6	-0.4	0.3
GDP	-0.5	1.1	-0.2	0.9

(a) Contributions may not sum due to rounding.

Table D
Contributions to Italian GDP growth(a)

Quarter-on-quarter contributions

	1995	1996		
	Q4	Q1	Q2	Q3
Domestic demand	0.7	0.1	-1.5	0.3
Stockbuilding	0.6	0.1	-1.6	0.2
Investment	0.3	-0.1	0.0	0.0
Government	-0.1	0.0	0.0	0.0
Consumption	-0.1	0.1	0.1	0.1
Net trade	-0.6	0.4	1.1	0.3
GDP	0.0	0.5	-0.4	0.6

(a) Contributions may not sum due to rounding.

are mixed, overall they suggest that the US economy slowed towards trend growth in the second half of 1996, but that activity was higher in the fourth quarter than in the third.

One indicator that underlying growth in the United States has remained quite strong is the big gap between the different measures of GDP—GDP(0) the official output measure, and GDP(I) the income measure of GDP. In the third quarter, GDP(I) rose by 4.1% on the previous year, compared with 2.0% for GDP(0). Tax revenues were more buoyant than expected, adding support to the impression of high income growth. So the official data may be understating growth.

Net exports led a revival in Germany and France in the third quarter

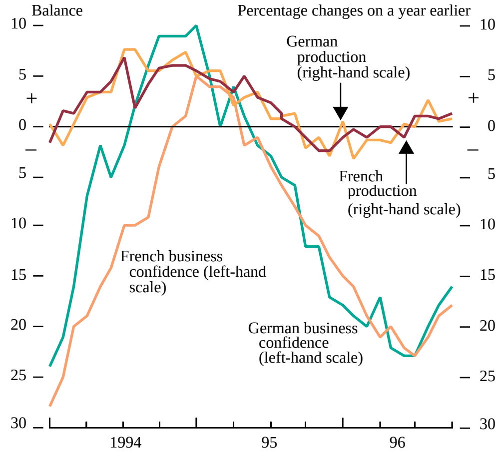
Data for the third quarter of 1996 suggested that growth picked up in the larger continental European economies (see Chart 2). GDP grew by 0.8% in Germany, by 0.9% in France and by 0.6% in Italy. The increase was driven by net exports, particularly in Germany where they contributed 0.8 percentage points to growth in the third quarter (see Table B). That was the first positive contribution from net exports in Germany since 1993 Q1. Domestic demand, by contrast, remained weak. Private consumption, business investment and government spending were all subdued.

GDP growth in France and Italy was sustained by consumer spending in the third quarter, and, to a lesser extent, by investment and net trade (see Tables C and D). But some of the growth reflected special factors which unwound in the fourth quarter. In France, a significant part of the increase in consumption in the third quarter reflected the effects of the car incentive scheme which brought forward sales into the third quarter. The monthly measure of household consumption fell by 2.6% in October, after the scheme had ended. In both France and Italy, third quarter GDP was also boosted by a higher-than-usual number of working days. The seasonal adjustment processes in these countries do not take account of this effect. INSEE, the French statistical body, have estimated that extra working days added 0.25% to GDP in the third quarter. Over much of 1996, consumption in these two countries was sustained by a fall in the saving ratio. A reversal of this fall is a downside risk to activity during 1997.

The growth of industrial production slowed down in Germany during the fourth quarter; in France industrial production fell in both September and October. And the Italian economy was weakest of all. Forward-looking indicators, however, suggest that the recovery in the major European Union (EU) economies will continue. As Chart 3 shows, industrial confidence rose steadily from its mid-year trough in Germany and France, as it did in most EU countries, and there was a marked rise in November. But, the consumer sector was weaker (see Chart 4). Consumer confidence barely picked up at all in the EU in the second half of 1996, and indeed fell in Italy.

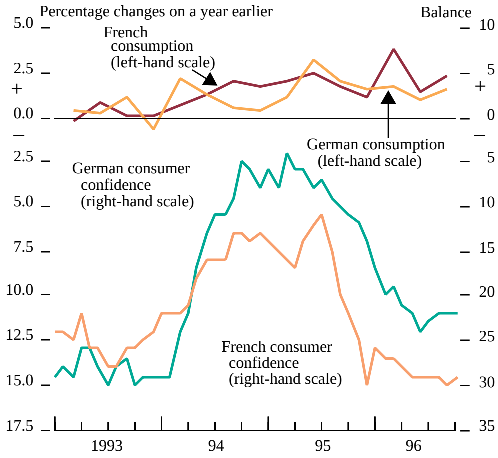
Labour market conditions continue to have an adverse effect on consumer spending and domestic demand in the European economy. Unemployment in the EU rose further in the third quarter of 1996, to an average 11.2% in October. In Germany, unemployment (pan-German, seasonally adjusted) rose by about 50,000 in each of the four months September-December 1996. German

Chart 3
Industrial confidence and production



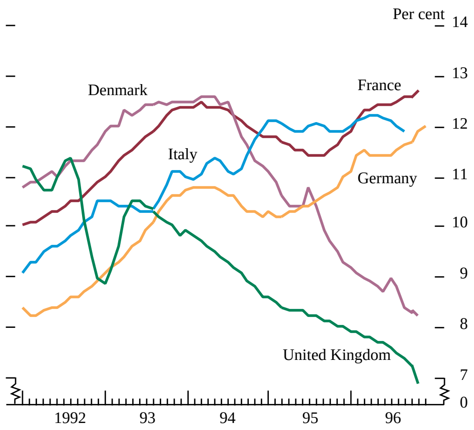
Source of survey: European Commission.

Chart 4
Consumer confidence and consumption



Source of survey: European Commission.

Chart 5
Unemployment



unemployment in December was 4.2 million, or 10.9% of the workforce. In France, unemployment rose to 12.7% in November, continuing on an upward trend. In Italy, unemployment is measured quarterly and rose from 11.7% to 12.2% between July and October last year, confirming the slowdown in the economy (see Chart 5).

The continued weakness in the labour market and the tighter fiscal stance in 1997 are likely to dampen the recovery in the largest continental European economies. It is unlikely that GDP in these countries will grow much above trend, despite the existence of spare capacity and the favourable impetus from low interest rates, strong corporate profitability and the generally weaker Deutsche Mark. And the recovery will depend on the extent to which the rise in net exports feeds through into investment and employment.

The smaller continental EU economies performed better on average last year

Outside the largest three continental European economies, EU growth in the second half of 1996 was more broadly based, although net exports underpinned activity in most countries. Austria, Belgium and the Netherlands, whose currencies are closely linked to the Deutsche Mark, benefited from increased export competitiveness in the second half of 1996. Business fixed investment rose markedly in Belgium and Ireland. Labour market flexibility and/or the introduction of new measures to increase flexibility seems to have led to falling unemployment in Ireland, the Netherlands and Denmark during 1996—this has underpinned household spending. Domestic demand was also strong in Finland, Spain and Portugal in the second half of 1996.

The weak recovery in Japan continued

Japanese third quarter GDP data confirmed the view that the recovery was weak (see Table E). GDP rose by 0.1% in the quarter, to a level 3.5% higher than a year earlier. Estimates of earlier growth were revised upwards; GDP growth in 1995 is now estimated at 1.3% rather than 0.8%. Domestic demand was extremely weak in the third quarter of 1996, falling for the second quarter in succession. Consumer spending fell, partly because of temporary factors such as the bacteria food poisoning scare and the unusually mild summer. Consumption is likely to have picked up in the fourth quarter, as these effects unwound. Household expenditure rose in November for the first time since June. The strength of net trade in the third quarter probably reflected the improved competitive position of the large manufacturing companies resulting from the weaker yen. Recent Tankan surveys have suggested that they are more optimistic than smaller companies. In particular, the survey showed that small firms remained cautious over the investment outlook. Capital investment has been an important factor maintaining the weak recovery so far. Business investment grew by 5.7% in fiscal year 1995 and by an annualised 5.3% in the first half of fiscal year 1996.

The wider international picture is brighter

There is some evidence of synchronised growth in all the main trading areas. As noted above, the large EU economies experienced lower growth in 1996 than the other large industrialised countries, but showed some signs of a recovery. Growth in Central and

Table E
Contributions to Japanese GDP growth(a)

Quarter-on-quarter contributions

	1995 Q4	1996 Q1	Q2	Q3
Domestic demand	1.8	2.4	-0.1	-0.2
Stockbuilding	0.1	0.1	-0.2	-0.2
Investment	1.1	1.0	0.7	0.1
Government	0.0	0.1	0.0	0.1
Consumption	0.6	1.2	-0.6	-0.1
Net trade	-0.4	-0.3	-0.2	0.3
GDP	1.3	2.0	-0.3	0.1

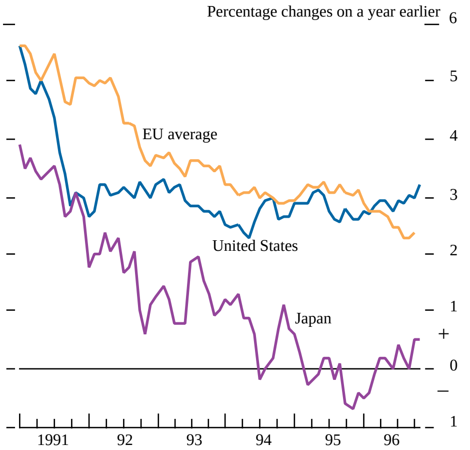
(a) Contributions may not sum due to rounding.

Eastern European economies, which are important export markets for Germany, firmed significantly last year, following sharp contractions in the early 1990s. Among other developing countries, there was a pick-up in Latin America (notably Mexico and Argentina) and Africa in 1996. Growth in the dynamic Asian economies slowed in the first half of 1996, reflecting tighter monetary policies. Their exports in 1996 were affected by some loss of competitiveness as currencies appreciated against the yen, and by rising unit labour costs and a fall in demand for computer-related products. But there seems to have been some recovery in the second half of the year, to a rate of growth slightly lower than in earlier years, but one which may be more sustainable over the medium term.

Inflation remains low

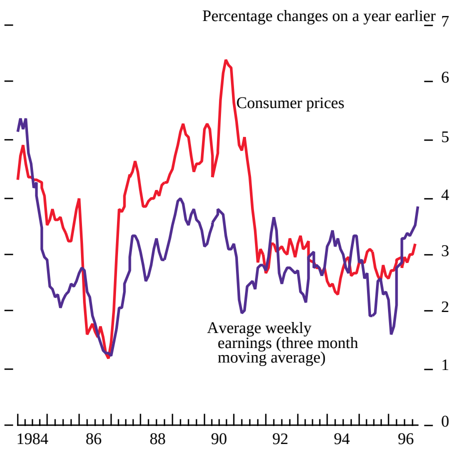
The trend towards lower inflation has been a worldwide phenomenon. The IMF estimated in its October *World Economic Outlook* (WEO) that average consumer price inflation fell between 1995 and 1996 from 19.8% to 13.3% in developing countries, and from 128% to 41% in transition countries. Those falls are in spite of higher oil and food prices. The IMF concluded that 'a large part of the recent decline in inflation can be attributed to the adoption of sustained non-inflationary policies'.

Chart 6
Consumer prices



Recent news on inflation in the major industrialised countries continued to be good, as Chart 6 shows. In December, annual consumer price inflation was 1.4% and 1.7% in Germany and France respectively, and 2.5% in Italy. The downward trend continued in Spain, where annual consumer price inflation fell to 3.2%. In the EU as a whole, consumer price inflation fell to 2.2% per year in November, its lowest rate since compilation of the figure began in 1983. Six countries had inflation rates below 2%; the lowest was Sweden where prices were 0.3% *lower* than a year earlier. Measured consumer price inflation in Japan remained negligible, at about 1/2% per year. In the United States, inflation has remained surprisingly low, given the likely absence of an output gap, and the decline in unemployment towards its 'natural rate'.

Chart 7
United States consumer prices and average weekly earnings



Among the industrialised countries, upside risks to inflation are most evident in those countries estimated to have small (or no) output gaps. In the United States, consumer price inflation rose from 3.0% in September to 3.3% in December, partly reflecting higher oil prices. That compares with consumer price inflation of 2.5% in 1995. And rising average hourly earnings (up to an annual rate of 3.8% in December) may put further upward pressure on US inflation (see Chart 7). But core inflation (excluding energy and food) remained at around 2.6%, lower than the 3% rise recorded in 1995. Output gaps are expected to narrow in several EU countries during 1997, notably in the Netherlands and Denmark, which may result in some upward pressure on inflation. But inflation is very low in these countries.

Interest rates

Official interest rates were unchanged in the G3 countries in 1996 Q4, but were cut in Canada, France, Italy and a number of other European countries. Both German and US short-term interest rate expectations were revised down in the fourth quarter on signs of continued weak growth in Germany, and the FOMC decision in September 1996 to leave US interest rates unchanged.

Table F
Real interest rates[(a)]

Per cent per year

	Mid-Nov.	Mid-Dec.	Mid-Jan.
United States	2.68	2.65	2.71
Germany	1.35	1.16	1.33
France	1.69	1.57	1.45
Italy	4.21	4.10	3.90
Japan	-0.65	-1.00	-1.14
Canada	1.68	2.04	1.64

(a) Based on one year nominal euro currency rates and inflation expectations expressed in Consensus Forecasts Inc.

Table G
Ten-year interest rate differentials

As at 2 January 1997

	Spot yield	Forward rate
UK-US	1.13	0.96
UK-Japan	4.79	3.73
UK-Germany	1.37	0.04
UK-France	2.13	0.93
UK-Canada	0.97	0.14
UK-Italy	0.05	-0.94

Chart 8
Average narrow money and nominal GDP growth in the G7

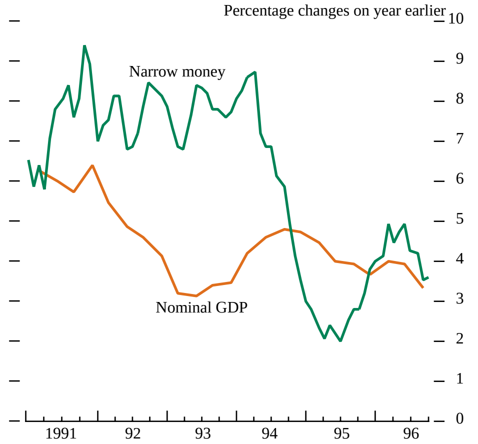


Table F shows movements in real interest rates in the M6 economies. Real interest rates became more negative in Japan between November and January, as inflation expectations firmed. Real rates fell a little in France and Italy, but were largely unchanged in the United States and Germany.

Ten-year bond yields fell over the fourth quarter as a whole (see Chart 12 in the article on the operation of monetary policy on page 13). US yields fell by 28 basis points, but were 83 basis points higher than at the start of 1996. Towards the end of the fourth quarter, bond yields in the United States began to rise, in part reflecting strong mortgage demand, and this was accompanied by increases elsewhere.

European bond yields continued to be influenced by sentiment towards EMU. Bonds yields declined over the quarter as a whole, and the convergence of European yields continued. In particular, the spread of Italian and Spanish government bond yields over German government bond yields continued to narrow as the prospects for a wider EMU were seen to improve. The lira resumed its full participation in the exchange rate mechanism (ERM) on 25 November. The Stability Pact agreed in Dublin in December was also regarded as improving the chances of a wider EMU.

Ten-year yields on Italian bonds fell below equivalent UK bond yields on several occasions in November and December. But it is misleading to look at ten-year spot rates alone. This is because the difference between bond yields for two countries at a particular maturity largely reflects the difference in the expected path of short-term interest rates for the two countries up and until the maturity date. (Other contributory factors include differences in risk premia and market liquidity.) A large difference in the expected path of short-term interest rates in the *near term* may account for a large proportion of the difference in long-term bond yields between the two countries. Table G compares zero coupon spot rates with ten-year forward rates. While the spot yield differential at ten years between Italy and the United Kingdom is negligible, Italian ten-year forward rates were more than 90 basis points higher than UK rates at the start of the year.

The table also shows that, comparing UK and German yields, the ten-year forward-rate differential is only a few basis points. So almost all of the difference in spot ten-year yields can notionally be attributed to differences in expected short-term nominal interest rates.

Narrow money

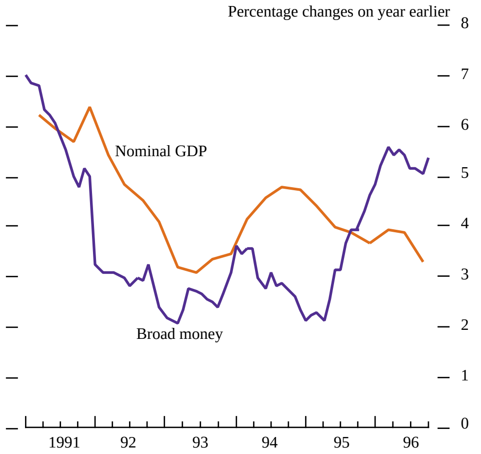
In 1996 Q3, the weighted average of annual narrow money growth (M1) in the G7 countries fell significantly to 3.5%, from its previous peak of 5.0% recorded in each of the first two quarters of the year (see Chart 8). Figures for the fourth quarter so far suggest that narrow money growth increased again in at least half the G7 countries.

Narrow money growth was substantially higher than nominal GDP growth during the early 1990s, and grew more slowly during 1995. But during 1996 nominal GDP and narrow money were growing at similar rates. The weighted average of nominal GDP growth in the G7 fell slightly to about 3.2% in the third quarter, its lowest since early 1993.

As usual, there were significant differences among G7 countries. Annual M1 growth in the United States became even more negative over the reporting period. Indeed, excluding the United States, average annual narrow money growth in the remaining six countries was around 8.9% in the third quarter. Japan still had the highest narrow money growth rate in the G7 in the third quarter, although growth fell sharply between the second quarter and November. German M1 growth was slightly more subdued in the third quarter than in the second and fell to 10.0% in November.

Broad money

Chart 9
Average broad money and nominal GDP growth in the G7



The weighted average of annual broad money growth in the G7 economies was 5.1% in 1996 Q3 compared with 5.4% in the second quarter (see Chart 9). In October 1996, the average annual growth rate returned to 5.4%, broadly in line with growth over the previous year. Average broad money growth in the G7 led average nominal GDP growth by about a year in the first half of the 1990s, but, since end-1995, the lead time seems to have shortened. But it is too early to draw any firm conclusions about this. In Germany, broad money growth in 1996, at 7.9%, exceeded its target range of 4%–7%.

Both the Bundesbank and the Bank of France announced new money supply targets for 1997. The Bundesbank set the target corridor for M3 growth between 1996 Q4 and 1997 Q4 at 3.5%–6.5%. It also extended its target horizon for M3 from one to two years, indicating that the special circumstances of the run up to Stage 3 of EMU, and increased volatility in the monetary aggregate, resulting from international financial markets, required it to place greater emphasis on the medium-term operation of monetary policy. An annual rate of growth of around 5% over 1997 and 1998 is considered appropriate to ensure price stability.

The Monetary Policy Council of the Bank of France announced that it will simultaneously monitor the main narrow and broad money aggregates. The broad money reference aggregate has been amended to take account of various savings schemes.

The Italian authorities announced an inflation target of 2.5% for 1997, and 2% for the following two years. The Bank of Spain announced a medium-term policy objective of achieving inflation close to 2% during 1998. Broad money growth not exceeding 7% will be regarded as acceptable from 1997.

Fiscal policy

Tighter fiscal policy is planned in Japan and the EU

At the end of 1996, the Japanese government put forward a supplementary package for fiscal year 1996/97 and announced the Budget for the following fiscal year. The former offered a further small stimulus worth ¥3.6 trillion which should occur in the second quarter of 1997. But fiscal policy will nevertheless be contractionary in fiscal year 1997/98 by around 1% of GDP after allowing for increased expenditure.

As reported in the previous *Quarterly Bulletin* virtually all EU countries introduced 1997 budgets aimed at achieving a fiscal deficit/GDP ratio of 3% or less, in accordance with the Maastricht convergence criterion reference value.

The diagrams in the box on page 30–31 show the performance of EU countries against the four quantitative convergence criteria during 1996. The data for inflation and interest rates refer to the twelve-month period to September 1996. The data for the ratios of the government deficit and general government debt to GDP are the EC forecasts for 1996. Provisional estimates for outturns in 1996 available from Germany and France are broadly in line with these forecasts.

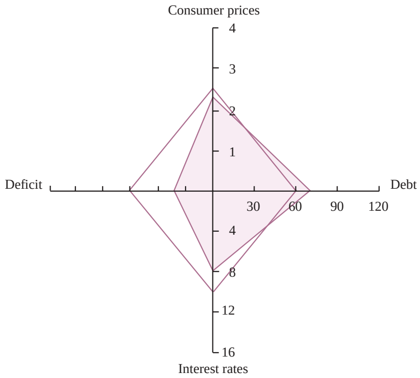
Preliminary estimates from the German Finance Ministry showed that the general government deficit in Germany rose in 1996 by DM 15 billion to DM 138 billion, or 3.9% of GDP (3.5% in 1995). A fall in tax revenues accounted for most of the overshoot. The ratio of government debt to GDP rose to 60.3%.

In France, the cumulative budget deficit at the end of November was nearly Ffr 330 billion, compared with the target of Ffr 288 billion. Net fiscal receipts were marginally lower than forecast; expenditure was higher. The French government was confident that the target for the year as a whole would be met, because of financial flows in December.

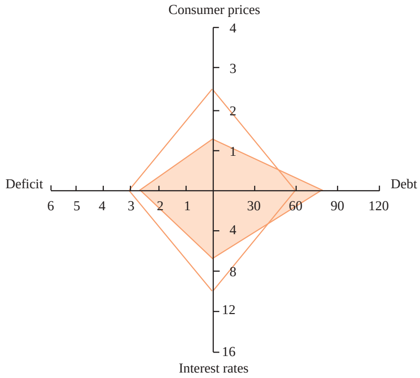
Preliminary figures from the Italian Treasury in January revealed a substantial overshooting of the target for the State Sector Borrowing Requirement (SSBR) in 1996. The SSBR was 7.4% of GDP in 1996, according to preliminary figures, compared with 7.3% in 1995 and a target of 6.6% set in September 1996. Official estimates for the outturn had been revised up during the year, as the GDP growth turned out lower than expected. The general government deficit in 1996 may be slightly less than the SSBR, because of differences in national and EU accounting standards.

Recent performance relative to Maastricht convergence criteria

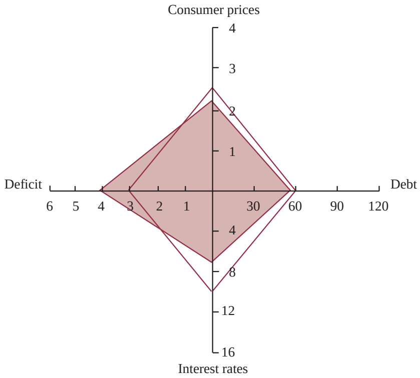
Denmark



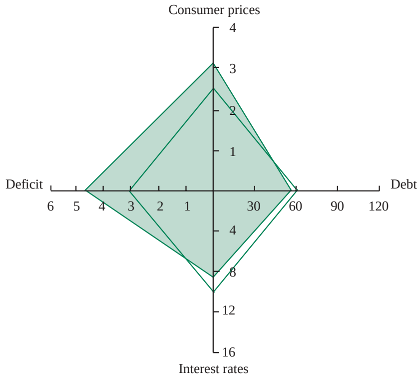
The Netherlands



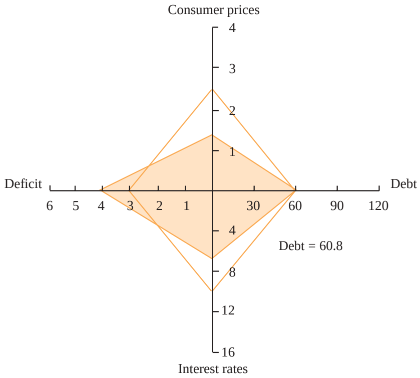
France



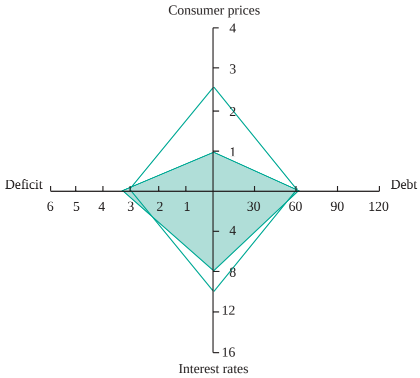
United Kingdom



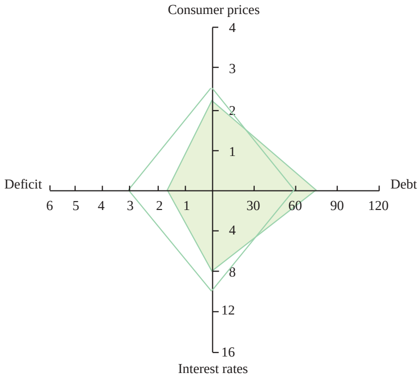
Germany



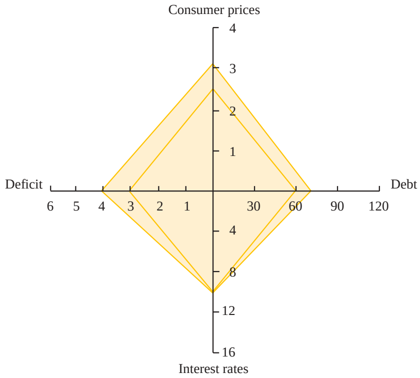
Finland



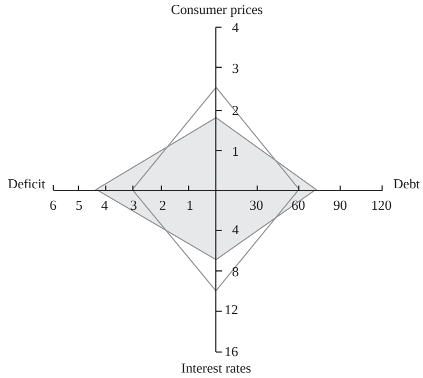
Ireland



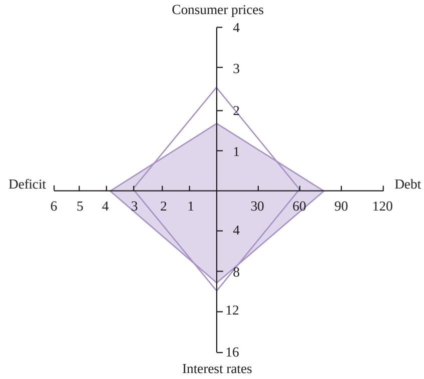
Portugal



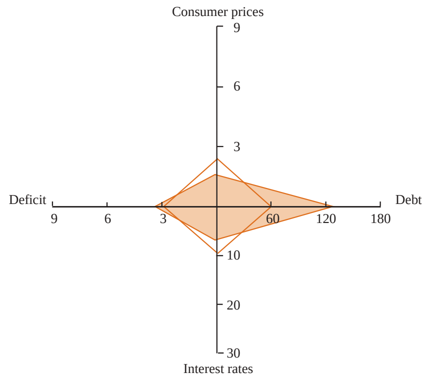
Austria



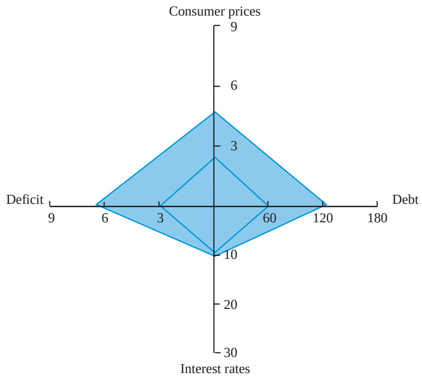
Sweden



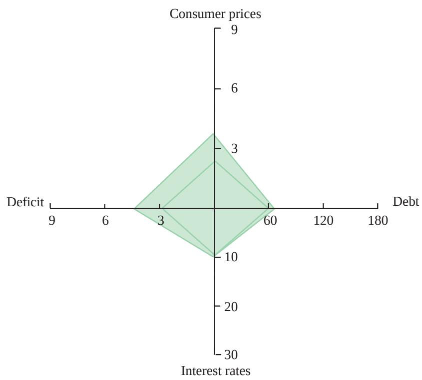
Belgium(a)



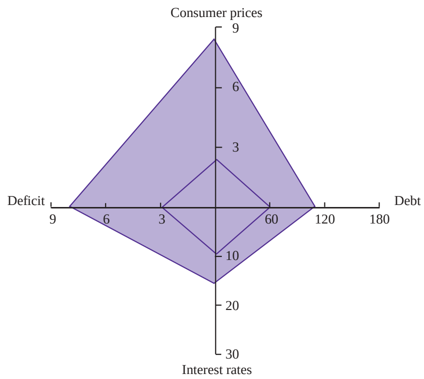
Italy(a)



Spain(a)



Greece(a)



Source: Eurostat data and national country.

(a) A different scale is used for these four countries.

The diagrams show the recent performance of EU countries against the convergence criteria for fiscal deficit and debt, inflation, and long-term interest rates. The shaded 'kite' shows the country's performance, while the other 'kite' shows the reference points for each criterion.

- The measure of inflation is the interim harmonised measure of consumer prices. The diagrams show the increase in the indices in the twelve months to September 1996. The reference value for the convergence criterion is 1.5 percentage points above the three best performing countries.

- The interest data are average long-term government bond yields for the twelve months to September 1996. The reference value is 2 percentage points above the three best performing countries in terms of inflation.

- The deficit and debt are expressed as a percent of GDP and are European Commission autumn estimates for 1996, and are in line with Maastricht Treaty definitions. The reference values are 3% of GDP for the deficit and 60% of GDP for the debt.