

Monographic April 2004:

Macroeconomic Policy

INDEX

1. U.S.A.
2. Euro-zone
3. Spain
4. France and Germany
5. Japan
6. Argentina and Brazil

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1.- The United States

This month, our aim (as in all OCEI reports) is to reflect mainly upon macroeconomic management in recent times. Taking into account the analysis included in the already considerable volume of previous reports, three main ideas can be extracted, which will be developed in more detail this month:

- 1) Macroeconomic policy over the past three years marks an unusually expansive era in US economic history.
- 2) The country has witnessed an alarming deterioration in its budget and current account balance, while inflation remains under control and the unemployment rate has risen moderately, thanks to the worrying fall in the activity rate.
- 3) While the result of such expansive policies has been discreet in terms of growth, it has been disastrous for employment.

In the following analysis a historical comparison is used, which covers the last four decades, with a total of 11 legislatures (Table 1, at the end of this report).

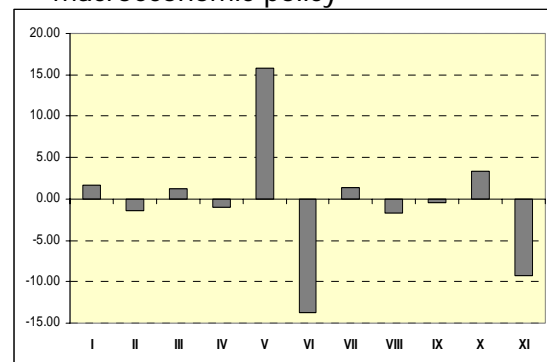
The policies

Throughout the successive economic climate reports¹, recent monetary and financial policy has been dealt with in some detail. In this case, we propose a

¹ As well as the special report dedicated to the Bush Administration's tax policy, in July 2003.

synthetic indicator to capture the expansive/contracting tone of both policies as a whole, by adding Fed reference interest rate variations and the structural budget balance. A negative sign denotes a drop in interest rates and/or an increase in the structural deficit, and, therefore, is of an expansive nature. Figure 2 compares the macroeconomic performance of the last 11 legislatures in the United States (the result presented is the average for the corresponding years).

Figure 2.- Direction of macroeconomic policy



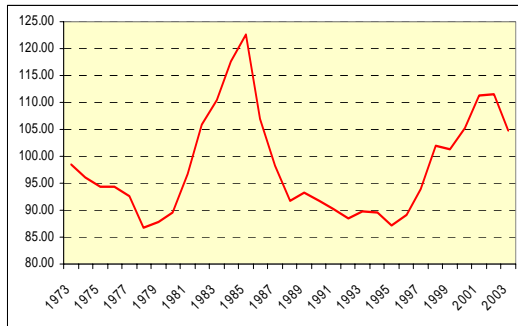
Source: own elaboration with data from FRED II

The current legislature is the most expansive in terms of macroeconomic policy in four decades, except for R. Reagan's first term, as can be appreciated in the graph.

Nevertheless, even with respect to this case, there are several aggravating circumstances: firstly, the 81-84 period follows a time in which interest rates soared to control the inflation effects of the supply crisis in the 70s. Secondly, during Reagan's first term, the dollar's real effective exchange rate appreciated by 30%, taking a lot of power out of financial and monetary stimulus. During the current presidency, on the contrary, the exchange rate has

been maintained (although fluctuating markedly up and down) at the same level as in December 2000 (Figure 3).

Figure 3.- Real Effective Exchange Rate



Source: own elaboration with data from the Department of Commerce

Thirdly, in 2004 the trend towards macroeconomic relaxation has done nothing but become more pronounced. On one hand, the Federal Reserve reaffirms its commitment to be "patient" despite the inflation breaking out in the first quarter of the year. It is true that the origin of this inflation is imminently linked to that in commodities², producing a dramatic 5.1% increase in the general CPI (annually adjusted quarterly figure). Nevertheless, even core inflation progressed at an annual pace of 2.9%, although it is true that there are reasons not to expect runaway inflation in the short term (stong progress in productivity, not much room for businesses to raise prices, low productive capacity utilisation). However, there are reasons to fear, contrary to all monetary principles implanted in the main central banks over the last decade, that the Federal Reserve is adopting very worrying backward looking perspective – waiting

² With the surprising contribution of the hotel sector, which increased its prices in March at an annual rate of 57%.

to verify price acceleration to later react³. We maintain our forecast for reference interest rates to reach 1.5% by the end of 2004, which would hardly offset the enormous decrease experienced since 2000 at all.

Furthermore, looking at taxation, the circumstances are not only very expansive, but directly worrying. The structural deficit in 2004 is forecast to reach 3.9% of GDP (1.1% more than last year), accentuating the the macroeconomic action already described, despite the forecast of growth to be around 4.5%.

The Imbalances

To assess the existing imbalances in the US economy, we have extended the so-called Misery Index⁴, originally proposed by Arthur Okun at the beginning of the 70s. The original indicator (later modified by various authors⁵) was an aggregate of inflation

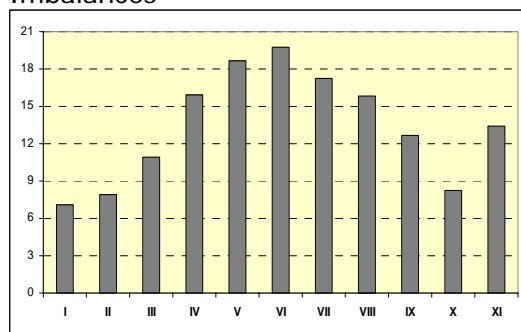
³ Some analysts show concern over the maintenance of interest rates at a minimum not because of price patterns, but due to the fear of provoking financial and real estate bubbles which, contrary to the stock market bubble at the end of the 90s, would be difficult to respond to on behalf of the monetary authority. In this line, Stephen Roach, chief analyst at Morgan Stanley, has repeatedly proposed in recent weeks an immediate increase in rates of 200 basis points to prevent this situation. [<http://www.morganstanley.com/GEFdata/digests/20040227-fri.html>].

⁴ The term Indicator of Imbalances used here, while clearly different to the original terminology, is in our opinion closer to the meaning of what we wish to express.

⁵ See a brief history of the indicator in Lovell, M. y Tien, P. L.(1999); "Economic discomfort and consumer sentiment", Eastern Economic, 26, 1, pp.1-9.

rates and unemployment. For our *Imbalance Indicator*, the current account and Federal Government deficits as percentages of GDP have been incorporated. The aggregate of the four variables gives us an enlarged Indicator of Imbalances, which captures the trajectory over the past 11 administrations (annual average), in Figure 4.

Figure 4.- Enlarged Indicator of Imbalances



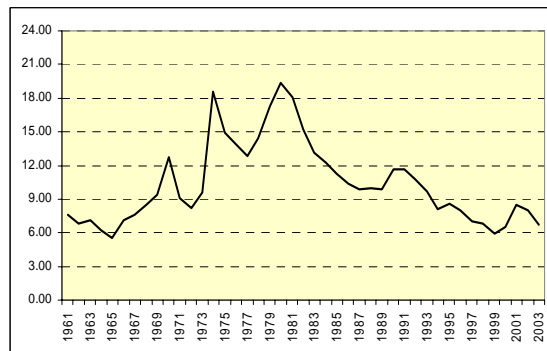
Source: own elaboration with data from the BLS and FRED II

The average imbalance in the period from 2001-2003 is not seen to stand out especially in the last four decades, although a deterioration with respect to the Clinton era can be seen. Even if we confine our analysis to the original Misery Index (taking into account only inflation and unemployment) the overall result for the three-year period is outstanding (Figure 5), although this is almost exclusively due to the inflation control exercised by the Federal Reserve since the end of the 90s (as opposed to unemployment, which has ranged from one decimal point above to two decimal points below the mean for the past four decades).

The scenario changes radically when we concentrate on the budget and external deficit (Figure 6). In 2003, according to our Additional Indicator of

Imbalances (which aggregates both variables), the United States registered the largest deterioration in the last four decades⁶.

Figure 5.- Original Misery Index



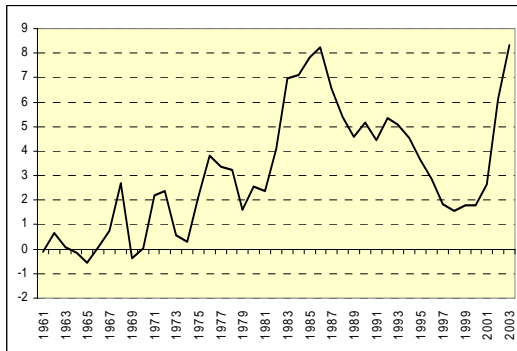
Source: own elaboration with data from the BLS and FRED II

The outlook for 2004 is for this tendency to intensify, given that the Federal Government deficit (521 billion dollars) will reach, in the best of cases, 4.5% of GDP (more than one point worse than last year) and the current account balance will presumably maintain a deficit of close to 5% (4.9% in 2003).

As pointed out in previous reports (October 2003), insufficient savings in the US economy (and not unfair competition on behalf of other countries) is what is forcing the US to seek funds externally, and which, in turn, leads to an external deficit. The same lack of budget control in recent years, with the fastest deterioration in the history of the US economy is what is to a great extent responsible for the external deficit.

⁶ In fact, the largest in a longer period of time, but our research dates from 1961.

Figure 6.- Additional Indicator of Imbalances



Source: own elaboration with data from the BLS and FRED II

At this point in time, we must refer to the latest research published on the fundamentals, future evolution and implications of the US financial deficit. In this line, the (dual party) Congress Budget Office shows how only 6% of the deficit can be attributed to economic weakness, while the Bush Administration's legislative changes account for the immense majority. These changes have been particularly concentrated in tax cuts⁷, scandalously biased to favour higher income earners. The liberal Center on Budget and Policy Priorities shows how funds raised through income tax are the lowest, in terms of GDP, since 1955, with the peculiarity that those who earn more than one million dollars benefit from a reduction in taxes that is 200 times greater than that of a middle income family! Even if this is correct by the level of income, this privileged group sees its income after tax increase by three times that of a representative family, as a result of the Republicans' taxation policy.

The outlook for the future in the medium term, if the current administration's priorities are respected,

⁷ See OCEI special report, July 2003.

are not exactly heartening. The proposed elimination of the sunset clauses, which limit the length in time of these tax cuts, would cost 1.3 trillion dollars in the next decade. The changes in Medicare⁸ would add a further 500 billion dollars to be added to the 400 billion dollar increase in the deficit resulting from other planned modifications.

The IMF, surprising, dedicated a section in its recently released World Economic Outlook to highlight the worrying implications, on both the domestic and international scene of the US deficit⁹. One particularly negative figure: if the current trend is not corrected, the cost of the upward pressure on interest rates could reach two points of output potential (both in the US and externally) in one decade. While this is an extreme scenario, the IMF report discloses the potential cost of this imbalance.

In response to the existing general concern, the Republican executive intends to bring a law into force that is similar to the Balance Budget and Emergency Deficit Control Act passed in 1985 and renewed in 1990 to contain the deficits of their republican predecessors, R. Reagan and G. Bush. However, the new project has one peculiarity: the original law prohibited all expenditure increases or tax cuts not covered by savings of the same magnitude in other areas. The current proposal maintains the same line with

⁸ Critics consider that this will be a succulent business for pharmaceutical companies.

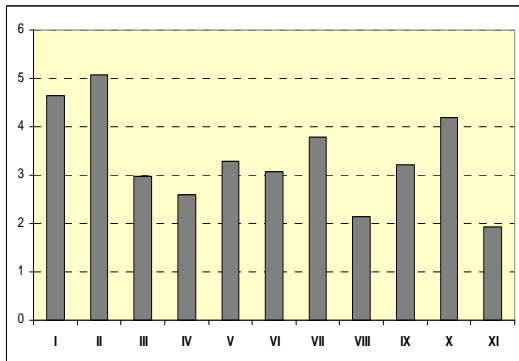
⁹ See chapter 2, dedicated to this issue, along with Chinese growth, at <http://www.imf.org/external/pubs/ft/weo/2004/01/index.htm>

respect to increases in expenditure...but does not say anything about tax cuts, precisely what has led the deficit to soar.

The Results

When one observes the combination of extremely expansive macroeconomic policy and the accumulation of worrying imbalances in government accounts and the external sector, one would expect to find, at least, particularly satisfying results in terms of economic growth and employment, which are basic to balance the books in the immediate future. Nothing could be further from reality.

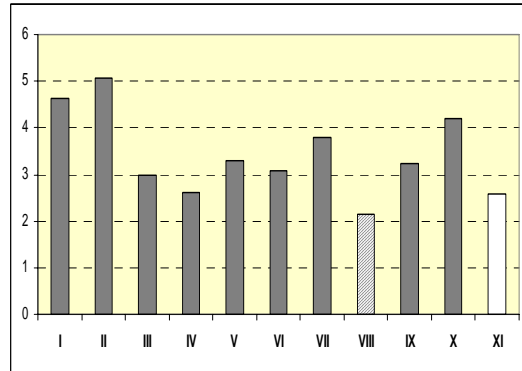
Figure 7.- Real GDP Growth (1961-2003)



Source: own elaboration with data from FRED II

The average increase in GDP under the current administration (2001-2003) is the poorest in the four decades studied (Figure 7). Even if we are optimistic and place the current year's GDP growth at 4.5%, George W. Bush's legislature will close having only had the honour of better the growth figures obtained by his father (Figure 8).

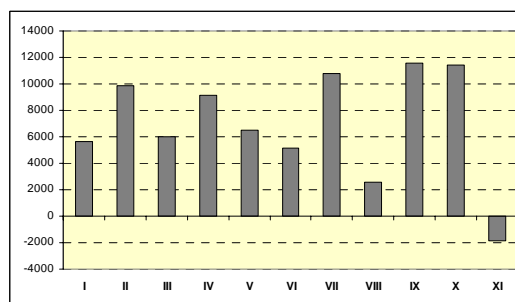
Figure 8.- Real GDP Growth (forecast for 2004)



Source: own elaboration with data from FRED II

Despite these disappointing growth results, it is not necessary to remind readers of these economic climate reports that the situation is worse still when looking at the employment pattern, which will close our analysis for this month. Despite the data released for March, the current government is bravely fighting to avoid being the first to end a legislature with net jobs lost since the beginning of statistics (Figure 9). It must be remembered that, in the eight years previous to G.W. Bush's arrival, with less macroeconomic imbalances and slightly restrictive policies, as stated in this report, over 23 million net jobs more were created...

Figure 9.- Payroll Employment Pattern (1,000s of people)



Source: own elaboration with data from the BLS

TABLE 1.- Periods under analysis

	PERIOD	ADMINISTRATION	Months in recessi on
I	1961- 64	J. F. Kennedy / L. Johnson	2
II	1965- 68	L. Johnson	0
III	1969- 72	R. Nixon	11
IV	1973- 76	R. Nixon / G. Ford	16
V	1977- 80	J. Carter	6
VI	1981- 84	R. Reagan	16
VII	1985- 88	R. Reagan	0
VIII	1989- 92	G. Bush	8
IX	1993- 96	W. J. Clinton	0
X	1997- 2000	W. J. Clinton	0
XI	2001- 03 *	G. W. Bush	8

* Data up to March 2004 for job creation
Source: own elaboration

Vicente J. Pallardó
Valencia, April 28 2004

2.- Euro-zone

Fiscal Policy

European Union norm framework sets financial rules that restrict national policy action by establishing criteria to guarantee balanced public finances. According to the European Community Treaty, member states should avoid excessive deficit. The budget deficit must not exceed 3% of GDP and public borrowing cannot exceed 60% of GDP.

Following this, the Stability and Growth Pact provided the treaty's budget rules with operative criteria, forcing member states to respect the medium term budget target of near equilibrium or surplus; specifying excessive deficit procedures in detail; and establishing the exceptions of deficits caused by events beyond the control of the government or severe economic recessions.

The need for the Stability Pact is based on the fact that balanced public finances are fundamental in order to preserve macroeconomic stability, which is, in turn, necessary for price stability. Moreover, in the Monetary Union as a whole, public finance stability avoids undesirable behaviour. In effect, firstly, the Monetary Union, by homogenising interest rates, fosters the access of those countries which have behaved more licentiously (and which have historically borne higher interest rates) to bank loans, thereby creating a bias towards deficit. In the second place, expansive financial policy in one country produces a negative effect in the remaining EU member states, due to the fact that financing an excessive deficit exercises upward pressure on long-term interest rates in

the entire area. Table 1 displays the pattern of the European Union's budget in both aggregate and disaggregate terms. In the first part of the table, the overall deficit is shown, in the second part, the primary deficit (in other words, excluding interest payments) and in the third, public borrowing. The aggregate shows that the public deficit decreased noticeably in the '90s, particularly up to 1997, the deadline set for countries to achieve the objectives laid down by the Maastricht Treaty. In recent years, however, total deficit has remained constant, basically due to the reduction of interest rates, whereas the primary surplus has been fallen drastically. Public borrowing during the period in question has increased by 12 points, pushed up by France and Germany's lack of budget discipline. Figure 1 shows the year by year pattern of the primary surplus.

However, to ascertain the real dimension of discretionary fiscal policy, a cycle-adjusted measurement must be used, that is, excluding the effect of automatic stabilisers on public accounts. In Table 2 fiscal policy is seen to be clearly restrictive up to 1997 and expansive between that year and 2002. The various member states have performed differently. On one hand, Greece and Spain's effort to reduce their cycle-adjusted deficits figured prominently, while on the other hand France is the only country that still had a cycle-adjusted primary deficit in 2002. The deterioration of public accounts from 1997 onwards shows that fiscal consolidation has, to a certain extent been exhausted and has been linked to the fact that the public sector has lost weight. In other words, less public

income and expenditure (Tables 3 and 6).

Table 7 analyses the pattern of the various types of tax in the Euro Area as a whole. In the last column there is an indicator of the tax burden, based on the sum of the previous columns. From 1991 to 2000, fiscal burden is seen to increase, but from then onwards, the burden has decreased. This total hides a (moderate) redistribution among the weightings of the various types of tax. While direct tax (both on households and also companies) and indirect tax are rising, in general terms, social security contributions on behalf of employers and employees are diminishing.

Figure 1. Primary Surplus
(percentage of GDP)



Source: ECB

Monetary Policy

Monetary policy in Euroland is in the hands of the European Central Bank (ECB). The sole objective of the ECB's monetary policy, as opposed to that of other central banks, is to maintain price stability. Price stability is defined, in quantitative terms, as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. This definition

makes certain aspects that are relevant for the interpretation of monetary policy clear: 1) 2% is the top end of the range; 2) by speaking of increases close to 2%, the danger that very low inflation rates could imply is anticipated; 3) a specific indicator is used, the HCPI; 4) the decision is made on the Euro Area price index as a whole, without taking into account geographical differences.

The choice of 2% was historically motivated, but also arbitrary to a certain extent, in light of the fact that when ECOFIN adopted the master guidelines of economic policy in 1995, the 2% mark was considered the highest inflation rate compatible with price stability.

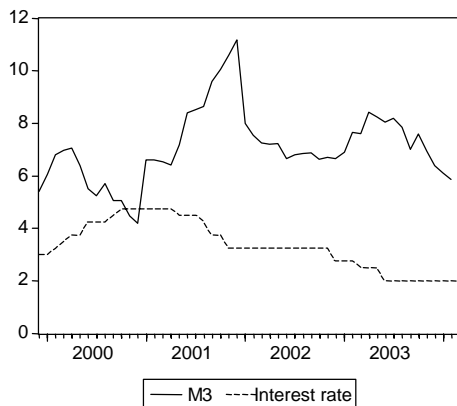
The ECB believes that temporary lags in the transmission of interest rate mechanisms to prices makes controlling prices in the short term by means of monetary policy impossible. For this reason, ECB policy decisions must be understood to form a part of a medium-term strategy, making them incompatible with excessive activism and meaning that they must be "forward looking."

As opposed to other Central Banks, the ECB does not follow one sole economic model to make its decisions, but instead seeks to incorporate all the relevant information. The weight of this information varies over time. By increasing the number of variables and on lacking an objective model, the degree subjectiveness also increases, which, on occasions, makes the ECB's decisions difficult to interpret.

The strategy of the ECB is based implicitly on two cornerstones. The first

consists in monitoring the M3 aggregate, which does not mean that it is a monetary objective, that is, the ECB does not react automatically to maintain the M3 at a reference value (which has historically been considered at 4.5%¹), a fact that is unquestionable in view of Figure 2.

Figure 2. M3 Growth and Reference Interest Rate



Source: Own elaboration

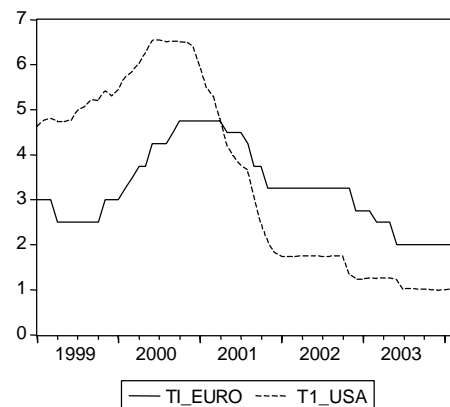
The second cornerstone consists in monitoring a wide range of economic indicators, related to the connection between supply and demand in the goods and services and factors markets.

The first cornerstone summarises those models that recognise that the inflation objective in the medium and long term is a monetary. The second is coherent with models that emphasize the importance of pressures that connections between supply and demand as well as cost variations can exercise on prices.

¹ De hecho recientemente el pilar monetarista ha perdido peso, dada la dificultad para compatibilizar la evolución de M3 y del tipo de interés.

In Figure 3, you can observe the pattern of the reference interest rate in Euroland and the United States, where the Federal Reserve's monetary policy since 2000 is seen to have been much more aggressive than that of the ECB. The ECB, precisely, has been accused in recent years of being ultraconservative.

Figure 3. Reference Interest Rates in the United States and Euroland



Source: Fed, ECB and own elaboration

If we concentrate on prices, which is, as mentioned, the sole objective recognised by the ECB, Figure 4 shows that, since the year 2000, inflation has remained relatively stable, but in a range that is slightly above the threshold established as the target of the ECB. Therefore, except in the last three months, monetary policy has not seemingly had much margin for further interest rate cuts.

In the next few paragraphs, out attention turns to production. Figure 5 shows the relationship between interest rate movements (standardised to zero) and the economic cycle, measured by the monthly EuroCoin indicator. At first sight, monetary policy appears to have been procyclical, that is, expansive in

expansive phases of the cycle and restrictive in phases of recession.

Figure 4. Reference Interest Rate and Inflation Rate

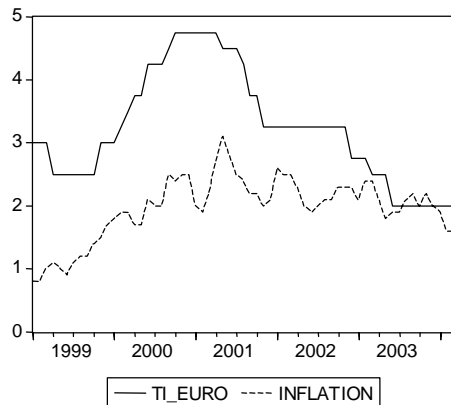
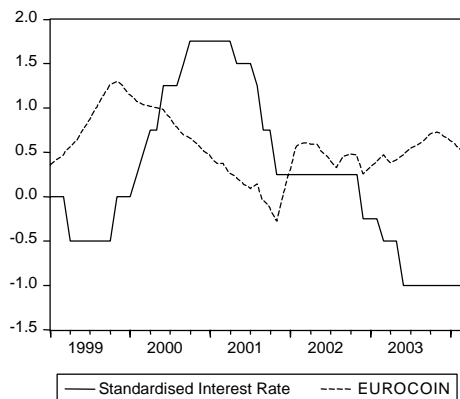


Figure 5. Interest Rate and EuroCoin



Source: own elaboration

However, this result can be taken further by attempting to answer two questions of interest: Has monetary policy used the ups and downs in production to justify its action? Figure 6 captures the correlation between the interest rate and the cycle. Monetary policy does not seem to have accomodated movements in production, as its performance with respect to this variable has been anti-cyclical and with a considerable lag. Second question: when used, has monetary policy had an

impact on production? This seems to have been the case. In Figure 6, monetary policy is seen to perform procyclically and is slightly leading with respect to production.

In November 2001, the ECB Observatory carried out a survey among 190 experts, asking them the following question: "Monetary policy or Fiscal policy, which tool is better to combat Euro-zone recession?" The distribution of responses can be found in Table 8. Seemingly, monetary policy is preferred to fiscal policy, although the high percentage of answers proposing no policy action is striking.

Table 8. Experts opinons on the effectiveness of different economic policies

Monetary Policy	33.4%
Fiscal Policy	13.2%
Both	28.9%
Neither	19.4%
Other	2.1%

Source: OBCE

Supply Policies

A large group of structural reforms, basically microeconomic, can be defined as supply policies, aimed at improving labour, product and financial market performance. The reference framework for these supply policies is the so-called Lisbon Agenda, due to the fact that Lisbon hosted the European Council that established the new strategic objective for the next decade of transforming the Union into the most competitive and dynamic economy in the world. This goal has two mainstays: on one hand solid macroeconomic policies (see the two previous sections) and on the other hand as coordinated series of structural reforms.

Member states appear to widely agree with the detailed diagnosis laid down in Lisbon, on structural reform priorities. However, criticism of the Lisbon Agenda, mainly on behalf of the ECB and the European Commission, point out the need to provide this well-intentioned framework with a more precise timetable for these policies to be executed.

This, nevertheless, has meant a certain advance in the implementation of reforms in various markets. Financial markets have seen the launch of the "Financial Services: Action Plan" (FSAP), which seeks to achieve common financial legislation across member states. In the labour market, the tools used have focused basically on social transfer cuts and the introduction of more flexible working contracts, which has provoked a moderate reduction in the NAIRU since halfway through the '90s. However, the employment rate in the Euro-zone was 62% in 2002, compared to 75% in the United States. The Lisbon target is to generate an employment rate of 70% by 2010, which certainly seems a long way off. As far as the goods and services market is concerned, measure have been adopted to open up European energy markets, to modernise competition policy, to create one sole sky and to introduce a patent on a community scale.

Future priorities, outlined by J.C. Trichet (2004), as far as structural reform is concerned, focus on four large areas: (1) reduce the high youth unemployment rate; (2) improve the unsatisfactory performance of the Single Market services sector; (3) increase productivity in the Euro-zone,

fostering investment in R+D; (4) alleviating the negative effects of an aging population by managing social protection schemes.

Javier Ferri,
Valencia, May 1 2004

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Table 2 – Cycle-adjusted Deficit / Surplus (percentage of GDP)

	1991	1995	1997	2002
Belgium	2.9	5.3	6.1	6.1
Denmark	5.7	3.9	5.4	5.5
Germany	-1.9	0.1	1.4	0
Greece	-2.4	2.2	5.1	3.7
Spain	-1.5	-0.3	2.3	2.8
France	0.1	-1.4	1.2	-0.3
Ireland	4.5	3.8	4.7	0.4
Italy	-0.3	3.8	6.5	3.6
Luxembourg	--	--	--	--
Netherlands	2	2.1	3.7	2.2
Austria	0.6	-0.6	2.5	3
Portugal	-0.2	1.5	0.8	0.5
Finland	2.6	1.9	1.8	7
Sweden	4.5	-0.5	5.3	3.8
United Kingdom	1	-2.1	1	1.1
Euro-12	-0.5	0.8	2.8	1.6
EU15	0	0.4	2.7	1.6

Source: Briotti (2004)

Table 3. Public Revenue

	1991	1995	1997	2002
Belgium	46.9	48.5	49.5	50.1
Denmark	55.4	58	58.3	57.2
Germany	44.1	46.1	46.6	45
Greece	33.3	39.3	42.4	45.1
Spain	39.2	38.4	38.6	39.6
France	49.1	49.7	51.9	50.8
Ireland	42	39.4	38.6	33.7
Italy	43.8	45.8	48.4	45.2
Luxembourg	45.7	47.6	46.5	48
Netherlands	52.2	47.3	47.1	46.1
Austria	51.2	52	52.1	51.4
Portugal	37.5	39.6	41.2	43.4
Finland	57.3	55.6	55	54
Sweden	64.6	60.3	61.4	59.5
United Kingdom	40.9	38.9	38.9	39.5
Euro-12	45.4	46.5	47.6	46.1
EU15	45.5	46.1	46.8	45.5

Source: Briotti (2004)

Table 4. Cycle-adjusted Public Revenue (percentage of GDP)

	1991	1995	1997	2002
Belgium	46.1	48.8	49.5	50.1
Denmark	56	57.8	57.9	57.2
Germany	42.5	46	47.1	45.4
Greece	33	40.5	43.3	44.5
Spain	38.3	39.4	39.3	39.6
France	48.8	50	52.4	50.7
Ireland	41.8	39.8	38.1	33.2
Italy	43.5	45.7	48.2	45.4
Luxembourg	--	--	--	--
Netherlands	51.4	47.5	46.9	46.2
Austria	50.5	52.2	52.5	51.4
Portugal	36.3	40.2	41.3	43.7
Finland	58.7	56.8	54.2	54
Sweden	65	60.5	62	59.2
United Kingdom	41.7	38.8	38.5	39.7
Euro-12	44.6	46.7	47.9	46.3
EU15	44.9	46.3	47	45.6

Source: Briotti (2004)

Table 5. Cycle-adjusted Primary Expenditure

	1991	1995	1997	2002
Belgium	43.2	43.5	43.4	44
Denmark	50.3	54	52.5	51.7
Germany	44.4	45.9	45.7	45.4
Greece	35.4	38.3	38.2	40.8
Spain	39.8	39.7	37	36.8
France	48.7	51.4	51.1	50.9
Ireland	37.3	36	33.4	32.8
Italy	43.7	41.9	41.7	41.8
Luxembourg	-	-	-	-
Netherlands	49.3	45.4	43.2	43.9
Austria	49.9	52.9	50.1	48.4
Portugal	36.5	38.7	40.5	43.1
Finland	56.1	54.9	52.4	47
Sweden	60.6	61	56.7	55.4
United Kingdom	40.7	41	37.5	38.6
Euro-12	45.1	45.9	45	44.7
EU15	45	45.9	44.3	44

Source: Briotti (2004)

Figure 3. Correlations between Reference Interest Rate and the EuroCoin lag (-j) and lead (+j)

EUROCOIN(-i)	EUROCOIN(+i)	i	lag	lead
. ** .	. ** .	0	-0.2115	-0.2115
. * .	. *** .	1	-0.1087	-0.3286
. .	. **** .	2	0.0012	-0.4313
. * .	. ***** .	3	0.1120	-0.5173
. ** .	. ***** .	4	0.2213	-0.5728
. *** .	. ***** .	5	0.3260	-0.6068
. **** .	. ***** .	6	0.4191	-0.6170
. ***** .	. ***** .	7	0.4927	-0.6123
. ***** .	. ***** .	8	0.5476	-0.5946
. ***** .	. ***** .	9	0.5884	-0.5676
. ***** .	. ***** .	10	0.6134	-0.5369
. ***** .	. ***** .	11	0.6333	-0.4961
. ***** .	. ***** .	12	0.6429	-0.4537
. ***** .	. **** .	13	0.6496	-0.4036
. ***** .	. **** .	14	0.6407	-0.3507
. ***** .	. *** .	15	0.6193	-0.2990
. ***** .	. *** .	16	0.5870	-0.2550
. ***** .	. ** .	17	0.5665	-0.2134
. ***** .	. ** .	18	0.5527	-0.1682
. ***** .	. * .	19	0.5370	-0.1255
. ***** .	. * .	20	0.5046	-0.0883
. ***** .	. * .	21	0.4716	-0.0571
. **** .	. .	22	0.4388	-0.0301
. **** .	. .	23	0.4134	-0.0043
. **** .	. .	24	0.3883	0.0167

Source: own elaboration

Table 1. Budget position of EU countries (percentage of GDP)

	Deficit (-) / Surplus (+)				Primary Deficit (-) /surplus (+)				Public Borrowing			
	1991	1995	1997	2003	1991	1995	1997	2003	1991	1995	1997	2003
Belgium	-7.5	-4.3	-2	0.2	3.9	4.9	6	5.8	130.9	134	124.8	100.5
Denmark	-2.4	-2.3	0.4	1.5	4.9	4.1	6.1	4	62.5	69.3	61.2	45
Germany	-2.9	-3.5	-2.7	-3.9	-0.1	0.2	0.9	-0.7	40.4	57	61	64.2
Greece	-11.4	-10.2	-4	-1.7	-2.1	1	4.2	3.9	82.2	108.7	108.2	102.4
Spain	-4.3	-6.6	-3.2	0.3	-0.6	-1.4	1.6	2.9	44.3	63.9	66.6	50.8
France	-2.4	-5.5	-3	-4.1	0.6	-1.8	0.7	-1.1	35.8	54.6	59.3	63
Ireland	-2.9	-2.1	1.4	0.2	4.8	3.3	5.3	1.6	102.9	82.7	65	32
Italy	-11.7	-7.6	-2.7	-2.4	0.2	3.9	6.7	2.9	100.6	123.2	120.2	106.2
Luxembourg	1.2	2.1	3.2	-0.1	1.5	2.5	3.6	0.1	3.8	5.6	6.1	4.9
Netherlands	-2.7	-4.2	-1.1	-3	3.4	1.7	4.1	-0.1	76.9	77.2	69.9	54.8
Austria	-3	-5.3	-2	-1.1	1.2	-0.9	2	2	57.5	69.2	64.7	65
Portugal	-7.6	-5.5	-3.6	-2.8	1.2	0.8	0.7	0.1	60.7	64.3	59.1	59.4
Finland	-1.1	-3.9	-1.3	2.3	0.8	0.1	2.9	4.1	22.6	57.1	54	45.3
Sweden	-1.1	-7.4	-1.7	0.7	3.9	-0.8	4.6	2.7	51.3	73.6	70.5	51.8
United Kingdom	-3.1	-5.8	-2.2	-3.2	0.1	-2.1	1.5	-1.1	34.4	51.8	50.8	39.8
Euro-12	-5	-5.1	-2.6	-2.7	0.5	0.5	2.5	0.8	58.6	73	75.4	70.4
EU15	-4.6	-5.2	-2.5	-2.6	0.6	0.2	2.5	0.6	54.9	70.2	71	64

Source: Briotti (2004) and own elaboration

Table 5. Public Spending (percentage of GDP)

	Total				Interest				Primary Expenditure			
	1991	1995	1997	2002	1991	1995	1997	2002	1991	1995	1997	2002
Belgium	54.4	52.8	51.4	50	11.9	9.3	8	6	43	43.6	43.4	44
Denmark	57.8	60.3	58	55.2	7.3	6.4	5.7	3.6	50.6	53.9	52.3	51.6
Germany	47.1	49.6	49.3	48.6	2.6	3.7	3.6	3.2	44.3	45.9	45.7	45.4
Greece	44.7	49.4	46.4	46.3	10	11.2	8.2	5.5	35.4	38.3	38.2	40.8
Spain	43.5	45	41.8	39.6	3.9	5.2	4.8	2.9	39.8	39.8	37	36.8
France	51.6	55.2	55	53.9	2.9	3.8	3.7	3.1	48.6	51.5	51.3	50.9
Ireland	44.9	41.5	37.1	33.9	7.9	5.4	3.8	1.3	37.2	36.1	33.3	32.6
Italy	55.5	53.4	51.1	47.5	10.5	11.5	9.4	5.7	43.7	41.9	41.7	41.9
Luxembourg	44.5	45.5	43.3	45.5	0.4	0.4	0.3	0.4	44.2	45.2	43	45.1
Netherlands	54.9	51.4	48.2	47.2	5.9	5.9	5.2	3.2	48.8	45.5	43.1	44
Austria	54.2	57.3	54.1	52	4.1	4.4	4	3.5	49.9	52.9	50.1	48.4
Portugal	45.1	45	44.8	46.2	8.6	6.3	4.2	3	36.3	38.8	40.6	43.1
Finland	58.5	59.4	56.3	49.2	1.4	4	4.2	2.2	56.6	55.3	52.1	47
Sweden	65.6	67.7	63.1	58.2	4.8	6.6	6.3	2.9	60.6	61.1	56.8	55.3
United Kingdom	44	44.6	41.1	40.7	3.8	3.7	3.7	2	40.8	41	37.4	38.7
Euro-12	50.5	51.5	50.2	48.4	5.2	5.6	5.1	3.7	45	46	45.1	44.7
EU15	50.1	51.3	49.3	47.4	5	5.4	4.9	3.4	44.9	45.9	44.3	44

Source: Briotti (2004)

Table 7. Euro-zone Taxes (percentage of GDP)

	Direct Tax: households	Direct Tax: corporations	Indirect Taxes	Social contributions: employers	Social contributions: employees	Capital Taxes	Fiscal Burden	
1991	9.2	2.2	13	8.6	5.3	0.2	38.5	
1992	9.6	1.9	13	8.7	5.4	0.6	39.2	
1993	9.7	2.1	13.2	8.7	5.6	0.3	39.6	
1994	9.2	2	13.4	8.5	5.7	0.2	39	
1995	9.2	2	13.3	8.4	5.6	0.3	38.8	
1996	9.3	2.3	13.4	8.7	5.6	0.3	39.6	
1997	9.3	2.6	13.5	8.8	5.6	0.4	40.2	
1998	9.6	2.5	14.1	8.5	5	0.3	40	
1999	9.9	2.5	14.3	8.5	5	0.3	40.5	
2000	10	2.7	14.2	8.4	4.9	0.3	40.5	
2001	9.8	2.5	13.9	8.4	4.8	0.3	39.7	
2002	9.5	2.4	13.9	8.4	4.7	0.3	39.2	

Source: ECB and own elaboration

3.- Spain

The gradual process of European integration, despite having a significant and favourable effect in terms of disciplining the behaviour of economic agents', has meant a reduction in the number and effectiveness of the tools available to national governments for the control of aggregate demand, economic imbalances and the cycle.

The integration process has also resulted in a considerably restrictive barrier for the independent use of practically all the remaining economic policies (wage, employment, financial, etc.), in light of what the application of disparate policies on behalf of member states could cost the country itself, or the Monetary Union as a whole.

Fiscal Policy

With the transfer of trade, agriculture, regional, monetary and exchange rate policies, the most powerful weapon currently available to governments is financial policy. This policy area includes all decisions taken by the government in two key fields: income (amount, types, structure, calendar, deductions, exemptions, sectors of the population that are taxed, inspection, etc.) and the level of expenditure (volume, sectoral distribution, priority areas, long-term employment, wages, decentralisation, etc.). Once both these areas are established, both the level of savings and also the public deficit are set. The latter implies the financing needs of the public sector, or appeal for private saving, with all the consequences this entails for the economy as a whole.

This policy, with all its limitations (drawn out process of passing bills and the achievement of desired effects), has become, on paper, the main management tool for aggregate demand and, therefore, for the cycle and inflation itself that is currently available to governments.

As a result, governments should make a considerable effort to implement a framework in which financial policy may gain efficiency, speed and transparency, thereby eliminating uncertainties that could arise in punters in light of an eventual incorrect use of this tool.

However, accepting this information means taking two key suppositions into account:

- Economic authorities' capacity to anticipate the current economic cycle in advance so that the measures approved have the desired effect
- In the second place, the competent authority's willingness to regulate its behaviour in line with the ups and downs of the cycle regardless of other determinants (for example, those of a political nature).

If such premises are not accepted, the effect of discretionary action on the economy and economic agents themselves would be an increase in uncertainty.

Features of Taxation Policy

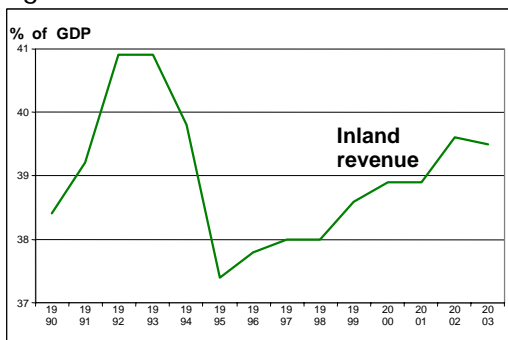
The main features that characterise the pattern followed by Spanish fiscal

policy in recent years could be detailed as follows:

1. Increase in the tax burden

Contrary to what has been said and reiterated *ad nauseam*, the tax burden in Spain has increased in recent years. The only relaxation of the tax burden was that applied in the budgets of 1994 and 1995. During those two years, taxes were seen to decrease by 3.5 points from 40.9 in 1993 to 37.4 in 1995.

Figure 1: Inland Revenue Pattern



Contrary to this, between 1995 and 2003 the tax burden has increased once more by 2.1 points in terms of GDP, rising from 37.4% to 39.5%.

However, both patterns, in particular the decrease in 1994 and 1995, must be linked to a greater extent to income elasticity and, consequently, to the cyclical pattern itself, rather than to the modification and adjustment of tax rates.

2. Structural Change in Taxation

The relative weight of the various taxes, however, has undergone changes. Successive tax reform bills have resulted in a change in the relative importance of the various

taxes, making the system, in principle, more regressive, by increasing the weighting of indirect tax and reducing that of direct tax.

Figure 2: Weight of the various taxes

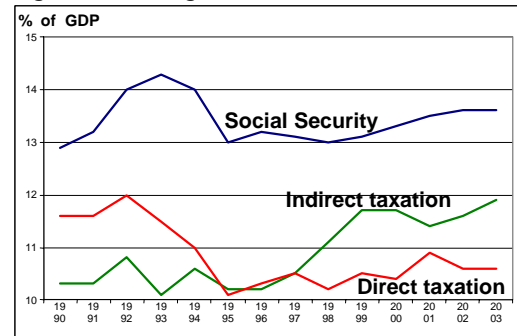


Table 1: Relative weight of taxes as a percentage of GDP

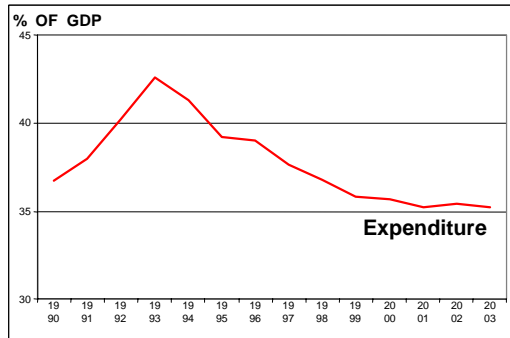
	1990	1996	2003
Direct taxation	11.6	10.3	10.6
Indirect taxation	10.3	10.2	11.9
Social Security	12.9	13.2	13.6
Other income	3.7	4.2	3.3
Total Revenue	38.4	37.8	39.5

While direct taxation decreased by a point in terms of GDP between 1990 and 2003, indirect taxes have increased their relative importance by 1.6% and Social Security, the tax levied on the use and utilisation of the labour factor, has also risen by 0.7%.

3. Controlled Government Expenditure

The third element that figures prominently is the containment of government spending in recent years. In this line, public expenditure reached 42.6% of GDP as a result of the 1993 crisis, but since then has followed a downward trend, which bottomed out and stabilised at around 35% of GDP.

Figure 3: Government Expenditure Pattern



4. Reasons for the restraint

The decline in expenditure, particularly from 1996 onwards, has two easily identified causes.

- On one hand, the decrease in interest rates, which has resulted in less of a financial burden and
- On the other hand, civil servant pay restraint, with salaries increasing at a slower rate than prices, reflected by the drop in these workers' real wages.

Figure 4: Wage and Interest payments as a percentage of GDP



Table 2 shows that public spending in terms of GDP between 1996 and 2003 decreased by 3.8%. Civil Servant wage restraint accounts for 1% of this drop and the decline in interest rates the remaining 2.8%.

Table 2: Government Expenditure Framework

	1990	1996	2003
Civil Servant Wages	10.7	11.3	10.3
Public Consumption		7.8	7.7
Social Trans. in Kind		10.1	10.3
Other Social Transfers	13.9	13.8	12.3
Interest	3.9	5.3	2.5
Subsidies + other costs	3.9	2.0	2.4
Total Expenditure	36.7	39.0	35.2

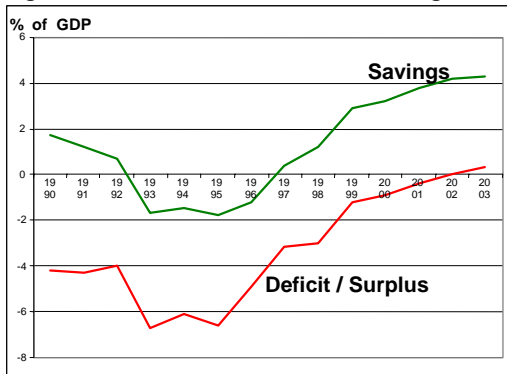
5. Reduction in the deficit and improved public savings

The juxtaposition of the 3.8% cut in public expenditure in terms of GDP and the 1.7% increase in income has enabled the government to eliminate the public deficit (6.6% between 1993 and 1995) and to recover the rate of public savings (from -1.8% in 1995 to 4.3% in 2003).

Certainly, these figures require a further explanation, which could go in two directions:

- The 1995 and 1996 accounts for certain costs with the resulting increase in the deficit carried out by the incoming government and
- The transfer of certain expenditure items to bodies and institutions that do not figure in the public sector accounts, meaning that the final deficit is somewhat higher than the figure entered in the accounts.

Figure 5: Deficit and Public Savings



6. Heterogeneous Deficit Contention

The effort to control the deficit has not been homogeneous among the entirety of Government Bodies. The Central Government has accounted for most of this control, particularly in the accounts of Social Security. On the contrary, the autonomous regions have exercised considerably less restraint and local bodies have even increased their negative balances, albeit slightly.

Table 3: Public Body Financing Capacity (+) or necessity (-)

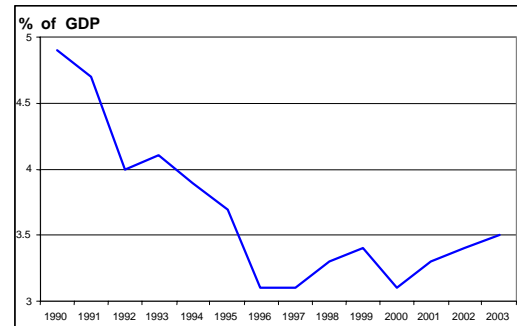
	1995	2002
Central Government	-24,804	-3,353
Regional Governments	-2,777	-1,912
Local Bodies	-115	-205
Social Security	-1,361	+4,888
Total Govt. Bodies	-29,057	-582

7. Public investment remains weak

Another area where the Government has tightened its belt is Gross Fixed Capital Formation. After the effort made in the early 1990s when GFCF in the public sector reached almost 5% of GDP, with the resulting impact on the accumulation of public capital, investment dwindled to just above 3% in 1996. This figure has been

maintained, with ups and downs, over all these years.

Figure 6: Gross Investment – Public Sector



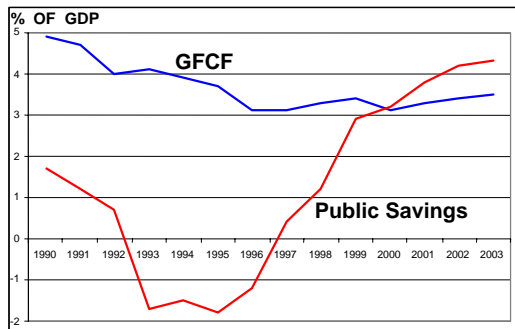
If we consider that fixed capital consumption represents 1.6% of GDP per year, capital stock in the Spanish economy has increased over these past years at a rate of between 1.5% and 2% of GDP per year.

8. Public savings exceeds investment financing needs

The constant improvement in public savings and the moderate investment effort these years has resulted in the savings rate surpassing the actual

financing needs of public investment. In other words, since 2000, financing is being obtained from the savings generated, even leaving a surplus to redeem financial assets issued previously.

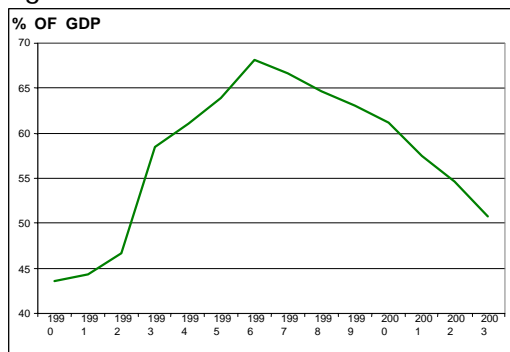
Figure 7: Public Savings and Investment



9. Debt Reduction with respect to GDP

The favourable performance of the public deficit together with the markedly expansive period since 1996 have resulted in a constant reduction in debt volume in terms of GDP. In light of the growth in debt stock during the first half of the 1990s, due mainly to the major crisis in 1993, the Spanish economy is began to reestablish its financial balances, leading to a reduction in the volume of debt stock issued and its relative weight began an uninterrupted downward trend reaching 50% of GDP in 2003.

Figure 8: Debt Stock in relation to GDP

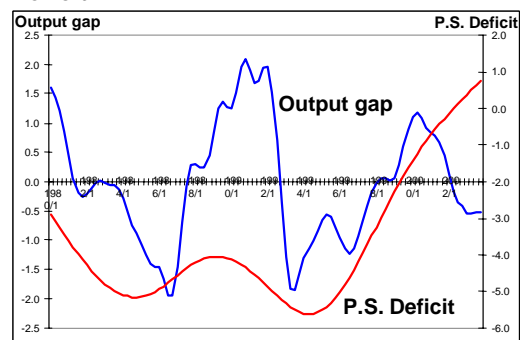


10. The Public Sector has not played an anticyclical role...

As indicated, the absence of alternative tools means the bulk of containing strategies, in the case of possible deviations of aggregate demand from the straight and narrow or of domestic balance tensions, on financial policy. The next step will consist in analysing whether or not this role has been played out over recent years, particularly from 1999 onwards, with the entry of the euro.

To do this, nothing better than beginning by presenting a graph showing the output gap and financial deficit. The first series was obtained by applying the Hodrick-Prescott filter to quarterly GDP growth data in constant euros, the second by quarterly adjusting annual public sector deficit figures by applying smoothing techniques to the series. The result can be observed in Figure 9.

Figure 9: Output Gap and Public Sector Deficit



Both curves have followed relatively synchronised patterns over the past 25 years, up to approximately 2000. In other words, until that year output gap deterioration was accompanied by increases in the public sector deficit, either due to the implementation of a

deliberate anticyclical policy or to the mere effect of automatic stabilisers.

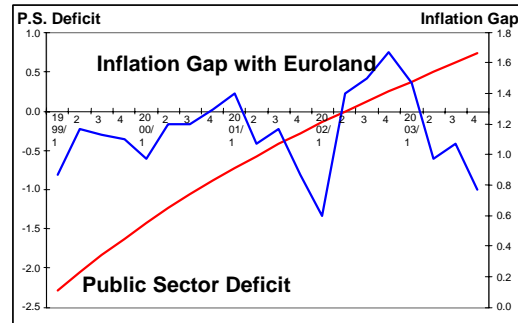
However, from 2000 onwards, the output gap deterioration has been parallel to a constant improvement in deficit figures. Financial policy has been contrary to what could be expected, at least apparently, and has not offset the negative percentage changes in aggregate demand, but has drained its resources instead.

11. ... and has been more worried about controlling inflation

The second possible goal is inflation control. In other words, to analyse whether public sector performance can be explained by the possible attempts to correct domestic imbalances, in particular the price gap with respect to Euroland. The lack of monetary and exchange rate policy forces Monetary Union countries to try and smooth out price tensions by means of financial tools. Thus, excessive pressure on prices caused by excess aggregate demand (overheating) means restrictive financial policies must be employed to try and cool down the situation and vice-versa.

However, financial policy over the past few years has been too linear. One of the indirect objectives of this policy may have been the curbing of domestic price pressure, but this is not seemingly the main goal. If this were the case, a much more aggressive financial policy, with larger surpluses in public accounts, to attempt to offset the absence of alternative policies effectively.

Figure 10: Price Gap with Euroland and Public Sector Deficit

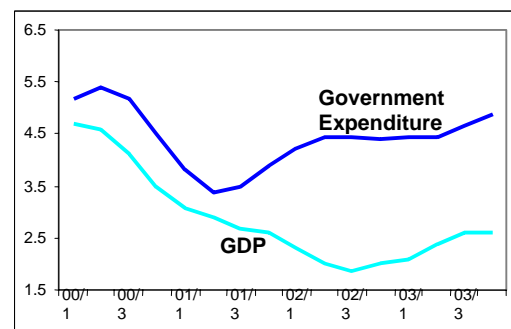


However, the deficit pattern suggests that a zero deficit was the objective itself, regardless of the cycle and domestic price tensions, perhaps believing that this case scenario would maximise the favourable impact of the public sector on the economy as a whole, sending a message to punters of neutral behaviour whatever the situation may be.

12. National Accounts verify this hypothesis

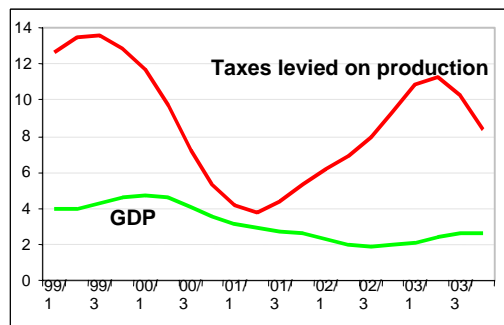
Two additional elements confirm this suspicion. Government expenditure growth has outpaced GDP growth since 2001, demonstrating this variable's clearly expansive performance and the improvements in the deficit have been achieved by means of controlling social transfers.

Figure 11: Government Expenditure Growth



In the second place, the substitution of direct tax by indirect tax has resulted in increases in the taxes levied on products and on production that are appreciably higher than those of GDP.

Figure 12: Taxes levied on Production



This substitution has had a marked inflationary impact on the Spanish economy and has impeded price convergence with respect to Euroland.

Conclusions

Despite the important changes in financial policy over recent years, particularly in the field of income and the recovery of savings and budget balance, the area still pending attention is the achievement of a public sector that is flexible enough to substitute the lack of its own monetary policy and for it to be able to control, as far as possible, domestic imbalances, especially inflation.

The new budget stability pact, which sooner or later will have to be accorded in Euroland, will determine governments' total deficit limits. Consequently, to obtain greater financial manoeuvrability, governments should assume the target of maintaining a balanced budget throughout the cycle, which has greater margins for positive and negative

fluctuation, depending on the phase of the cycle, making the deficit more procyclical and increasing its importance as a manager of domestic demand.

Aurelio Martínez Estévez
Valencia, April 22 2004

4.- France and Germany

This report aims to carry out a brief analysis of financial policy in both the German and French economies. Monetary policy has been left to one side due to the fact that, since the enactment of the European Union Treaty, this responsibility corresponds exclusively to the European Central Bank and is independent of national governments.

The analysis of financial policy in France and Germany is of particular interest at the moment, given the fact that both countries violated the Stability and Growth Pact in 2003, with the *rebellion* this behaviour implied within the framework of the European Monetary Union (EMU).

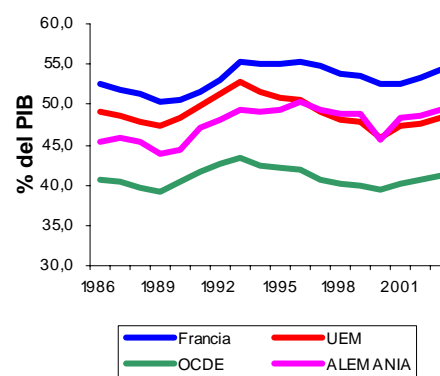
Finally, all the information under consideration in this report has been taken from the databases of the Organisation of Economic Cooperation and Development (OECD).

1.- Public Expenditure

Both France and Germany have high levels of government expenditure in relation to GDP, above the average registered by OECD countries, which fluctuates around the 40% mark over the period under consideration. Furthermore, this percentage is also higher in the case of both countries, to a greater or lesser extent, than the EMU countries as the whole, which is in the vicinity of between 45% and 50%. Nevertheless, there are clear differences between the two in this context: while this variable remained relatively stable at around 52-53% in France over the period of study, Germany has registered a lower

percentage in all sample years and shows a significant reduction from 1993 onwards, which brought the figure much more in line with the EMU as a whole at the end of the period.

Figure 1 – Public Expenditure



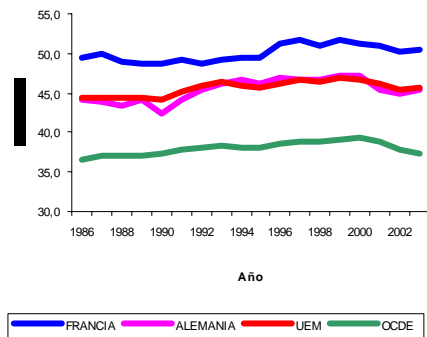
Government expenditure is seen to be anticyclical throughout this period: as a result of this, the crisis in the early 90s caused an increase in this variable, which began to revert halfway through the decade as the crisis waned. Expenditure once again rose with the beginning of the current crisis. This anticyclical behaviour is also a feature of the EMU's behaviour and that of the OECD as a whole.

Two important conclusions may be drawn from this pattern: in the first place, the financial rules imposed by the Stability Pact do not seem to have meant a significant change in government expenditure in EMU countries; in the second place, the reunification of Germany does not seem to have produced a significant change in this variable either, when one compares the German figure to that of the EMU mean.

2.- Government Income

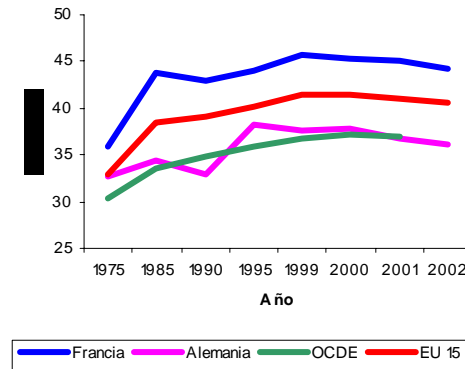
The analysis of the behavior of government income in relation to GDP provides conclusions that are very similar to those obtained from government expenditure. In other words, both France and Germany register figures above the OECD average, which in this case is around 37-38% of GDP, although it is much higher in France (almost 50%) than in Germany (around 45%), which is very similar to EMU countries. Income is seen to be much more independent of the economic cycle than government expenditure, which suggests that this variable's behaviour provides little stability.

Figure 2 - Public Income



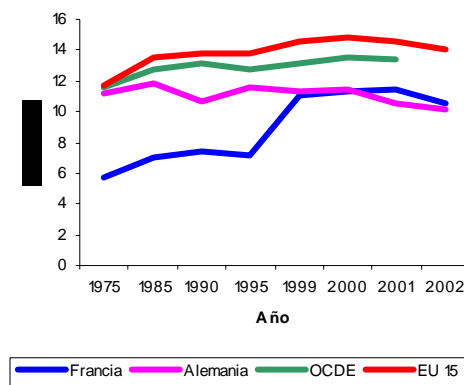
As far as the tax burden is concerned, differences are also significant. The tax burden in France (slightly below 45%) is higher than in both the European Union's 15 member states (slightly below 40%) and also Germany and the OECD (around 35%). The pattern followed by this variable is that the burden increased between 1975 and 1985, was reduced from this time until the change of century when it stabilised. Within this general scenario, the ebb of the German tax burden between 1985 and 1995 stands out.

Figure 3 – Tax Burden



If, within the tax burden, only income and corporate profit taxes are considered, the low starting level in French economy, practically half that of the other countries or groups under study, is quite striking. Nevertheless, between 1995 and 1999 these taxes were doubled in the French economy, reaching the same level as in Germany. It is also worth highlighting that both in France and Germany the tax burden is less in terms of these concepts than in the other two groups of countries considered, although the gap has also been slightly reduced in this case in the last few years of the period. If the overall tax burden in Germany is similar to that of the OECD average at that the same time as income and corporate tax is lower, this indicates that the rest of the income (for example, indirect tax) must be higher. In any case, these figures are surprising in light of the general belief that the Germany welfare state is expensive. Paralell to this, we believe that this data illustrates why the situation in France appears to worry the European Commission more than that in Germany, when the deficit level is similar.

Figure 4 – Income and Corporate Tax Burden



In this area, it must be pointed out that in 2003 and 2004, France has increased its indirect taxation, as a way of raising income in light of the demands from Brussels to achieve the deficit targets. At the same time, direct tax cuts are announced with the objective of stimulating the economy, even though these cuts will not be applied until next year, and a renovation of the privatisation policy, which had been paralysed in the past. Germany has also planned cuts in direct taxation for 2005, reducing the maximum income tax rate from 45% to 42% and the minimum from 16% to 15%.

3.- Social Expenditure

Social expenditure has become more relevant in recent times in the analysis of financial policy, demonstrated by the interest that international bodies such as the OECD or EUROSTAT dedicate to it. The reason is that it is a more reliable indicator of financial policy orientation than total government expenditure. The following graph summarises the pattern of government social expenditure since 1980 in a quite wide-ranging group of economies,

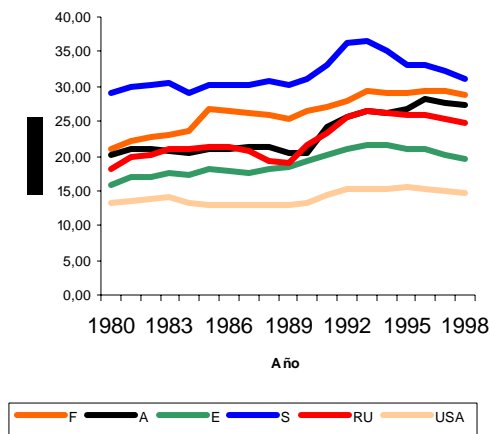
despite unfortunately lacking data after 1998. In any case, the figures available enable us to obtain some interesting conclusions. Firstly, they show that both France and Germany are at the top end of this distribution, always above 20% of GDP, although without reaching the most outstanding countries in this area, such as Sweden, which channels 30% of GDP to social transfers. Secondly, France registers a higher figure than Germany in all sample years, although the gap between the two economies narrows at the end of the sample. Thirdly, all the countries considered register an increase in this variable in the early 90s, possibly brought about by the economic crisis (unemployment expenditure), which is later corrected slightly towards the end of the decade, without the interruption in the series allowing us to see the reaction to the crisis in 2000, although it will have almost certainly increased. Finally, the pattern followed by government social expenditure has possibly been affected by the reunification, which could help to explain how the data referring to Germany closed the gap with respect to their French counterparts.

It must be taken into account that there is general agreement that both economies, and in particular the Germany economy, must carry out serious structural reform, which will foreseeably affect this variable to a greater or lesser extent¹. In any case, despite recognising the need for action in this sense (and timid measures are being taken, such as health benefit and unemployment cuts in Germany and

¹ In the case of Germany, the reform package known as "Agenda 2010" and involves measures of this type.

the latter in France), both countries are seemingly awaiting the economic expansion to apply the necessary measures to minimise the social and political repercussions. In this sense, the name given to the German reform package is clearly indicative of the panorama that is being considered for this action.

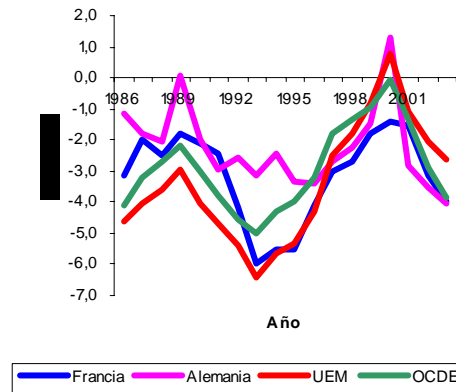
Figure 5 – Social Contributions



4.- Public Deficit

The next graph illustrates the pattern of public deficit. In light of the previous figures referring to government income and expenditure, it is not surprising that, except for the odd occasion, the normal scenarios is one of deficit. The public deficit shows a clearly procyclical pattern in all sample countries. The expansion in the 80s produced a surplus tendency, which was later frustrated by the crisis in the 90s, expect, surprisingly, in the case of Germany. Not until halfway through the 90s did the economic expansion produce a considerable reduction in the deficit, finally reaching a surplus, or thereabouts, in 2000. From then onwards, the deficit has once again increased.

Figure 6 – Public Deficit



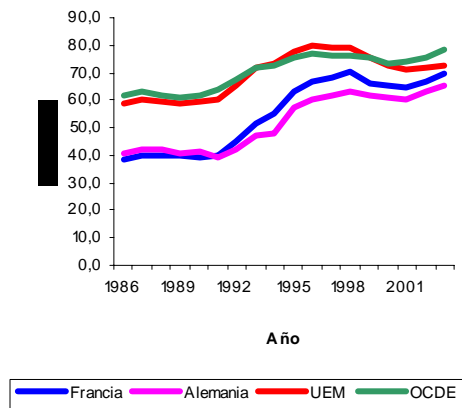
It is worth pointing out that the reunification does not seem to have had a special impact on the German deficit, as shown by the figures in the 90s. Nevertheless, the German case shows a particularly negative pattern throughout the current crisis: while Germany recorded the lowest deficit of all countries considered during the 80s and 90s, from 2000 onwards, the deterioration of the deficit has been the worst of all, finally reaching the lowest figure. As far as the French deficit is concerned, the figure is almost always worse than Germany's, particularly in the middle 80s and 90s, except for, of course, from 2000 onwards. In any case, even if the Stability Pact is violated, it does seem possible that the French deficit could reach 5% of GDP, as it did in the last crisis².

² However, the French deficit for 2003 has just been released and is higher than that considered up to then (represented by the text graph), reaching 4.1% of GDP (the same as Germany). In addition to this, both countries are expected to breach the Stability Pact once again.

5.- Public Borrowing

The public deficit pattern could not cause more damage to anything than to the increase in public borrowing. In effect, figures show that this variable was controlled in the late 80s, when the deficit was clearly diminishing, but has grown since then. Finally, the large French deficit has resulted in the country's level of public borrowing exceeding that of Germany's from the early '90s onwards, although in both cases, the amounts are lower than the EMU and OECD, even though the former will be overtaken shortly. Currently, French public borrowing represents almost 70% of GDP and German public borrowing 65%.

Figure 7 – Public Borrowing

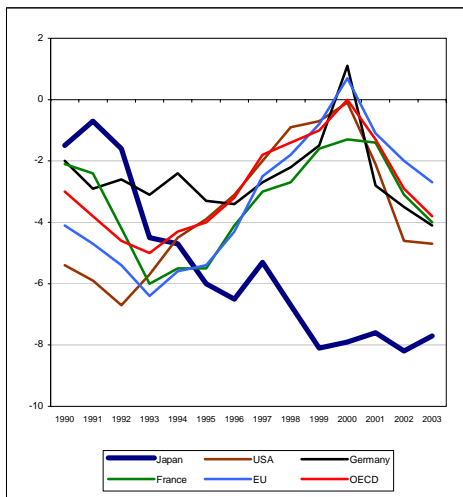


Antonio Cutanda
Valencia, April 28 2004

5.- Japan

Japan's financial policy has less automatic stabilisers with respect to other industrialised countries. For this reason, budget policy has been more discretionary. As a result of this, the last decade has witnessed considerably uncoordinated, restrictive monetary policy and expansive financial policy. The accumulated effect of the financial policy carried out in the 90s, took public debt to above 150% of GDP at the end of 2003, with a budget deficit of 8% of GDP.

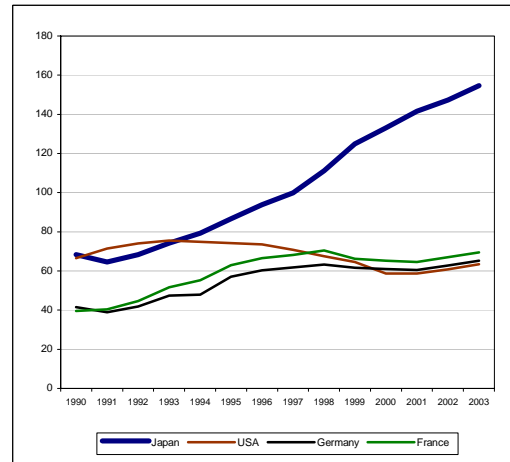
Figure 1 – Public Deficit (% of GDP)



Source: Economic Outlook Report, núm. 74, OECD

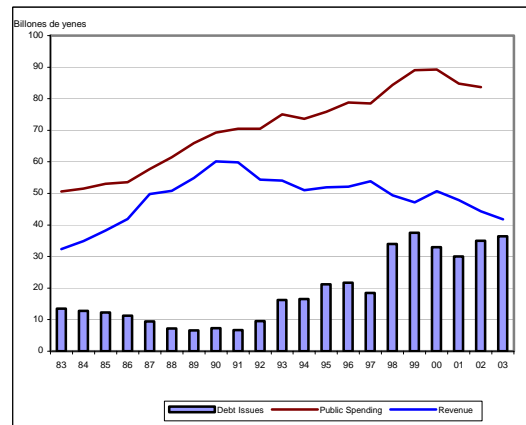
The last decade was not only characterised by the growth in public debt: there was also a drastic increase in the budget's dependence on debt issues, as successive rises in public spending were accompanied by tax cuts, which deteriorated the Government's revenue (also due to the slowdown in the economy), without significantly reactivating domestic demand.

Figure 2 – Public Debt (% of GDP)



Source: Economic Outlook Report, núm. 74, OECD

Figure 3 – Public spending, revenue and debt issues

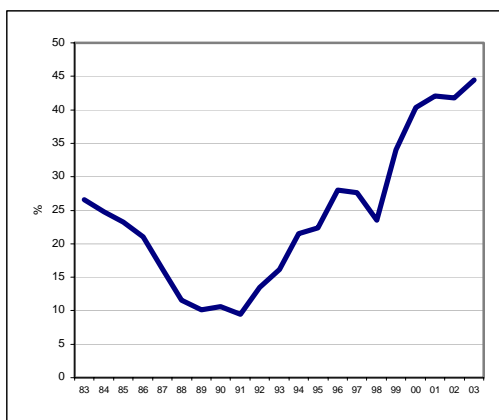


Source: Ministry of Finance.

In light of the accumulated debt burden and the imbalances in spending commitments and revenue, some analysts believe the Government will have to increase direct taxes by up to 5%, due to the growing need of financing that the already high average age of the Japanese population is beginning to impose. In any case, financial policy is unlikely to add an expansive ingredient to the economic recovery (see Table 1). The consolidation of the recovery will

sooner or later require progress of some sort in private consumption to reinforce the upturn in the external sector and investment. It does not seem feasible that financial policy will be able to play that role in the next few years.

Figure 4 – Financial Dependence on Public Debt



Note: Financial dependence on public debt calculated as debt issues divided by total public spending.

Source: Ministry of Finance.

Smooth financial restraint together with lax monetary policy, more coordinated than in the past, is currently being observed, partly due to the fact that budget policy has little room to manoeuvre. On March 16, 2001, the government officially recognised that the economy had entered a period of deflation for the first time since World War II. Three days later, the Bank of Japan began to adopt a decidedly lax monetary policy, although the zero exchange rate policy had already been put in place in February 1998. As these measures have been applied at different times, the result is that today, 40% of government bonds are monetised (historically, the proportion has been 15%) and interest rates are maintained at an extremely low level.

Despite this, deflation seems loathe to leave the Japanese economic scenario and, in line with the range of figures from previous months, the monetary aggregate M2+CD grew by 1.9% in March in annual terms, in comparison to the 1.7% rise the previous month, while liquidity decreased by 0.7%, compared to the 1% drop in February. And all this occurred despite a 15% increase in the monetary base in the first quarter.

Table 1 – Public Deficit Forecasts

	EU		IMF		OECD	
	2004	2005	2004	2005	2004	2005
Euro-12	-2.7	-2.6	-2.2	-2.1	-1.5	-2.7
	(-2.7)	(-2.7)	(-2.8)		(-2.4)	
Germany	-3.6	-2.8	-1.5	-1.4	-	-3.5
	(-3.9)	(-3.4)	(-3.9)			
USA	-4.5	-4.2	-4.2	-2.9	-5.1	-4.9
	(-5.5)	(-5.4)	(-5.6)		(-4.2)	
Spain	0.4	0.6	-0.3	-0.1	0.2	0.3
	(0.1)	(0.2)	(0.1)	(0.2)	(-0.2)	
France	-3.7	-3.6	-3.9	-3.4	-	-3.5
	(-3.8)	(-3.6)	(-3.5)			
Italy	-3.2	-4.0	-2.7	-2.6	-	-3.9
	(-2.8)	(-3.5)	(-2.6)			
Japan	-7.4	-7.2	-6.6	-6.4	-6.5	-6.9
	(-7.2)	(-7.1)	(-6.5)		(-7.8)	
United Kingdom	-2.8	-2.6	-3.1	-3.1	-	-3.2
	(-2.7)	(-2.4)	(-2.7)			

Note: Data expressed as a percentage of GDP. Negative sign indicates the existence of a deficit. Social Security spending included. Previous forecasts in brackets.

Source: European Commission Spring Report 2004; World Economic Outlook, April 2004, IMF; Economic Outlook Report, núm. 74, OECD

Nevertheless, by maintaining a lax monetary policy in recent exercises, the bank multiplier has been able to recover, reaching values unheard of since February 1999, which indicates that the reactivation of the economy is in good shape. According to a recent survey on behalf of the Bank of Japan, inflation expectations have improved

substantially in recent months¹. Despite recognising these favourable aspects, the fact that bank loan concession dropped once again in March (a 4.3% annual decrease compared to the 4.4% decrease in February), illustrates that there is still a long way to go and confirms that the problems in the banking sector are still far from being overcome. In other words, in our opinion, deflation is more a consequence than a cause of the Japanese economy's problems.

Luis M. Granero
Valencia, April 28 2004

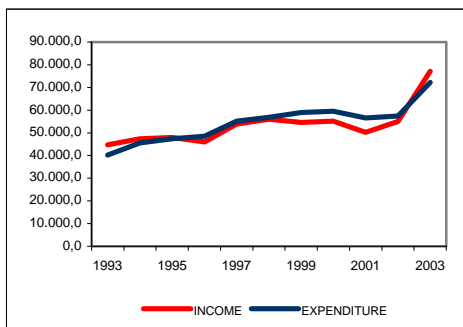
¹ "Survey on the General Public's Mindset and Behavior", Bank of Japan, April 2004.

6.- Argentina and Brazil

Argentina

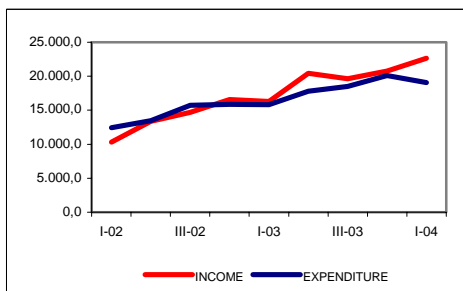
The excellent financial results in recent quarters has been the main cause of friction between the IMF and Argentina. From 2002 onwards, the government's accounts have registered a surplus that, as displayed by January 2004 data (see Figure 2) continues to increase. The main point of friction between Kirchner and his Minister Lavagna, on one hand, and the main international creditors on the hand, is the most appropriate use of that surplus.

Figure 1 - Current Income and Expenditure. Yearly data in millions of Pesos



Source: Ministry of Economy and Production

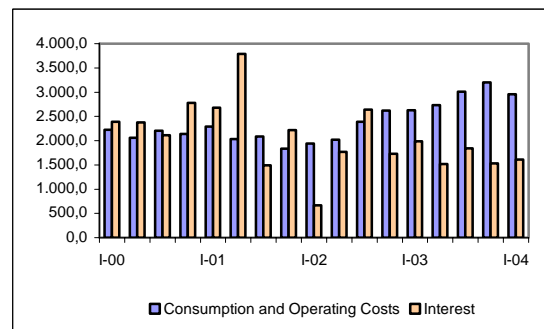
Figure 2 - Current Income and Expenditure. Quarterly data in millions of Pesos



Source: Ministry of Economy and Production

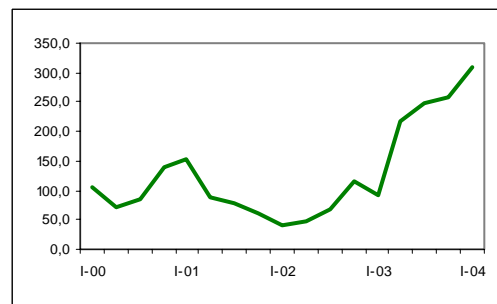
Interest payments made by the Argentinian government have been decreasing since the last quarter of 2002, at the same time as other non – current expenditure items have increased. This is the case of real direct investment, an expenditure item that is less important in terms of the budget than economically speaking, as it is a clear example of the government's intentions.

Figure 3 – Current Expenditure Items. Millions of Pesos



Source: Ministry of Economy and Production

Figure 4 – Real Direct Investment. Millions of Pesos

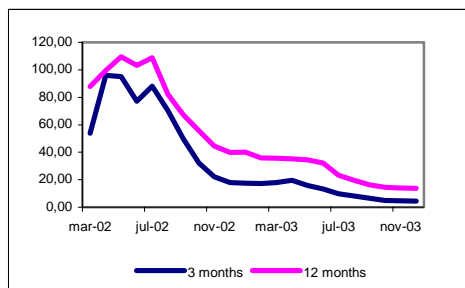


Source: Ministry of Economy and Production

While the decision to reduce interest payments to channel more resources to the reactivation of the economy has occurred more or less continuously since the end of 2002, monetary policy has also been clearly expansive since

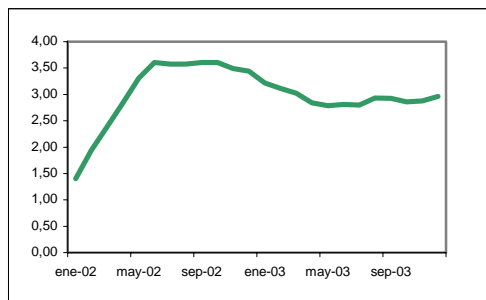
halfway through the same year (see interbank interest rates in Figure 5), although it is true that rates began their descent from relatively high up. In any case, the contribution of this policy seems clear and explains a large part of GDP growth in recent quarters, mainly based on investment, as mentioned in our January economic climate report. Part of the monetary expansion is also due to the accumulation of reserves, which steadily picked up speed in the last few months of 2003 (see Figure 7). Nevertheless, despite the interest rate pattern, marked changes in the evolution of the Peso with respect to the dollar have not been observed. The Peso has maintained a slightly appreciated value throughout this period, but within a general context of stability.

Figure 5 - Interbank Interest Rates



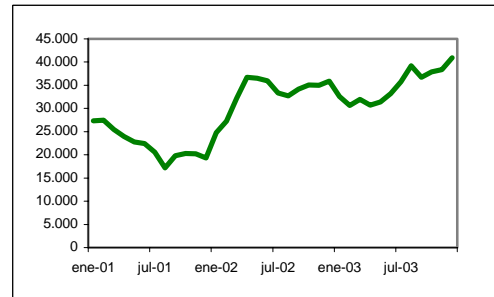
Source: Banco Central de la República de Argentina

Figure 6 – Peso / Dollar Exchange Rate



Source: Ministry of Economy and Production

Figure 7 – Total Reserves



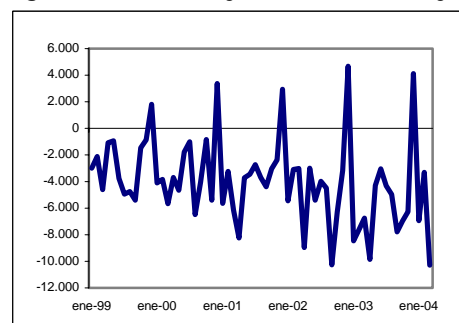
Source: Banco Central de la República Argentina

Brazil

Macroeconomic policy has taken a slightly different route in Brazil. In the first place, the government's accounts reveal a less favourable situation than in the case of Argentina, with a primary deficit that is progressively deteriorating.

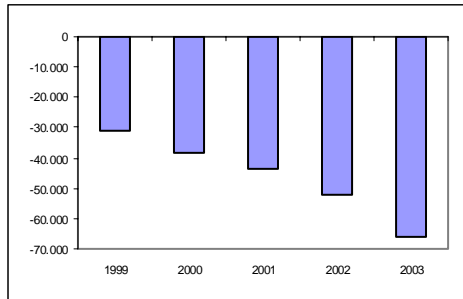
The Brazilian government has a lot less room to manoeuvre in terms of fiscal policy for various reasons. Firstly, Brazil's commitments with the IMF; secondly, the size of the structural reform that must be affronted, in accordance with president Lula Da Silva's programme. One element that cannot be discarded either is the increasing importance of expenditure items that may have an impact when using the public deficit to drive the economy.

Figure 8 – Primary Deficit. Monthly Data



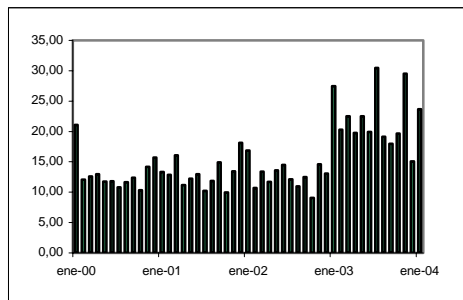
Source: Ministerio de Fazenda

Figure 9 – Primary Deficit. Yearly Data



Source: Ministerio de Fazenda

Figure 10 – Public Sector: percentage of wages and salaries over total jobs

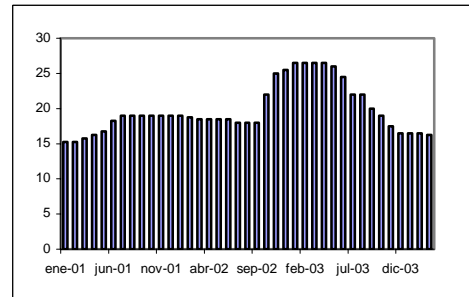


Source: Ministerio de Fazenda and own elaboration

In the last quarter of 2002 and practically up to halfway through 2003, monetary policy adopted a restrictive approach, with an increase in official interest rates which peaked (in May 2003) at 26%. From then onwards, rates have dropped steadily once the upturn in inflation during that period had abated. The negative side has been the extreme weakness in investment, which may not be entirely due to the interest rate pattern, but has certainly not been reinforced by the monetary authority.

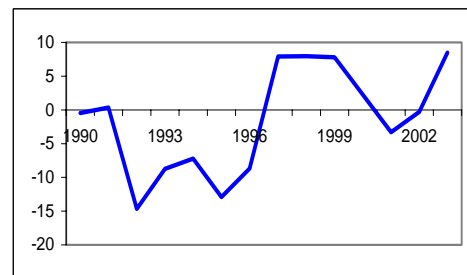
As in Argentina, although it is true that this moderately expansive monetary policy has been favoured by the increase in reserves observed in 2003.

Figure 11 – Official Interest Rate



Source: Bank of Brazil

Figure 12 – Change in Reserves in Millions of Dollars



Source: Bank of Brazil

Joan A. Martín-Montaner
Valencia, April 30 2004

