Global Letter

Ethan S Harris, +1 (212) 526 5477
John Llewellyn, +44 (0)20 7260 2272

A "New Economy" Recession?

A year ago, the US business press was full of the "unstoppable economic boom." Monetary policy, the assertion ran, was ineffective in the new economy. Now the buzz is that policy cannot stop a new economy recession. Maybe. But our bet is that old-fashioned monetary and fiscal policy stimuli can still prevent recession.

Pushing On A String

As the US stock market has sold off the gloom has worked its way in to views of policy effectiveness. A recent Business Week article captured this growing negative sentiment: "…now the New Economy just might be biting back…Companies with too much capacity have no desire to invest, no matter how cheap money is. In the extreme, rate cuts amount to 'pushing on a string.'"[1]

It Starts With Housing…

In reality, there are already several avenues of evidence that Fed easing is working. In particular, lower mortgage rates have induced a burst of housing-related activity:

- Sales of new and existing homes remain near record levels, encouraging housing-related consumer spending.
- Mortgage refinancing has surged, putting $6bn back into the pockets of consumers in the first quarter.
- Home prices continue to boom, up 8% over last year and helping to offset the negative wealth effect of the 20%-plus collapse in stock prices.

In other words, monetary policy is working at least through the tried and tested housing channel. True, monetary easing has not restored the economy to normal growth: but it has, at least so far, probably prevented a full-blown recession.

…And Spreads To Confidence And Stocks

Furthermore, there should be more to come. Monetary policy works with long and variable lags, with the peak growth impact typically coming 6 to 12 months after the easing. The channels of this impact are well known.

The stock market "wealth effect" has become an increasingly important driver of the economy. While the Fed is not willing to underwrite any particular level for the market, lower rates are an essential element in its eventual recovery. The mechanism is worth reiterating. As both the stock market and interest rates decline, equity investments become increasingly attractive relative to cash, and the market finds a floor. While there are exceptions, stock market recoveries typically lag the first Fed easing by 2 to 5 months. Hence the mantra "Don't fight the Fed."

Lower rates, and the collateral stock market improvement, should therefore provide an important offset, whether in whole or in part, to the gloomy news on company layoffs, thereby helping to stabilize consumer confidence.

Other policy channels will, it is true, take longer. In particular, inventories and business investment will respond only slowly to Fed easing. Expectations for sales are the main determinant of inventory investment, but the "cost of carry" is also important: low interest rates reduce the penalty for holding stocks. Similarly, shrinking demand and unused industrial capacity are depressing investment in new plant and equipment. But it is surely an exaggeration to say that the cost of capital is *irrelevant* to the investment decision. In every economic downturn, considerable excess capacity emerges; and yet every business cycle recovery features a dramatic rebound in business investment.

Fiscal Reinforcements

Furthermore, monetary policy is not the only game in town. There is also fiscal policy: and, for one of the few times in recent history, it looks as if fiscal stimulus may prove to be well timed. Historically, tax cuts have come too late: by the time the recession is recognized and legislation implemented, the recession is over. The "Kennedy" tax cut did not come until 1964, when the economy was near full employment. The Ford rebate came only in May 1975, some two months after the recession had ended. And most of the Reagan tax cut took effect after the recession was over.

By contrast, it now appears that a tax rebate of $60-$85bn will be implemented by late in the third quarter. This reflects both luck—Congress happened to be in a tax cutting mood at the right time—and good fiscal discipline—a large budget surplus creates room for a cut.

The bottom-line: while the US economy has some tough hurdles ahead, it would seem likely that policy makers have the requisite tools to put up a good anti-recession fight with, we judge, a 2 in 3 chance of success.■

[1] *Business Week 2 April 2001, p38.*

Global letter:

Joaquin Cottani, (212) 526-1979
John Llewellyn, +44 (0)20 7260 2272

Argentinian Woes

Indiscriminate bailouts, for example by the IMF or the World Bank, could well encourage "moral hazard." But when moral hazard is not patently obvious, as in the case of Argentina today, pragmatism should prevail.

Once Again

Fears of default and devaluation are again hitting Argentina. On previous occasions, the trigger was mostly external. The Mexican devaluation crisis and the Russia-LTCM crisis affected Argentina primarily through financial contagion. The current crisis is different, however: its origin is not pure financial contagion. Rather, as a result of the strength of the US dollar, the devaluation of the Brazilian Real, and a steep decline in the terms of trade, competitiveness in industry and farming has fallen markedly. As a result, investment has dropped a full four percentage points of GDP, and the annual growth rate of GDP has fallen to 0.4%, from 6.5% over the period 1991-97.

In the initial expectation that these shocks would prove temporary, Argentina elected to borrow to finance its widening current account and fiscal gaps. The public debt to GDP ratio increased from less than 35% in 1997 to 44% in 1999. Then, as the economy was beginning to recover in late 1999, the government implemented a strict fiscal adjustment plan that undermined consumer confidence. September then brought the political crisis that culminated in the resignation of the vice president.

International financial markets are currently closed to Argentina on concerns that the fragile political and fiscal situation will prevent growth from resuming. While this does not pose an immediate risk (the treasury can raise enough cash in the local market to last until December), thereafter things will likely get complicated. The financing program requires US$9bn of external bond issuance to roll over a similar amount of amortization payments. Hence, unless the international credit market reopens to Argentina, the probability of default could increase alarmingly.

To avert fears of default, Argentina needs to convince investors that the government will persist in its effort to reduce the fiscal deficit, from 2% to 1.4% of GDP. And, for that, prompt approval of the 2001 budget is necessary. This may not be sufficient, however, as the more immediate concern is liquidity rather than fiscal solvency. In a perfect world, the IMF would step in to avoid a foretold crisis from coming true.

After all, the IMF has supported Argentina's convertibility program for almost ten years, and with generally good results. Now that the program is in peril, the solution would be a US$10-15bn contingent credit line (CCL) to be used only in the event that a payments crisis materialized. By its nature, the CCL could stop the liquidity crisis from happening: and in that case no money would be disbursed.

Unfortunately, the world is not perfect. While the CCL exists in the menu of credit facilities supported by the IMF, in practice no country has ever made use of it. The reason: only countries for which the probability of using the funds is low are eligible—thereby defeating the purpose of the facility. For countries like Argentina, assistance can come, in the form of a supplementary reserve facility (SRF), only after the crisis has occurred, and provided there is a clear possibility of contagion to other member countries.

Warning Signs

Investors know that a total collapse in confidence would be signalled by a fall in deposits and international reserves. This has not happened yet, thanks to strong liquidity requirements in US dollars held by Argentine banks. However, were a drop in deposit demand to occur, a bank panic would be inevitable.

At this point, we judge that the probability of a default or debt-restructuring scenario in the case of Argentina is relatively low (say 20%). However, this probability has been growing, and will continue to do so for as long as the IMF remains ambiguous about its credit policy stance towards Argentina in the event of a payments crisis. If Argentina were to default or devalue, Brazil would also stand to suffer, which could aggravate the consequences of default in the region.

The bias against indiscriminate intervention by the IMF and the World Bank, expressed in the recent meetings of these institutions in Prague, is understandable, given policymakers' fear of encouraging moral hazard. However, when moral hazard is not patently obvious, as in the case of Argentina today, pragmatism should prevail. In retrospect, "bailing in" may have been the right policy response in the cases of Russia and Ecuador. But, just as intervention was justified in Mexico (1995) and Brazil (1999), it would seem the right response now in the case of Argentina.■

Global Letter

John Llewellyn, Global Chief Economist
+44 (0)207 260 2272
jllewell@lehman.com

Mid-Year Stocktaking

Our mid-term review points up the sharply divergent circumstances of each of the major economic zones, and the considerable uncertainties about how each is going to behave. No wonder that markets are confused and a little irritable. We offer our judgements.

Three Zones, Three Circumstances

The United States. Clearly, the behaviour of the US economy has changed in two important respects. Intense product market contestability is keeping price inflation in check; and innovative commercial application of the new technologies is producing impressive productivity growth. Hence, while growth has been faster than we had expected, inflation has *not* been. But the economy risks running out of labour, and thereby ultimately becoming inflationary. And meanwhile the pattern of sectoral financial balances is becoming problematic, with the private sector now in unprecedented deficit - spending exceeds income to the tune of 5% of GDP[1].

With the stance of fiscal policy not set to change, adjustment burden falls on monetary policy. Thus the Fed faces the challenging and curious task of slowing down an economy of uncertain momentum to a potential growth rate of unknown magnitude - to avoid an inflation which has yet to be seen.

Investors, as revealed by the futures markets, judge that the underlying growth momentum remains strong, so that the Fed will find itself having to raise short rates by another 40bp-odd by the end of the year in order to realise its inflation objective. We do not share this view. Despite having underestimated the pace of growth in recent quarters, we - like the Fed - expect private-sector caution to rise somewhat, causing the economy to slow without further policy restraint. If we are right, then 10-year bond yields[2] stand to ease modestly, to perhaps 5.2% by the end of the year.[3]

The euro area. The world's second largest economy faces almost a mirror-image problem. While Europe's growth is too slow, many investors consider that its structural problems will prevent a decent non-inflationary acceleration. Hence the futures markets reveal that they consider that such growth pick-up as may occur will oblige the ECB to raise short rates by 100bp-odd over the next year. This seems unduly pessimistic. We judge that while GDP growth is speeding up, it will rise only to a modest 3%-odd rate; that most labour markets will remain quiescent in the face of considerable slack and strong competition from the region's neighbours; and that structural problems, even if unaddressed, will start to bite only in the later years of recovery. And further, the euro should rise as growth accelerates, adding to disinflation.

Japan. The key issue in the world's third-largest economy is different again: whether the strong, government-expenditure-led, first-quarter GDP pick-up will soon induce the private sector to accelerate its spending. We doubt that it will and, like most others, look for yet another big fiscal package before year-end. But we are concerned about the implications of this and the many other pressures on the budget deficit. We expect bond yields to rise progressively, putting increasing pressure on the BoJ to accelerate the growth of base money so as to turn inflation positive again and thereby, through the resulting 'inflation tax', check the rise in the now nearly out of control public debt. And with this is likely to come a weaker yen - say 130 by year-end.

A Slow Non-Inflationary 2000

If these judgements are broadly right, then even with the expected pick-up of non-Japan Asia[4] (9.3% of the world economy) to 5.3% in 2000, and the acceleration to 3.8% in Latin America[5] (4.9% of the world economy) world growth in 2000 stands to be of only the same order as the 2.5% we expect for this year - see the table. This is scarcely the stuff of a sustained commodity price boom; so world inflation, and bond yields outside Japan, should stay firmly in check. But the three key determining issues remain what they have been for some time:

- US domestic demand growth - we expect some deceleration
- Euro-area domestic demand growth - we expect a modest acceleration; and
- Japan's private domestic demand - we expect stagnation.■

Lehman Brothers Global Forecasts
(GDP % y-o-y; yields at end of year)

	1999		2000	
	GDP Growth	Bond Yields	GDP Growth	Bond Yields
USA	4.1	5.2	2.8	5.2
Euro area	2.0	4.8	3.0	4.9
Japan	0.1	2.5	0.0	3.0
World	2.5	-	2.5	-

[1] *The IMF, particularly troubled by this development, has an extensive discussion of the risks it presents to activity in its July World Economic Outlook, pp 58 et seq.*
[2] *For a detailed consideration of the prospects for US and world bond yields, see the article in this week's Global Weekly Economic Monitor.*
[3] *For details of the reasoning, see the US section in this week's edition of the Global Weekly Economic Monitor.*
[4] *For details, see the Asia section in this week's Global Weekly Economic Monitor.*
[5] *For details, see the Latin America section in this week's Global Weekly Economic Monitor.*

Global Letter

John Llewellyn, Global Chief Economist
+44 (0)207 260 2272
jllewell@lehman.com

St. Augustine's Prayer

Was the Fed right to increase interest rates by only a modest 25bp? And is that the end? Or will there be a string of further increases? The answers depend not only upon whether or not there is something new in the behaviour of the US economy, and on how fast it is now growing, but also upon the risks attendant to further hikes.

Investors' Views

Some investors place their primary emphasis on the strong and growing level of competition in US product markets, the powerful investment-led late-cycle performance of labour productivity, and the quiescence of wages notwithstanding low unemployment. Accordingly, those among this group who judge further that US economic growth is already at or near its peak consider it appropriate that the Fed should have raised rates only modestly. And, believing that the Fed shares their analysis, they now judge that it will not be in any hurry to raise them much again.

Other investors, while agreeing that new disinflationary forces are indeed about, nevertheless consider that the underlying growth of the economy is too strong. Accordingly they consider not only that the Fed was right to raise rates, but that it should, and will, nudge rates higher in order to slow the economy.

A third large group of investors, however, are yet more sceptical. Burned in the past by having wrongly believed claims of changed economic behaviour, these investors point out that the intensity of competition is unmeasurable, claim that productivity growth in an increasingly service-oriented economy is uncertain, and argue that wages have been well-behaved only because of the disinflation that has resulted from a strong dollar and generally weak commodity prices. They therefore feel that, whatever the underlying growth of the US economy may be, it is unsustainably fast; and accordingly they consider that the Fed, still 'behind the curve', will end up having to increase rates several more times.

The overall net view, as expressed by the Fed funds futures, is that there will be a further 40 bp-odd of Fed tightening within the next year.

Policymakers' Views

Amongst policymakers too there is a range of opinion, but in general it is less hawkish than in the investor community. Both the IMF and the OECD, for example, express their concern that the US economy may be growing unsustainably fast in terms that are mild, even by their standards.[1] And many national policymakers not only consider that the Fed is right to have proceeded cautiously but trust that it will not be quick to take further action to slow the US economy. Their principal concern is that the continental European economy has only just started to recover, and that Japan is not yet anywhere near achieving a sustained upswing. Accordingly, emphasising the risks to those economies and hence the world economy as a whole, including the United States, they are concerned lest the US economy slow down, or be slowed down, with undue haste.

None of this is to overlook the fact that policymakers are concerned about risks in the longer term, principally those which may flow from rapidly-growing US international indebtedness, now approaching 15% of US GDP. A growth soft landing would probably imply only a gradual depreciation of the dollar: but were the dollar to weaken sharply, the attendant effects on inflation could oblige the Fed to tighten sharply, as well perhaps as causing turbulence in financial markets, damaging world and thereby US growth. But here their attitude is akin to St Augustine's prayer - "Give me chastity and continence, but not yet."[2]

So Which View Is Right?

In our view, the Fed has got it about right, at least for now. After all, there are good reasons why the economy should start to slow[3]. Moreover, most corporate CEOs state flatly that they have little or no pricing power. And many workers, even if not unduly sceptical about being able to find another job, may well worry in this world of rapid technological change and factor mobility about being able to find another that pays as well. That said, the US economy does risk running out of labour. So there is a good case for seeking to slow the US economy, *slightly.*

Accordingly we judge that the Fed, having signalled its clear intention to see the US economy slow somewhat, will now wait to see if that starts to happen. Only if there is no sign will it raise rates again; and then only cautiously.■

[1] The IMF wrote in its May World Economic Outlook that "…at some point policies will need to be tightened if domestic demand does not slow in line with current expectations." (p. 6). And the June OECD Economic Outlook judged that "…US monetary authorities can afford to wait for a clear modification in the inflation situation before changing the present stance of policy…" (p. x).

[2] Confessions, Book. 1, Chapter 1.

[3] See Ethan Harris' article "Will A Growth Slowdown Stop The Fed" in last week's Global Weekly Economic Monitor.

Global Letter

John Llewellyn, Global Chief Economist
+44 (0)207 260 2272
jllewell@lehman.com

Structural Policy Confusion

Structural policy problems, for example in continental Europe, do indeed stand to inhibit the achievement of sustained, non-inflationary, growth. But they are most unlikely to prevent a cyclical pick-up in activity.

Fashion Comes And Goes

Every era has its policy fashions and concerns. At the risk of over-generalising, it is probably fair to say that in the 1960s and 1970s, the preoccupation was with keeping output as close as possible to potential. The role of fiscal policy was to manage demand and the role of monetary policy was broadly to keep interest rates down. By the 1980s, however, with the build-up of huge budget deficits, fiscal activism was seen as a dangerous excuse for fiscal irresponsibility, and monetary policy was seen as the best tool for policy action.

The 1990s, by contrast, is seeing another principal policy concern come to the fore, at least as regards core Europe. Increasingly observers, ranging from the European Central Bank to private sector financial market participants, are pointing to the need not for fiscal policy changes, nor for monetary policy changes, but for improvements in Europe's *structural* policies. This concern is sensible and warranted: but it is important to understand the limits to what structural policy can be expected to achieve.

The Meaning Of Structural Problems

Unfortunately, but probably inevitably, the term "structural problem" has come to acquire quite different meanings. Some commentators, including many equity investors, tend to apply the term to the corporate sector. Their concern is with companies that need to restructure so as to increase productivity and profitability by reducing labour, investing in new technologies, and improving work organisation.

Other commentators apply the term "structural problems" to situations such as those in Japan or Europe where the corporate sector has failed sufficiently to develop a whole area of economic activity, such as computer manufacture (Europe) or biotechnology (Japan).

Among policymakers, however, the term "structural problems" refers to any of a range of past policy decisions that, enacted largely through a labour market or social policy motivation, have – inadvertently – inhibited the macroeconomic performance of the economy.

Some Examples

While such structural problems can take many forms, two classes of structural problem stand out as particularly important. First, there are high taxes, paid on a per-employee basis by employers, that drive a large wedge between the cost of employing a worker and the market value of what he or she produces. Although neither the theory nor the empirical evidence is fully settled on this matter, it looks increasingly as if this phenomenon has been important in biasing employers in Europe towards capital-intensive methods of production. While in the 1970s and 1980s the resulting relatively-rapid growth of labour productivity tended to be looked upon with approval, more recently it has come to be recognised that this is inappropriate in a high-unemployment economy. Much better to have the investment spread more evenly, so as to employ a greater proportion of the labour force, albeit with labour productivity growing less fast overall.

A second important class of structural problems affects the ability of an economy to grow in a satisfactory, non-inflationary manner. In this category belong policies which discourage those who in principle wish to work or would be willing actively to seek it. The result is that the labour market starts to become inflationary long before all of the measured or indicated unemployment has been taken up.

While the full panoply of structural problems is without doubt wider and more complex[1], this broad stylisation does serve to indicate what should, and should not, be expected to result in economies characterised by such structural problems.

For it is evident that such structural problems will do little, if anything, to inhibit the early stages in a cyclical pick-up in activity, such as the euro area is currently experiencing. But structural problems *will* throw up two types of problems, which will manifest themselves sooner, and with more force, than they should. First, there will tend to be less employment take-up in relation to GDP than there would be were the various distortions less. And second, the economy will tend to run into an inflation constraint sooner than it ought – and certainly before it approaches anything like true full employment.

Conclusion

Observers of the euro-area scene are absolutely right to be concerned that a range of structural problems stand to prevent the continental economy from having as much success as it needs in reducing unemployment. And, importantly, they are right to take note that the European Central Bank, recognising this, will more regularly, and sooner, look for troubling signs of an inflation pick-up than it would were the structural policy side of Europe in better shape.

That said, it would be going too far to infer, as some commentators are doing, that structural problems will prevent any significant pick-up in Europe. If the present recovery gathers momentum, as it should, several years of reasonable growth may well lie ahead.■

[1] For a seminal discussion of the nature and effects of structural problems on Europe's economic performance, see *"The Role Of Shocks And Institutions In The Rise Of Unemployment"*, O. Blanchard and J. Wolfers, March 1999.

Global Letter

John Llewellyn, Global Chief Economist
+44 (0)207 260 2272
jllewell@lehman.com

Hesitant Growth Prospects

Mr Greenspan has given his clearest hint yet that he intends to try to slow the US economy to a more sustainable rate. Achieving this smoothly will not be easy, however. And the rest of the world is not perfectly poised to take up the growth baton.

All Change

How rapidly the world has changed. It was only ten months ago that the Russian default sparked off a global wave of distrust in financial assets. And only nine months ago that that distrust transmogrified into fear, as substantial parts of the US capital market froze solid.

Fortunately, the credibility of the Fed in general, and of Mr Greenspan in particular, proved sufficient to lay the ghost of financial collapse. A prompt 25bp reduction in the Fed funds rate, with just two more quickly following, did the trick. The US capital market, which supplies fully two-thirds of the capital needs of the world's largest economy, started to function again.

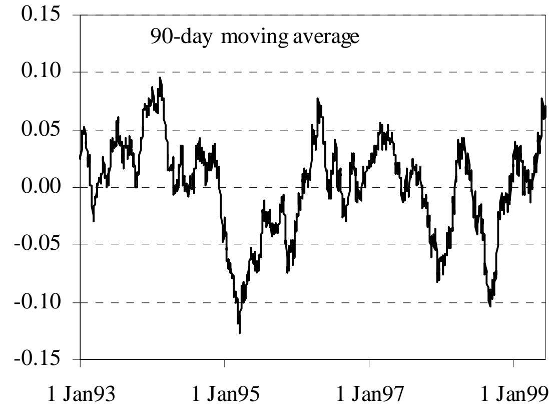
Indeed so successful was the Fed that now, just ten months further on, the US authorities see themselves facing the exact opposite problem. While intense product market competition has kept inflation quiescent, and astonishing labour market flexibility has contained nominal wages[1], the growth of the US economy has been such that it now risks running out of labour. Accordingly, in his address last Thursday to the Joint Economic Committee, Mr Greenspan gave his clearest hint yet that he wishes to see the US economy slow.

Apparently, Mr Greenspan judges the amount of unused labour to be now so small as to make the maximum sustainable growth of the economy only around 3%. But fine-tuning an economy down to a slower growth trajectory is an imprecise art. We suppose that the Fed will raise the funds rate by 25bp on 30 June, and maintain its bias to tighten[2]. But there is a risk that companies and consumers will judge that the time has come to pull in their horns, precipitating a sharper than desired slowdown.

Picking Up The Baton

It would therefore be comforting if, over the last ten months, the rest of the world had got itself into a position smoothly to take over the running from a slower United States. Unfortunately, that does not seem to be the case. Certainly, confidence in the rest of the world is in good shape. Our risk averseness index suggests that, in a remarkable turnaround, investors globally are today less risk averse than on any occasion bar two since 1992 - see the chart.

Lehman Brothers' risk averseness index*



** Note that above-zero readings imply that investors are "risk loving". For details of the index, see "Interest Rates: A Risk Averse World?", Global Weekly Economic Monitor, 29 May 1998.*

Furthermore, for Europe the survey evidence is that, even in the core, consumer confidence is high and business expectations are quite good. And indeed growth in the Euro area *is* picking up, with most of the growth coming, as it needs to, from domestic demand. That said, some of the rapid - 5%-odd growth in Q1 euro-area GDP is likely to have been pay-back from its dismal Q4 performance: it would seem unlikely that that pace will be maintained in the second quarter.

Japan however is more problematic. We, in common with many observers, doubt that that the world's third largest economy is anywhere near to achieving a sustained economic upswing. The strong first quarter 7.9% GDP figure owed much to government expenditure, which stands now to fade, and without any realistic prospect of its being immediately replaced by a pick-up in private domestic demand[3].

Confidence Is Key

The world is a markedly less dangerous place than it was a year ago. But even if the US economy slows smoothly, and even more if it does not, the world economy now seems set for a somewhat hesitant growth performance in the coming quarters. It is therefore vital that policymakers in Europe and Japan in particular should refrain from any action that could damage confidence, and thereby nip in the bud what is still only a fledgling recovery in non-US growth.■

[1] *For an elaboration of some of the ways in which the US economy has been 'finding' additional labour, see Joe Abate's article* "US Wage Puzzle" *in this issue.*

[2] *See Steve Slifer's article* "The Fed Changed The Rules" *in this issue.*

[3] *For a full discussion of the Japanese Q1 GDP figure, see Russell Jones' article* "Japan: Bamboozling Data", *in this issue.*

Global Letter

John Llewellyn, Global Chief Economist
+44 (0)171 260 2272
jllewell@lehman.com

Overdone Fiscal Concern

The euro is weak largely because the US economy is booming, while Europe's remains sluggish. But another injudicious spat between the ECB and Europe's finance and economics ministers, this time over the interpretation of Italy's revised budget outlook, is adding unnecessarily to the euro's weakness.

Budget Progress

The perception developed this week that, by revising up its 1999 budget deficit forecast from 2% to 2.4% of GDP, Italy was signalling a relaxation of its fiscal stance. Not so: Italy is in fact continuing to tighten its fiscal stance. Consider.

Italy has long been making major strides in reducing its public sector deficit.[1] Standing at some 9.6% of GDP in 1993, the figure was brought down continually to just 2.7% of GDP in 1997 - see the top half of the table. Tax increases did some of the work, but expenditure reductions were important too, aided importantly by falling bond yields, which sharply lowered the cost of servicing the public debt.

General government financial balances
(deficit (-) as % of nominal GDP)

	1993	1994	1995	1996	1997	1998	1999
				- Actual -			
France	-5.7	-5.7	-4.9	-4.1	-3.0	-2.9	-2.5
Germany	-3.2	-2.4	-3.3	-3.4	-2.6	-2.0	-1.9
Italy	-9.6	-9.2	-7.7	-6.6	-2.7	-2.7	-2.5
				- Structural -			
France	-3.9	-4.5	-3.8	-2.8	-1.9	-2.4	-2.2
Germany	-2.8	-2.2	-2.7	-2.4	-1.7	-1.4	-1.1
Italy	-8.2	-8.1	-7.0	-5.6	-1.7	-1.4	-1.1

Source: OECD

The deficit was unchanged in 1998, but the government expected a further fall in 1999, to just 2% of GDP. However that is now unlikely, and this week Europe's finance and economics ministers agreed Italy's revised projection of 2.4% for the year.

Such an estimate is not new: the OECD, for example, published an estimate of 2.5% in its mid-year *Economic Outlook*. Further, the projected outturn, while not as good as earlier hoped for, would nevertheless represent a continuing reduction. And, importantly, the figure of 2.4% is still significantly below the trigger-value of 3% stipulated in the Growth And Stability Pact.

Most important, however, is the fact that the upward revision does not represent any change in the government's fiscal stance. Rather it is the consequence of the unexpectedly-long cyclical weakness of the economy, which is leading - as such weakness inevitably does - to reduced tax revenues and increased expenditures.[2]

Not only is this basic point well known, but estimates are freely available of these (cyclical) effects of the economy on the budget. The OECD and the European Commission, for example, regularly publish estimates of countries' 'structural', or cyclically-adjusted, budget balances - see the lower half of the table.

These figures demonstrate that Italy has tightened its fiscal stance *every year* since 1993. And they also show that, if the Italian, German and French economies were in the same cyclical state, Italy's 1999 deficit - like Germany's - would be just 1.1% of GDP. France's figure, however, would be double that.

Ill-Founded Criticism

Notwithstanding the figures, however, there has been criticism of Italy, out of both Germany and the European Central Bank, for not tightening its fiscal stance further. Such critics, who tend to dismiss cyclically-adjusted figures as something of an artefact, take note only of the *actual* deficit, which they would like to see stay firmly on a downward trend, notwithstanding the weak (cyclical) state of the economy.

Foolish Policy

To try to achieve that would however be risky. Those in doubt need only consider Japan's ill-fated fiscal tightening of 1997. While Japan's ghastly medium-term debt dynamics warranted - and still warrant - a much tighter fiscal position over the medium term, Japan unwisely chose to begin its tightening in a year when the economy was cyclically weak. That action contributed to turning conjunctural weakness into a deep recession, from which the economy has yet to emerge.

Italy, wisely, is refraining from committing this policy error. Germany, however, is not. Cyclical weakness notwithstanding, Germany is *tightening* its fiscal stance again this year, by between a quarter and a half percentage point of GDP. Hitting an economy further in this way, at a time when it is already on the ropes, is a risk that we for one would rather not see taken.■

[1] For greater detail on European budget analysis, see Klaus Baader's article "Budget Deficits In The Euro Area" in this issue.

[2] As it happens, Italy's budget deficit is rather less procyclical than are the budget deficits of other European countries, in part because Italy has a markedly less generous unemployment benefit system. Were Italy's system as generous as those of France or Germany, for example, the government would have had to raise its projected budget deficit figure significantly higher.