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April 1, 1983

To: Members of the Executive Board

From: The Secretary

Subject: European Monetary System - Realignment of Exchange Rates

There is attached for the consideration of the Executive Directors a paper prepared by the staff on the recent realignment of exchange rates within the European Monetary System (EMS).

This subject will be brought to the agenda for discussion on a date to be announced.

Att: (1)

Other Distribution:
Department Heads

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INTERNATIONAL MONETARY FUND

European Monetary System--Realignment of Exchange Rates

Prepared by the European Department

(In consultation with the Exchange and Trade Relations and Research Departments and the Office in Europe)

Approved by Brian Rose

March 31, 1983

I. Introduction

On March 21, 1983, the Ministers of Finance and Economy and the Central Bank Governors of the member countries of the European Community (EC) decided on an adjustment of central rates within the European Monetary System (EMS). Notifications to this effect have been received by the Fund from the countries participating in the EMS and have been distributed to the Board. The communiqué issued following the realignment is presented in Appendix I, and sets out the following percentage changes in central rates:

Deutsche mark	+5.5
Netherlands guilder	+3.5
Danish krone	+2.5
Belgian franc	+1.5
Luxembourg franc	+1.5
French franc	-2.5
Italian lira	-2.5
Irish pound	-3.5

Table 1 compares this seventh realignment with the six preceding ones and sets out the new ECU central rates. The new bilateral central rates and intervention limits, which came into effect as of March 21, 1983, are shown in Table 2. Section II of the paper gives the economic background and Section III the Staff Appraisal; country notes are contained in Appendix II.

II. Background

The realignment of June 1982 was followed by a period of calm in the foreign exchange markets for EMS currencies which continued to appreciate strongly as a group against the U.S. dollar until November. Strains within the EMS reappeared (Charts 1 and 2), however, before the dollar began to weaken as the deutsche mark and the Netherlands guilder gathered strength relative to the other currencies which came intermittently under pressure.

Table 1. EMS Realignments

	9/24/79	11/30/79	3/23/81	10/5/81	2/22/82	6/14/82	3/21/83
Percentage changes in bilateral central rates 1/							
Belgian-Luxembourg franc					-8.5		1.5
Danish krone	-2.9	-4.8			-3.0		2.5
Deutsche mark	2.0			5.5		4.25	5.5
French franc				-3.0		-5.75	-2.5
Italian lira			-6.0	-3.0		-2.75	-2.5
Irish pound							-3.5
Netherlands guilder				5.5		4.25	3.5

	ECU Central Rates		Central Rate Change
	Previous	New	(per cent)
Realignment of March 21, 1983			
Belgian-Luxembourg franc	44.9704	44.3662	1.36
Danish krone	8.2340	8.04412	2.36
Deutsche mark	2.33379	2.21515	5.36
French franc	6.61387	6.79271	-2.63
Italian lira	1,350.27	1,386.78	-2.63
Irish pound	0.691011	0.717050	-3.63
Netherlands guilder	2.57971	2.49587	3.36
Pound sterling 2/	0.560453	0.629848	-11.02

Source: EC Commission.

1/ Calculated as the percentage change against the group of currencies whose bilateral parities remained unchanged in the realignment; except in the case of the realignment of March 21, 1983, where, all currencies having moved, bilateral shifts need to be derived by combining the relative movements of the two currencies concerned. (For example, the devaluation of the French franc against the deutsche mark will be given by $\frac{0.975}{1.055} = 0.924$, i.e., -7.6 per cent.)

2/ The pound sterling is included in the calculation of the ECU; a notional central rate has to be ascribed to sterling for the calculation of the divergence indicator, and for other reasons related both to the workings of the EMS and the Common Agricultural Policy.

Table 2. EMS: Bilateral Central Rates and Intervention Limits

(Effective March 21, 1983)

		100 Belgian/ Luxembourg francs	100 Danish kroner	100 deutsche mark	100 French francs	1000 Italian lire	1 Irish pound	100 Netherlands guilders
Belgian/Luxembourg franc	U	...	564.10	2,048.35	668.00	33.970	63.2810	1,818.0
	C	...	551.536	2,002.85	653.144	31.9922	61.8732	1,777.58
	L	...	539.30	1,958.50	638.60	30.130	60.4965	1,738.0
Danish krone	U	18.54300	...	371.40	121.11	6.159	11.4735	329.6300
	C	18.1312	...	363.141	118.423	5.80057	11.2184	322.297
	L	17.72700	...	355.06	115.78	5.463	10.9687	315.13
Deutsche mark	U	5.106	28.165	...	33.350	1.696	3.160	90.770
	C	4.99288	27.5375	...	32.6107	1.59733	3.08925	88.7526
	L	4.882	26.925	...	31.885	1.504	3.021	86.780
French franc	U	15.659	86.365	313.63	...	5.2010	9.6885	278.35
	C	15.3106	84.4432	306.648	...	4.89819	9.47313	272.158
	L	14.97	82.565	299.85	...	4.6130	9.2625	266.10
Italian lira	U	3,318.9	18,305.0	66,473.0	21,677.0	...	2,053.53	58,997.0
	C	3,125.76	17,239.7	62,604.3	20,415.7	...	1,934.01	55,563.0
	L	2,943.8	16,236.0	58,960.0	19,227.0	...	1,821.45	52,329.0
Irish pound	U	1.6530	9.1168	33.1015	10.7964	0.549015	...	29.3832
	C	1.61621	8.91396	32.3703	10.5562	0.517061	...	28.7295
	L	1.5803	8.7157	31.6455	10.3214	0.486968	...	28.0904
Netherlands guilders	U	5.7535	31.7325	115.235	37.58	1.91100	3.5600	...
	C	5.62561	31.0273	112.673	36.7434	1.79976	3.48075	...
	L	5.5005	30.3375	110.1675	35.925	1.69500	3.4030	...

Source: EC Commission.
Legend: U = Upper limit
C = Bilateral central rate
L = Lower limit

Tension in the exchange markets increased in anticipation of parliamentary elections in Germany and municipal elections in France on March 6, 1983. The election results brought about intensified downward pressure on the French franc and upward pressure on the deutsche mark. The French authorities let the franc drop to its lowest intervention limit, thus gaining access to the very short-term credit facility for the financing of intervention, and drove short-term Eurofranc interest rates to extremely high levels. Subsequently, the Belgian franc, the Danish krone, and the Irish pound also dropped to their lower intervention points against the deutsche mark, while the Italian lira eased within its wider (6 per cent) band. After the second round of municipal elections in France on March 13, tensions within the EMS eased temporarily.

On March 9, Belgium raised its effective rates for discounts and advances by 2 1/2 percentage points to 14 and 15 per cent, respectively, and on March 14 the Belgo-Luxembourg Exchange Institute introduced emergency foreign exchange controls. Commercial banks were instructed to keep their debtor positions in foreign currencies on the official market below the equivalent of BF 20 million; Belgian and Luxembourg residents were required to convert their future export earnings immediately into francs; and penalties were tightened for overdrafts on nonresidents' convertible franc accounts. As a result of these measures the official rate for the Belgian franc rose temporarily to the top of the EMS band, although the discount on the financial franc widened to 8 per cent. Effective March 18, the Deutsche Bundesbank cut its discount and lombard rates by 1 percentage point to 4 and 5 per cent, respectively, and the Netherlands Bank lowered all official interest rates by 1/2 percentage point. Bank interest rates were allowed to rise in Ireland. The Swiss National Bank and the Austrian National Bank, whose currencies are closely tied to the deutsche mark, lowered their official lending rates by 1/2 and 1 percentage point, respectively.

Continued differences in external and domestic developments and prospects among EMS countries 1/, reflecting divergences in financial policies, largely explain the buildup of exchange market tensions and expectations of another realignment. The recent evolution of the trade balance and current account positions of France and Germany present a particularly sharp contrast (Tables 3 and 4); while Germany's trade balance and current account strengthened since 1980, with the current account moving into surplus in 1982, France's trade and current account deficits widened. France's trade balance with its EMS partners as a whole, and with Germany in particular, deteriorated markedly during 1982; all other EMS countries recorded an improvement in their overall trade balance (measured in U.S. dollars) and, except for Denmark, in their current account in 1982. The Netherlands was the only EMS country

1/ Although the United Kingdom is formally a member of the EMS, it does not participate in the EMS exchange rate arrangement. References to the EMS countries in this paper exclude the United Kingdom.

besides Germany to record both a trade and current account surplus. The current account deficits of Ireland, Belgium/Luxembourg, and Denmark remained relatively high in 1982, though below their record levels of 1981 for the first two countries.

Four years after the EMS went into effect, considerable discrepancies still persist in cost-price performance among participants (Table 5). Although inflation rates were down in 1982 in all the EMS members except Belgium and Luxembourg, consumer prices rose more than three times faster in Ireland and Italy than in Germany and the Netherlands, and in France they rose more than twice as fast. Only a small improvement in relative performance is projected for 1983.

The six previous realignments since the inception of the EMS in March 1979 have, for some countries, offset the differential between their own cost-price developments and their partners' (Tables 6, 7, and 8). Thus, from the beginning of 1979 through the end of 1982, exchange rate changes had corrected for most of France's higher rate of inflation vis-à-vis Germany. Without further changes, however, the continued large differential between the rate of increase in unit labor costs in France and Germany would have resulted by the end of 1983 in a marked deterioration in the former country's competitiveness vis-à-vis the latter. Ireland and Italy show the largest differentials between their own cost-price movements and those of the other EMS countries, even after taking account of exchange rate movements. By contrast, the combination of Belgium's relatively good price performance and exchange rate depreciation resulted in a marked improvement in its competitive position. Denmark's relative position vis-à-vis its partner countries has also improved since the inception of the EMS.

The appreciation of the U.S. dollar in 1981-82 vis-à-vis all EMS currencies resulted in an improvement in the EMS countries' overall competitiveness, but the relative position of the individual countries was little changed (Table 9). The depreciation of the pound sterling in the last quarter of 1982 and the first quarter of 1983, however, affected Ireland's overall competitiveness more than that of the other EMS participants, due to its close economic ties to the United Kingdom.

Besides the usual reservations regarding the data and methodology used to compile competitiveness indices, the interpretation of the indices calls for great caution. In some countries, like Belgium, the shrinkage of the manufacturing sector overstates the relative strength of the competitive position suggested by the index. Furthermore, the recorded improvement in the relative cost position may not be sufficient to offset other unfavorable factors such as an obsolete industrial structure or stagnant traditional markets.

Divergence in the evolution of costs and prices and of current account positions reflects to a large extent the lack of convergence of economic policies among the EMS participants. The deterioration of the

French and Danish current accounts in 1982 is due in part to relatively more expansionary policies in those two countries than in the others; GDP growth in these two countries was markedly faster than in the other EMS countries and their rates of unemployment increased less than elsewhere (Table 10).

Domestic credit expansion accelerated in France and Italy during 1982, in sharp contrast with the deceleration observed in Germany, Ireland, and the Netherlands (Table 11). Since the first year of the EMS, the differences between the participants' rates of credit expansion have widened instead of narrowed. Interest rate differentials have also widened (Table 12).

In both France and Italy, as well as in Denmark, the higher rate of credit expansion was associated in 1982 with larger public sector borrowing requirements (Table 13). In Belgium and Ireland, public sector deficits, though slightly lower than in 1981, remained exceedingly high and had to be financed largely through foreign borrowing.

By the end of 1982 and at the beginning of 1983, greater convergence of policies had become evident. Both France and Denmark had shifted to a more restrictive stance of financial policies, and Ireland's 1983 budget also represented a marked shift toward restraint on domestic demand. The changes came too late, however, or were insufficient to dissipate exchange market tensions.

The changes in effective exchange rates implied by the realignment of March 21, 1983 are given in Table 14. On the basis of changes in bilateral central rates, and abstracting from changes in the exchange rates of the EMS currencies vis-à-vis third currencies, the effective exchange rate of the Belgian and Luxembourg francs (against other EMS currencies) remains unchanged and all other currencies show changes ranging from a small appreciation of the Danish krone to a substantial depreciation for the Irish pound. Actual changes in effective exchange rates against all other currencies following the realignment will, of course, depend on the relative position of the various currencies within the EMS band of exchange rate fluctuations, as well as on the movement of the whole band vis-à-vis third currencies.

Immediately following the realignment, the Italian lira, the French franc and the Irish pound became the strongest currencies within the EMS, while the deutsche mark moved to the bottom of the band. The strong position of the Danish krone close to the top of the band allowed the Danmarks Nationalbank to lower its official interest rates by 1 1/2 per cent. The Belgian National Bank also reduced its discount rate by 3 percentage points to 11 per cent and there are indications that some of the exchange restrictions introduced before the realignment to stem speculation will be relaxed shortly. On March 25, the French authorities announced a package of measures including a reduction in government expenditures, increases in taxes, a lowering of monetary targets, and restrictions on expenditure for tourist travel to foreign countries.

III. Staff Appraisal

This latest realignment of exchange rates within the EMS is the seventh since the EMS was established in March 1979 and the twenty-first since the inception of the European common margins arrangement in 1973. It is also the first to have resulted in changes of bilateral central rates for all EMS currencies. Like previous realignments, it had become necessary as a result of the continued differences in the underlying strength of the participating countries' external positions, which reflect in turn divergences in economic policies and cost-price performance. These differences had built up expectations of exchange rate changes and led to large speculative capital flows.

As in October 1981 and June 1982, the deutsche mark and the Netherlands guilder were revalued against the other EMS currencies. As on these previous occasions, the adjustments were made in recognition of the two currencies' strength, based on current account surpluses and on improved competitive positions relative to the other EMS participants. Germany and the Netherlands had the lowest rates of inflation and of domestic credit expansion in 1982. The revaluation will allow them to maintain a monetary policy consistent with low rates of price increase.

By contrast, France, Italy, and Ireland, although they succeeded in narrowing the gap between their rates of inflation and those of Germany and the Netherlands, continued to have a poorer price performance than these two countries; moreover, their competitiveness relative to these two countries was expected to deteriorate further in 1983 in the absence of exchange rate adjustments. The devaluations of their currencies allow France and Italy to achieve a better competitive position vis-à-vis their EMS partners. But unless accompanying measures, and in particular greater restraint on credit expansion and a marked reduction in the public sector deficit in France, are effectively implemented with a view to obtaining convergence of price and cost developments with partner countries, the balance of payments improvement to be expected from the realignment may be short-lived. The staff welcomes therefore the general thrust of the financial policy measures announced by the French authorities on March 25, but their effect will need to be carefully monitored and they may have to be reinforced. Ireland's external position has been particularly weak, with a relatively large current account deficit, sizable external debt, and declining cost competitiveness coinciding with a high rate of unemployment. The devaluation of the Irish pound will contribute to some improvement in competitiveness, but if this improvement is not to be eroded rapidly, it will have to be supplemented by strong domestic measures to slow further the rise in costs and prices.

Belgium, Denmark, and Luxembourg chose to revalue the central rates of their currencies by small percentages, though the first two countries continue to record relatively large current account deficits and above average unemployment rates. The worsening of Denmark's current account in 1982 was largely due to a higher rate of economic activity than in most of the industrial countries, but there was also some loss of competitiveness during the last quarter of the year as a result of the devaluation of the Swedish krona and the weakening of the U.S. dollar. The exchange rate adjustments decided by Belgium and Denmark make it essential that, in order to achieve the improvement in their balance of payments which the large and growing foreign debt burden makes desirable, the two countries give priority to measures designed to reduce the wide deficits of their public sectors.

The impact of this realignment on third currencies can be expected to be minimal on average. The strongest currencies, no longer weighed down by intervention to support the weakest currencies, will gain some room to appreciate not only vis-à-vis the other EMS currencies but also vis-à-vis third currencies; the reverse applies to the weakest currencies. In this respect the realignment promotes better external adjustment not only within the EMS but also between the EMS participants and third countries.

Table 3. Current Account Developments for EMS Countries, 1974-83

	1974-78 Average	1979	1980	1981	1982	1983 1/
	(In billions of U.S. dollars)					
Trade balance 2/						
BLEU	-1.0	-3.1	-4.2	-3.5	-2.6	-0.5
Denmark	-2.2	-3.0	-2.1	-1.0	-0.9	-0.1
France	-1.9	-2.1	-13.1	-10.2	-15.8	-10.2
Germany	20.4	17.5	10.5	17.9	26.2	31.6
Ireland	-1.0	-2.8	-2.8	-2.7	-1.5	-0.8
Italy	-2.3	-1.0	-16.4	-10.6	-8.0	-5.7
Netherlands	0.2	-1.4	-1.3	4.0	3.8	3.8
Services and private transfers						
BLEU	1.3	0.7	0.1	0.3	1.2	0.8
Denmark	0.5	-0.4	-0.4	-0.8	-1.4	-1.3
France	3.6	9.0	10.6	7.4	6.4	5.4
Germany	-10.3	-17.3	-19.3	-18.6	-16.5	-17.5
Ireland	0.3	1.0	0.9	0.3	--	--
Italy	2.4	7.4	6.8	3.2	3.1	4.9
Netherlands	1.3	-0.5	-1.0	-0.1	0.3	0.3
Official transfers						
BLEU	-0.4	-0.6	-1.0	-0.9	-1.1	-1.0
Denmark	0.3	0.4	0.1	--	-0.1	-0.2
France	-1.2	-1.7	-1.7	-2.0	-2.8	-3.3
Germany	-3.8	-6.1	-7.5	-6.7	-6.6	-7.0
Ireland	0.3	0.1	0.1	0.1	0.1	0.1
Italy	-0.7	-1.0	-0.2	-0.8	-0.6	-0.6
Netherlands	-0.3	-0.2	-0.5	-0.8	-0.7	-0.8
Current account balance						
BLEU	-0.2	-3.1	-5.1	-4.1	-2.6	-0.7
Denmark	-1.4	-3.1	-2.4	-1.8	-2.4	-1.6
France	-0.4	5.2	-4.2	-4.8	-12.2	-8.0
Germany	6.3	-6.0	-16.3	-7.4	3.1	7.1
Ireland	-0.4	-1.7	-1.8	-2.3	-1.4	-0.7
Italy	-0.5	5.5	-9.7	-8.1	-5.5	-1.4
Netherlands	1.2	-2.1	-2.8	3.1	3.3	3.3
	(In per cent of GNP/GDP) 3/					
Current account balance						
BLEU	-0.1	-2.7	-4.0	-3.9	-2.8	-0.8
Denmark	-3.3	-4.6	-3.6	-3.0	-4.3	-2.7
France	-0.1	0.9	-0.6	-0.8	-2.3	-1.4
Germany	1.3	-0.8	-2.0	-1.1	0.5	1.0
Ireland	-4.7	-11.4	-10.3	-14.3	-8.3	-3.8
Italy	-0.6	1.7	-2.4	-2.3	-1.6	-0.4
Netherlands	1.6	-1.3	-1.6	2.2	2.4	2.4

Source: National sources and IMF staff estimates.

1/ Staff preliminary projections, excluding realignment effects.

2/ On a f.o.b./f.o.b. basis.

3/ Including official transfers.

Table 4. Bilateral Trade Balances for the EMS Countries, 1981-82 1/

(In billions of U.S. dollars)

		Belgium	Denmark	France	Germany	Ireland	Italy	Netherlands	EMS 2/	World
Belgium	1981	--	0.46	2.17	-0.55	-0.03	0.75	-2.28	0.52	-6.45
	1982	--	0.24	2.12	-0.88	-0.04	0.57	-2.68	-0.67	-5.47
Denmark	1981	-0.35	--	0.06	-0.57	0.02	0.31	-0.58	-1.11	-1.54
	1982	-0.17	--	0.13	-0.81	0.02	0.24	-0.67	-1.26	-1.77
France	1981	-0.60	-0.07	--	-4.16	-0.09	0.80	-2.49	-6.61	-14.53
	1982	-0.91	-0.18	--	-5.78	-0.24	-0.63	-2.18	-9.92	-19.02
Germany	1981	1.90	0.70	5.23	--	-0.02	1.72	-4.58	4.95	12.17
	1982	2.09	0.78	6.72	--	-0.03 3/	1.34 3/	-3.71 3/	7.14	18.42 3/
Ireland	1981	0.10	-0.02	--	-0.06	--	-0.04	0.11	0.09	-2.81
	1982	0.13	-0.03	0.21	-0.02 3/	--	-0.03 3/	0.03 3/	0.29	-1.41 4/
Italy	1981	-0.74	-0.33	-1.14	-2.53	0.01	--	-1.47	-6.20	-15.82
	1982	-0.67	-0.31	0.33	-2.06 3/	-0.02	--	-1.36 3/	-4.09	-11.92 3/
Netherlands	1981	1.22	0.58	2.99	6.10	-0.05	1.88	--	12.72	0.41
	1982	1.62	0.55	2.69	5.33 3/	-0.03	1.60 3/	--	11.76	2.03 3/

Sources: IMF, Direction of Trade; and staff estimates.

1/ A positive number indicates that the row country has a trade surplus vis-a-vis the column country or country group; a negative number indicates a trade deficit. Trade balances are reported on a f.o.b./c.i.f. basis.
2/ Total EMS countries.
3/ Trade balance January-November only.
4/ Trade balance January-September only.

Table 5. Cost and Price Developments in EMS Countries, 1978-83

(In per cent at annual rates)

	1978	1979	1980	1981	1982	1983 1/
GNP/GDP deflators						
Belgium	4.2	4.1	4.1	5.2	8.0	7.2
Denmark	9.5	7.5	8.7	10.8	10.4	8.0
France	9.5	10.3	11.8	12.0	12.2	9.0
Germany	4.2	4.0	4.5	4.2	4.8	4.0
Ireland	10.7	13.2	14.0	17.7	17.9	11.6
Italy	13.9	15.9	20.7	18.4	17.5	15.1
Netherlands	5.2	4.0	5.1	5.4	6.1	2.0
Consumer prices						
Belgium	4.5	4.5	6.6	7.6	8.7	7.2
Denmark	10.1	9.6	12.3	11.7	10.0	8.0
France	9.1	10.8	13.3	13.3	11.8	8.8
Germany	2.7	4.1	5.5	5.9	5.3	3.8
Ireland	7.6	13.2	18.2	20.4	17.1	11.5
Italy	12.1	14.7	21.2	17.8	16.5	14.5
Netherlands	4.1	4.2	6.5	6.7	5.9	2.5
Unit labor costs in manufacturing						
Belgium	1.2	2.4	5.5	4.1	-1.1	1.1
Denmark	5.7	8.3	6.6	2.5	8.2	5.4
France	8.2	7.6	12.1	11.3	10.1	7.7
Germany	4.6	1.6	7.3	4.3	3.3	2.1
Ireland	9.4	12.7	18.4	9.0	9.8	6.9
Italy	11.0	10.1	12.3	16.0	16.2	14.7
Netherlands	2.7	3.8	4.5	2.1	4.1	-0.4

Sources: IMF, International Financial Statistics; and IMF staff estimates.

1/ Staff projections excluding realignment effects.

Table 6. Changes in Consumer Prices Adjusted for Exchange Rate Developments in the EMS Countries from 1979-I to 1982-IV 1/

(In percentage points)

	Belgium	Denmark	France	Germany	Ireland	Italy	Netherlands
Belgium	-	-10.0	-14.7	-11.4	-43.3	-30.7	-12.3
Denmark 2/	10.0	-	-4.7	-1.4	-33.3	-20.7	-2.3
France	14.7	4.7	-	3.3	-28.6	-16.0	2.4
Germany	11.4	1.4	-3.3	-	-31.9	-19.3	-0.9
Ireland	43.3	33.3	28.6	31.9	-	12.6	31.0
Italy	30.7	20.7	16.0	19.3	-12.6	-	18.4
Netherlands	12.3	2.3	-2.4	0.9	-31.0	-18.4	-

Source: IMF, International Financial Statistics.

1/ The figures indicate the difference of consumer price inflation rates adjusted for exchange rate changes between the row and the column country. A positive number thus indicates a greater rate of price increase in a common currency in the row country than in respective column country. A devaluation would lower all figures in the row of the devaluing country.

2/ November 1982 figure for the consumer price index used.

Table 7. Movements in Relative Costs and Exchange Rates
Since the Inception of the EMS

(In per cent)

		Belgium	Denmark	France	Germany	Ireland	Italy	Netherlands	EMS 1/	World 1/
Belgium	(a)	--	3.5	1.0	-19.7	-7.6	5.8	-17.2	-10.1	-13.3
	(b)	--	-7.5	-22.3	-4.2	-30.2	-32.1	...	-12.1	-12.3
Denmark	(a)	-3.4	--	-2.4	-22.4	-10.7	2.3	-20.0	-13.5	-17.5
	(b)	8.2	--	-16.0	3.6	-24.5	-26.6	8.1	-3.8	-4.8
France	(a)	-1.0	2.4	--	-20.5	-8.5	4.7	-18.1	-12.2	-18.9
	(b)	28.7	19.0	--	23.3	-10.1	-12.7	28.7	15.4	14.4
Germany	(a)	24.5	28.9	25.8	--	15.1	31.8	3.1	23.6	8.5
	(b)	4.4	-3.5	-18.9	--	-27.1	-29.2	4.4	-13.8	-10.9
Ireland	(a)	8.2	12.0	9.3	-13.1	--	14.5	-10.4	1.0	-12.5
	(b)	43.2	32.4	11.2	37.1	--	-2.8	43.1	24.9	22.2
Italy	(a)	-5.5	-2.2	-4.5	-24.1	-12.7	--	-21.8	-18.1	-23.6
	(b)	47.4	36.3	14.5	41.2	2.9	--	47.3	36.9	33.9
Netherlands	(a)	20.8	25.0	22.0	-3.0	11.6	27.8	--	9.2	2.8
	(b)	...	-7.5	-22.3	-4.2	-30.1	-32.1	--	-10.1	-11.1

Source: IMF staff estimates.

1/ Weights used in EMS and world calculations for all countries other than Ireland correspond to those used in calculating relative unit labor costs (IFS). Trade-related weights were used in the calculations for Ireland.

Note: (a) Changes in spot rates or effective rates based on weights used in the calculation of relative unit labor costs between March 13, 1979, and March 18, 1983. A negative number indicates a depreciation of the row country vis-à-vis the country (or country group) in the column heading. (b) Changes in unit labor costs in domestic currency in country listed in row by comparison with developments in unit labor costs in domestic currencies in countries (or country groups) listed in headings between 1979-I and 1982-IV. A negative figure indicates a gain in "competitiveness" unadjusted for exchange rate changes.

SM/83/57
Corrected: 4/13/83

Table 8. Indicators of Competitiveness in Manufacturing as Measured by Unit Labor Costs Adjusted for Exchange Rate Changes in Relation to EMS Partner Countries 1/

(1979 I = 100)

		Belgium	Denmark	France	Germany	Ireland	Italy	Netherlands
1975		100.4	104.1	108.1	86.8	108.6	122.8	98.5
1976		102.4	106.9	108.2	91.2	99.1	109.3	97.4
1977		105.1	105.0	99.9	95.1	98.5	108.5	99.4
1978		102.0	101.7	98.5	98.8	100.7	105.2	97.6
1979		98.3	102.1	101.6	98.3	106.7	104.8	96.6
1980		94.5	93.0	107.2	97.4	115.7	104.7	93.2
1981		92.3	89.1	109.8	96.0	117.4	109.0	89.5
1982		81.7	85.9	105.3	99.3	121.8	111.8	94.6
1983 2/		76.8	85.7	104.3	98.1	122.6	122.1	92.1
1978	IV	100.1	102.2	99.8	100.2	101.2	102.1	96.2
1979	I	100.0	100.0	100.0	100.0	100.0	100.0	100.0
	II	98.7	105.5	103.0	97.0	102.9	106.1	95.7
	III	97.8	103.7	100.7	97.8	112.1	109.2	94.6
	IV	96.9	99.4	102.7	98.5	112.0	103.9	96.3
1980	I	94.6	93.6	104.1	98.8	112.6	105.7	93.5
	II	95.2	93.7	107.7	98.3	113.1	101.6	92.5
	III	93.6	93.8	107.7	96.5	114.9	105.3	94.8
	IV	94.6	90.7	109.3	95.9	122.1	106.2	91.8
1981	I	93.8	90.9	112.6	92.7	114.1	111.9	90.1
	II	92.3	87.9	108.8	97.0	115.4	109.2	88.6
	III	91.0	90.0	109.7	95.6	117.6	111.6	88.8
	IV	92.2	87.7	108.1	98.9	123.9	103.3	90.7
1982	I	89.7	89.6	110.4	94.8	115.4	110.0	93.5
	II	79.4	87.7	109.3	98.3	121.6	110.2	93.6
	III	80.0	84.3	101.2	102.0	122.6	113.1	94.2
	IV	77.5	82.1	100.3	102.2	127.4	114.0	96.9

Sources: IMF Data Fund; and staff estimates.

1/ Weighted by EMS country weights used in calculating IFS relative unit labor costs for 14 industrial countries. The weights for Ireland are estimated on the basis of trade weights; as it measures unit wage costs the series for Ireland is therefore not fully comparable with those of other countries. Data for Italy are based on national figures not yet included in the Data Fund.

2/ Illustrative projection based on exchange rates for the remainder of 1983 frozen at the level for the first three weeks of February 1983 and staff projections of unit labor costs (in national currencies) in 1983, as given in Table 5.

SM/83/57
Corrected: 4/13/83

Table 9. Indicators of Competitiveness in Manufacturing as Measured by Unit Labor Costs Adjusted for Exchange Rate Changes in Relation 14 Industrial Partner Countries 1/

(1979 I = 100)

		Belgium	Denmark	France	Germany	Ireland	Italy	Netherlands
1975		99.5	101.9	105.5	87.7	107.5	118.3	96.6
1976		100.8	101.3	103.3	89.0	97.2	104.2	94.5
1977		104.0	100.8	97.3	93.2	97.9	105.0	97.3
1978		101.0	99.3	96.8	96.8	100.0	102.8	96.1
1979		98.0	101.8	101.4	98.6	103.7	104.4	96.5
1980		92.6	90.1	104.3	95.9	103.6	102.5	91.4
1981		86.5	79.1	97.9	86.5	96.1	97.9	82.2
1982		76.5	76.3	92.7	86.9	97.6	98.6	85.4
1983 2/		72.9	78.7	93.7	87.6	103.1	108.5	84.1
1978	IV	99.3	101.1	98.5	98.6	101.0	100.5	95.3
1979	I	100.0	100.0	100.0	100.0	100.0	100.0	100.0
	II	98.0	104.3	101.8	96.6	100.3	104.7	94.9
	III	96.9	102.6	100.0	97.5	106.5	107.9	93.8
	IV	97.1	100.3	103.8	100.2	108.1	105.0	97.2
1980	I	94.3	93.8	104.4	99.7	105.2	106.1	93.7
	II	93.7	91.0	105.2	96.9	102.5	100.0	91.3
	III	91.7	90.8	104.7	95.2	102.6	103.0	92.9
	IV	90.9	85.0	103.1	91.8	104.2	100.8	87.9
1981	I	87.8	80.7	101.1	85.1	92.6	101.1	83.1
	II	86.1	77.4	96.7	86.6	93.0	97.7	81.1
	III	85.0	79.0	96.8	85.1	95.7	99.0	80.8
	IV	87.2	79.4	97.2	89.1	102.9	93.7	83.9
1982	I	83.8	79.0	96.8	84.1	93.6	97.0	84.7
	II	74.3	77.4	95.5	85.8	97.6	96.7	84.3
	III	74.8	74.5	89.4	88.3	97.0	99.6	84.9
	IV	72.9	74.3	89.3	89.3	102.2	100.9	87.8

Sources: IMF Data Fund; and staff estimates.

1/ Weighted by the country weights used in calculating IFS relative unit labor costs for 14 industrial countries. The weights for Ireland are estimated on the basis of trade weights; as it measures unit wage costs the series for Ireland is therefore not strictly comparable with those of other countries. Data for Italy are based on national figures not yet included in the Data Fund.

2/ Projections based on exchange rates for the remainder of 1983 frozen at the level of the first three weeks of February 1983; unit labor costs in national currencies for EMS countries are assumed to develop as in Table 5; for other countries according to staff projections as of March 1983.

Table 10. Unemployment Rate and GNP/GDP Growth Rate in EMS Countries

(In per cent at annual rates)

	1978	1979	1980	1981	1982
Unemployment rate 1/					
Belgium	8.4	8.7	9.4	11.6	13.7
Denmark	7.3	6.1	7.0	9.2	9.7
France	5.2	5.9	6.3	7.3	8.6
Germany	3.8	3.3	3.4	4.9	6.8
Ireland 2/	8.3	7.4	8.2	10.0	11.6
Italy	7.2	7.7	7.6	8.4	9.1
Netherlands	4.2	4.2	4.9	7.3	10.5
Growth rate of real GNP/GDP					
Belgium	3.0	2.0	2.4	-1.2	-0.7
Denmark	1.9	3.7	-1.1	0.1	2.6
France	3.8	3.3	1.1	0.4	1.5
Germany	3.6	4.0	1.8	-0.2	-1.2
Ireland	5.1	2.1	2.3	0.3	-0.5
Italy	2.7	4.9	3.9	0.1	-0.3
Netherlands	2.4	2.3	0.9	-1.1	-0.9

Sources: National sources; and staff estimates.

1/ These figures are not strictly comparable across countries.
2/ End of April figures; by the end of 1982 the unemployment rate was estimated to be 14 per cent.

Table 11. Money and Credit Developments in EMS Countries 1/

(In per cent)

	1979	1980	1981	1982 I	1982 II	1982 III	1982 IV 2/
Domestic credit expansion							
Belgium	14.8	11.5	12.9	15.6	11.9	12.8	...
Denmark	12.3	13.3	14.5	15.0	15.8	14.6	13.0
France	14.1	12.3	14.1	15.0	16.4	17.1	...
Germany	11.9	9.5	8.8	8.3	7.2	6.9	6.7
Ireland	25.4	18.6	18.0	17.6	12.3	9.5	13.0
Italy	18.5	18.6	18.1	18.2	19.4	22.4	20.8
Netherlands	17.2	10.4	5.9	7.0	5.9	4.8	...
Expansion of broad money 3/							
Belgium	6.2	3.3	6.5	7.4	5.2	8.9	...
Denmark 4/	10.8	8.1	9.6	11.6	11.1	11.8	11.4
France	13.9	8.3	11.1	12.2	11.9	12.0	...
Germany	5.2	4.6	3.7	5.9	6.2	6.8	7.0
Ireland 4/	18.7	17.7	17.4	15.5	12.1	12.3	16.0
Italy 4/	23.2	17.3	16.0	15.0	16.6	16.5	17.1
Netherlands	11.6	5.6	7.8	8.0	7.6	6.9	5.7

Sources: IMF, International Financial Statistics; and national sources.

1/ From end of period one year before.
2/ Partly estimated by staff.
3/ Broad money is defined as the sum of money and quasi-money in the IFS definition, unless otherwise indicated.
4/ National authorities' definition of broad money; Danish figures exclude certain deposits and include Treasury bills held by the non-banks; Irish and Italian figures refer to M3.

Table 12. Interest Rate Developments for EMS Countries, 1981-82

(Period averages in per cent per annum)

		Belgium	Denmark	France	Germany	Ireland	Italy	Netherlands
Call money rate								
1981	I	9.8	13.3	11.1	10.5	13.3	17.8	9.3
	II	12.8	15.2	16.1	11.7	13.7	19.8	10.6
	III	11.3	18.3	17.9	12.0	13.9	20.2	12.3
	IV	12.0	12.6	16.1	10.9	13.3	20.6	11.8
1982	I	11.5	13.1	15.2	10.0	13.3	20.5	9.3
	II	12.4	19.0	16.4	9.2	14.0	20.5	8.5
	III	11.7	14.6	14.6	8.6	14.0	19.8	8.2
	IV	10.2	18.8	13.3	6.9	11.0	18.9	6.2
1983	Feb. 2/	9.9	16.3	...	5.7	10.0	19.1	4.9
Government bond yield								
1981	I	13.2	17.6	14.1	9.8	16.1	17.6	10.9
	II	13.7	17.6	15.7	10.6	17.0	20.9	11.5
	III	14.1	20.0	16.6	11.1	17.8	22.3	12.0
	IV	13.9	20.6	16.2	10.0	18.3	21.6	11.8
1982	I	14.0	20.4	16.0	9.7	19.0	21.0	10.9
	II	13.7	21.2	15.8	9.0	18.4	21.1	10.3
	III	13.4	20.6	15.4	9.0	16.1	20.9	10.2
	IV	13.1	19.4	15.1 1/	8.1	14.7	20.1	9.0
1983	Feb. 2/	12.5	16.5	...	7.6	14.9	19.8	8.2

Sources: IMF, International Financial Statistics; and national sources.

1/ November rate.
2/ February figures are partly estimated by staff.

Table 13. Indicators of the Stance of Fiscal Policy 1/

(In per cent of GNP/GDP)

	1979	1980	1981	1982
Central government fiscal balance				
Belgium	-6.5	-8.6	-12.6	-13.2
Denmark	-2.7	-4.2	-8.0	-10.3
France	-1.1	-1.4	-2.7	-3.0
Germany	-1.9	-1.9	-2.5	-2.4
Ireland	-13.9	-14.3	-17.1	-16.5
Italy	-11.2	-10.9	-12.9	-15.1
Netherlands	-4.1	-4.6	-6.0	-7.2
General government fiscal balance				
Belgium	-8.9	-12.2	-16.5	-16.1
Denmark	-1.5	-3.1	-6.9	-9.1
France	-0.7	0.4	-2.1	-2.8
Germany	-2.7	-3.1	-4.0	-3.9
Ireland 2/	-14.5	-14.8	-18.0	-17.5
Italy	-9.5	-8.0	-11.7	-11.9
Netherlands	-4.8	-6.5	-7.4	-8.3

Sources: IMF, International Financial Statistics; and Fund staff estimates.

1/ The data are not comparable across countries since some are on a cash or administrative basis, others on a national accounts basis. The government concept may also differ between countries.
2/ Staff estimates.

Table 14. Changes in Effective Exchange Rates
Due to EMS Realignment

(In per cent)

	Change vis-à-vis deutsche mark	Change in Effective Exchange Rate vis-à-vis	
		All countries 1/	EMS countries 2/
Belgian franc	-3.8	-1.44	--
Danish krone	-2.8	-1.18	1.70
Deutsche mark	--	2.59	6.16
Dutch guilder	-1.9	0.42	2.31
French franc	-7.6	-6.07	-4.31
Irish pound	-8.5	-6.85	-4.50
Italian lira	-7.6	-5.99	-4.31

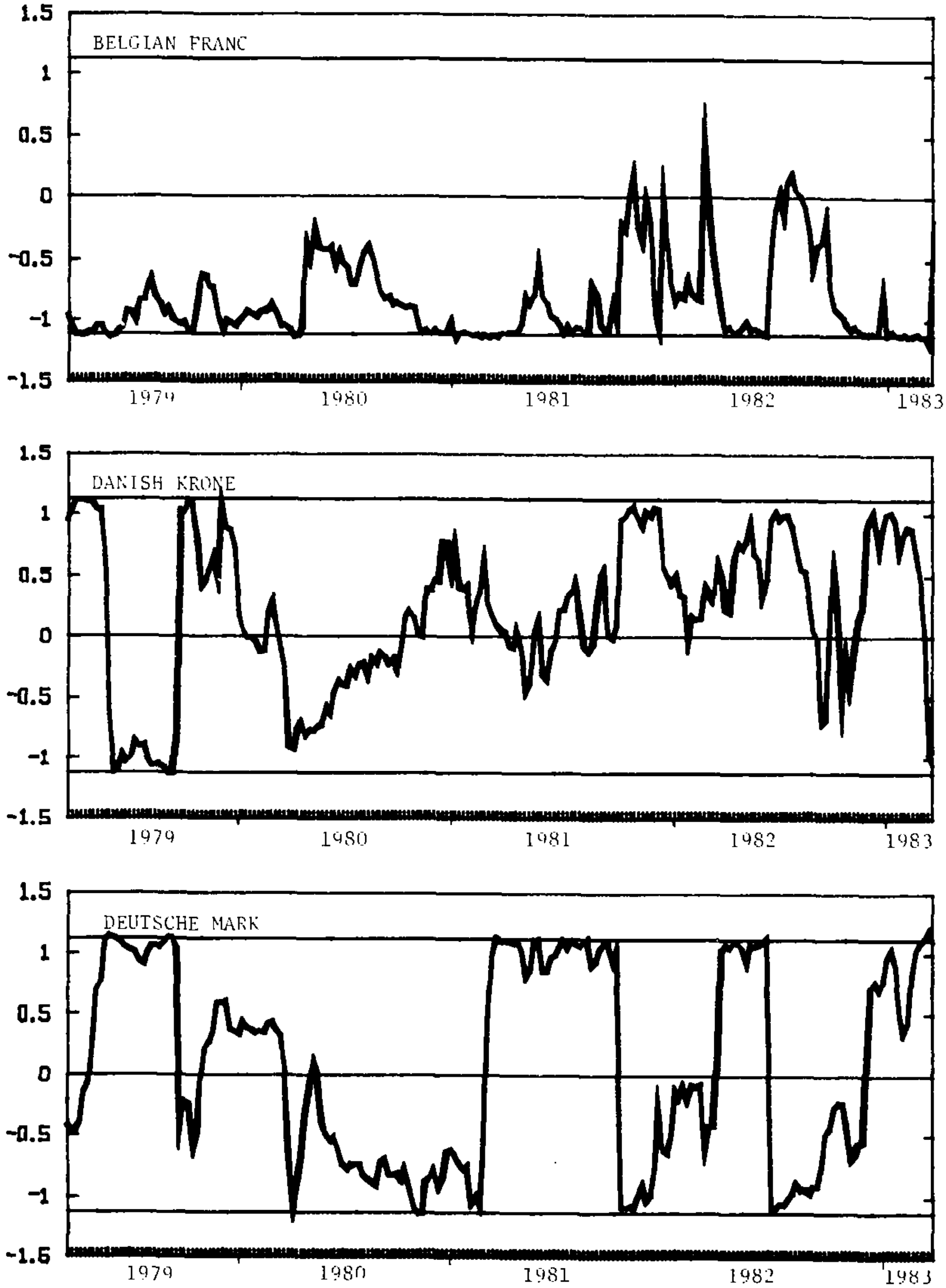
Source: Staff calculations.

1/ Calculation using MERM weights and on the assumption that the exchange rate of the deutsche mark vis-à-vis the U.S. dollar and other third currencies remains unchanged. A negative number indicates an effective depreciation.

2/ Calculated using MERM weights and abstracting from changes in the exchange rates between EMS currencies and all other currencies. Weights for EMS countries are derived by dividing the weight for each EMS country by the sum of the weights for all EMS countries, excluding the United Kingdom.

Chart 1

POSITION WITHIN THE EMS BAND 1/



Source: Fund staff calculations.

1/ Based on average weekly exchange rates for the period March 13, 1979-March 18, 1983.

Chart 1

POSITION WITHIN THE EMS BAND

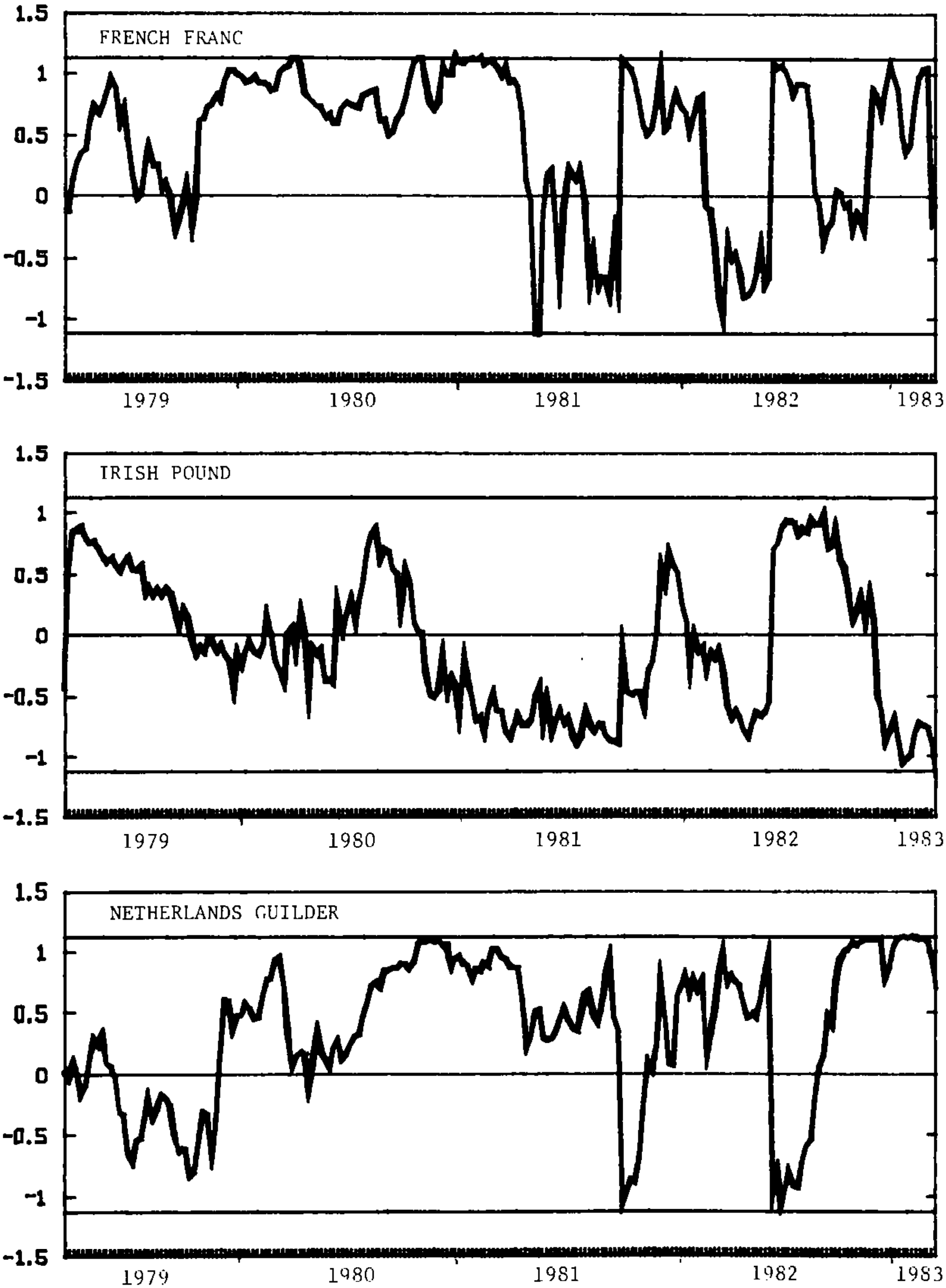


Chart 1

POSITION WITHIN THE EMS BAND

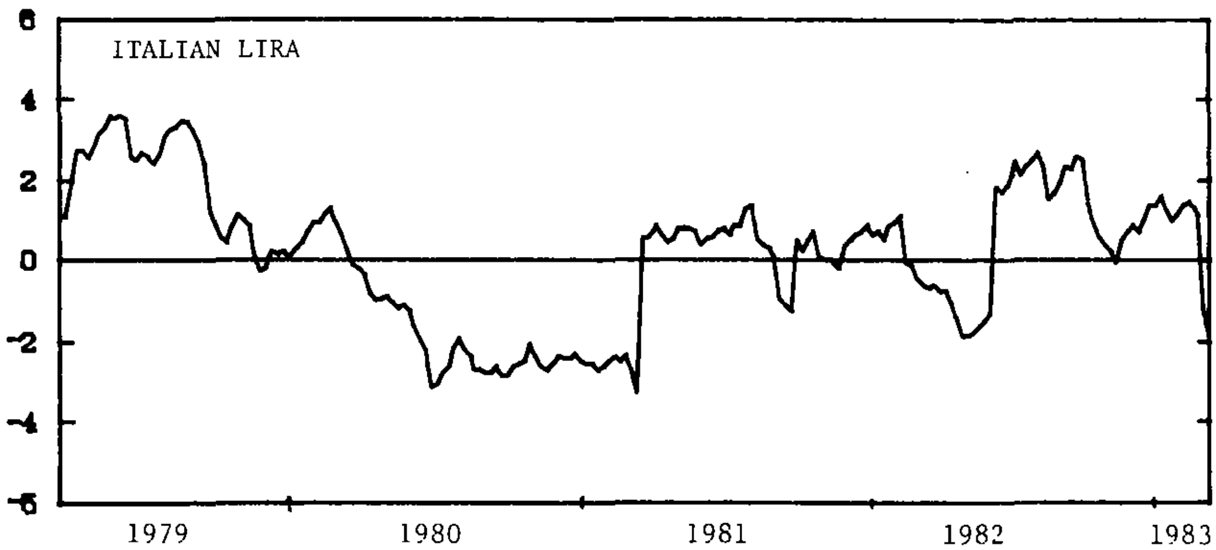
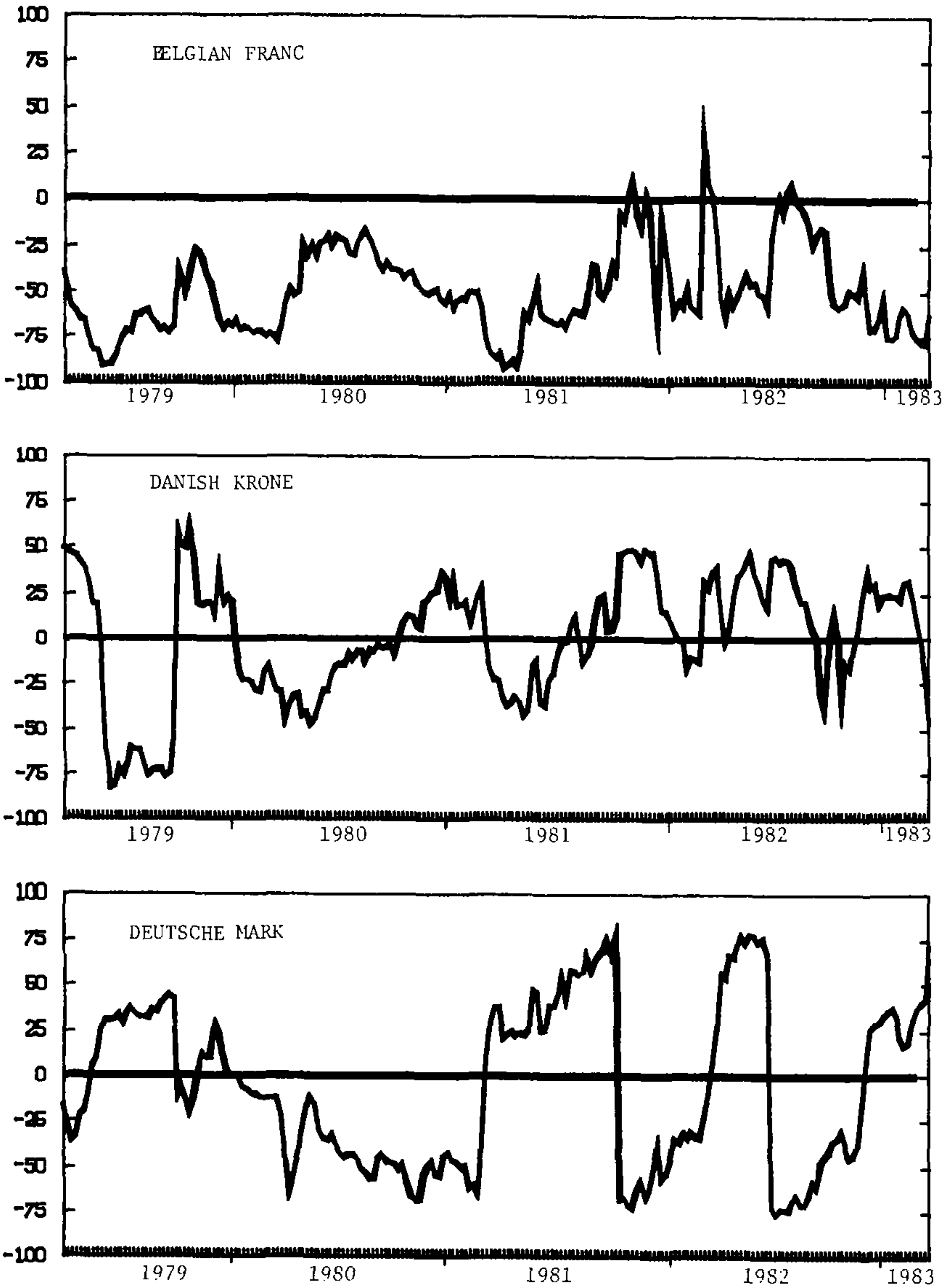


Chart 2

EMS DIVERGENCE INDICATOR



Source: Fund staff calculations for the period March 13, 1979-March 18, 1983.

Chart 2

EMS DIVERGENCE INDICATOR

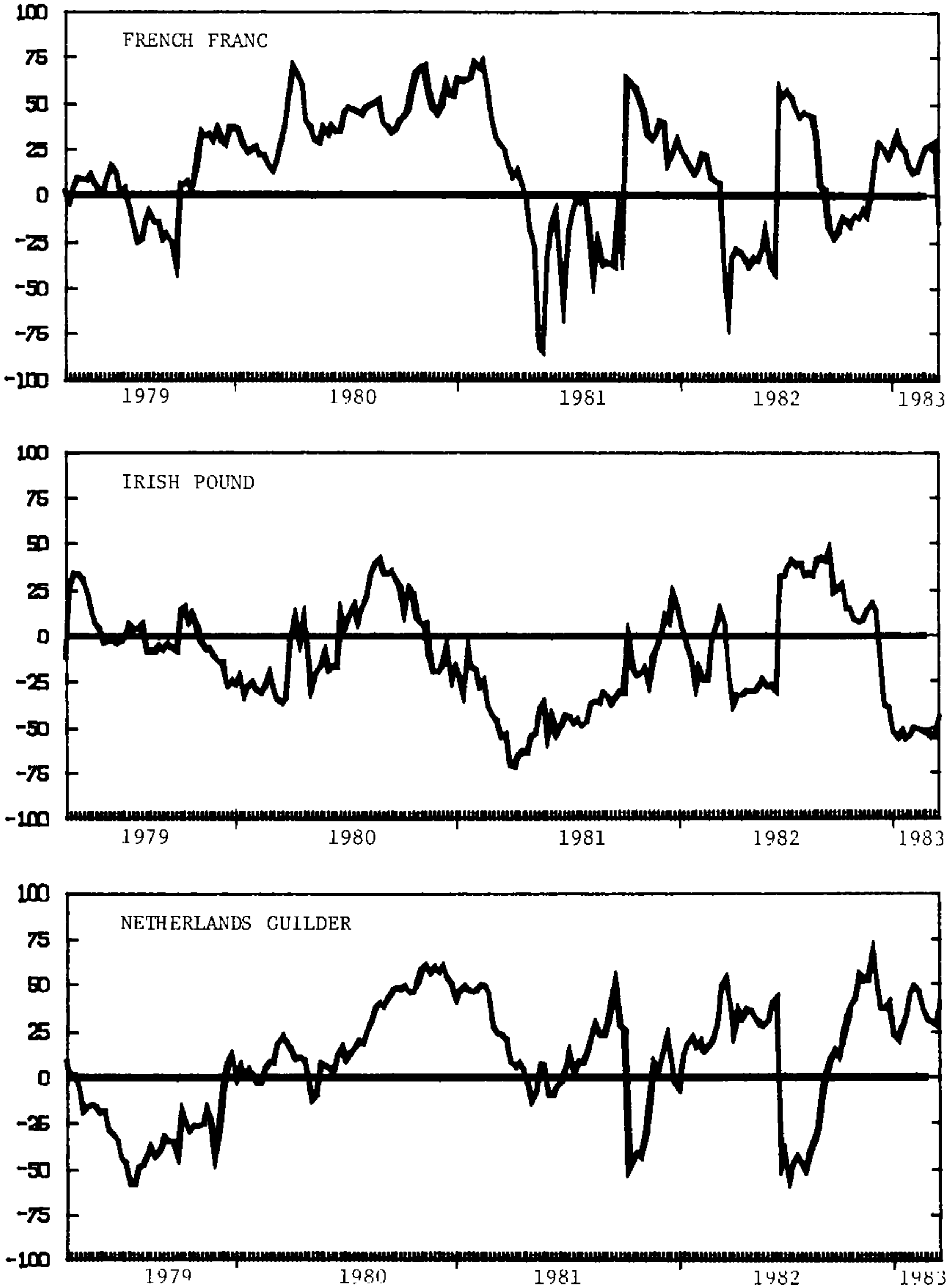
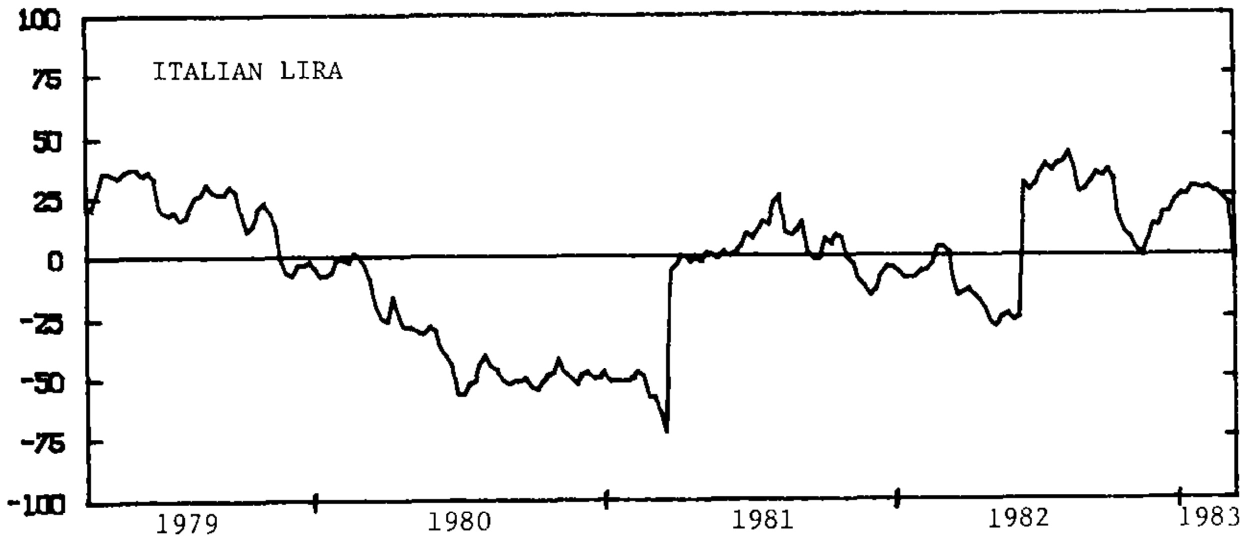


Chart 2

EMS DIVERGENCE INDICATOR



European Communities, Brussels, 21st March 1983

COMMUNIQUE

On 21st March 1983, the Ministers and Central Bank Governors of EEC Member Countries have by mutual agreement, in a common procedure involving the Commission and after consultation of the Monetary Committee, decided on an adjustment of central rates within the European Monetary System.

Changes in central rates are the following:

- German Mark	+5.5 per cent
- Dutch Guilder	+3.5 per cent
- Danish Kroner	+2.5 per cent
- Belgian Franc	+1.5 per cent
- Luxembourg Franc	+1.5 per cent
- French Franc	-2.5 per cent
- Italian Lira	-2.5 per cent
- Irish Pound	-3.5 per cent

The Ministers have requested that the agro-monetary consequences of this adjustment be examined immediately by the appropriate bodies.

Notwithstanding other provisions, Member States participating in the exchange rate mechanism of the EMS for whom monetary compensatory amounts are created or modified by this central rate adjustment, will not request changes in the compensatory amounts now introduced before the end of the current agricultural price fixing round, and the Commission will not make any proposal to that effect.

In view of the particular situation within the European steel industry, the Member States affected are recommended to act in such a way as to ensure that suppliers of steel in their countries will immediately bring steel prices into line with the orientation price level.

Country Notes

1. Belgium and Luxembourg

The steady deterioration in the external payments position of the Belgium-Luxembourg Economic Union (BLEU) since the first oil shock now appears to have been halted and partly reversed. The current account deficit declined in 1982: as a proportion of GNP, it fell from 3.9 per cent in 1981 to an estimated 2.8 per cent. Net private capital outflows also decreased in the first nine months of 1982 to half of what they were in the corresponding period of 1981. The current account deficit is largely financed by public sector foreign borrowing, and Belgium's total public and publicly guaranteed external debt in domestic and foreign currencies rose to the equivalent of more than 25 per cent of GNP at end-1982.

The adjustment program initiated in February 1982 has brought some improvement to the profitability and competitiveness of Belgian enterprises, but activity remains weak, and the average unemployment rate rose to 13.7 per cent in 1982. The suspension of wage indexation until mid-1983 and a temporary price freeze limited the impact on the rate of inflation of the franc's devaluation within the EMS in February 1982 and the subsequent depreciation in effective terms. Consumer prices rose nevertheless by 8.7 per cent in 1982, more than the average for industrial countries.

The main element of concern remains the imbalance in public finances and the mounting external debt of the public sector. Firm action on public sector finances is among the authorities' top priorities: the PSBR amounted to 16.1 per cent of GNP in 1982, down slightly from 1981, but still far from the official target of bringing the borrowing require- down to the European Community average by 1985. A rapid adjustment in public finances is essential to consolidate the achievements of the Government's economic program.

The Luxembourg economy continues to be affected by the economic downturn in its principal markets and especially the weak demand for steel products. Real GDP is estimated to have declined marginally in 1982. Consumer price inflation was more than 9 per cent in 1982, largely as a consequence of the February 1982 devaluation, and the suspension of full wage indexation has been continued into 1983. Despite a rise in the number of unemployed, the unemployment rate remains exceptionally low in comparison with other industrial countries.

The Belgian franc has been at the floor of the EMS band almost continuously since mid-1982. This reflects, however, the authorities' preference for channeling the proceeds of foreign borrowing to the market through official intervention at the lower end of the band. Official reserves showed only a slight decline during 1982. The discount on the financial franc widened, however, toward the end of 1982 and at the beginning of 1983, fluctuating around 6 per cent.

2. Denmark

Following an improvement during 1980-81, the current account balance deteriorated in 1982. The deficit rose from the equivalent of 3 per cent of GDP in 1981 to more than 4 per cent in 1982, due to a sharp rise in interest payments as well as a larger trade deficit (in Danish krone terms), in particular vis-à-vis the other EMS members. Consequently, net external debt in relation to GDP rose further to 33 per cent. While the growth of export volume decelerated, mainly because of the weak export market growth, the recovery of private consumption and investment led to a rise in import volume, reversing its declining trend in the preceding two years.

Real GDP rose by 2.6 per cent in 1982 which compared with a decline in all EMS partners except France. Unemployment continued to rise, however, reaching almost 10 per cent in 1982, and inflation remained high at 10 per cent, mainly as a result of increased wage pressure.

A major factor behind the renewed deterioration of the current account balance in 1982 was a significant easing of fiscal policy beginning in 1981. The policy shift was adopted because of high and rising unemployment in Denmark. The public sector financial deficit widened from 3 per cent of GDP in 1980 to 7 per cent in 1981, and further to 9 per cent in 1982. Monetary policy remained restrictive, however, and, despite the fall in interest rates abroad since mid-1982, real interest rates were kept high.

Against the large external and internal imbalances, the authorities implemented a new economic program in late 1982, comprising incomes and fiscal policy measures. The program was intended to contain domestic demand and cost pressures. In particular, wage indexation which had been in effect since World War I, was suspended until the spring of 1985. Fiscal measures were concentrated mainly on the expenditure side. They included the suspension of indexation for most transfer payments, including a freeze on unemployment benefits, and are expected to stabilize the public sector deficit in terms of GDP.

The foreign exchange market was relatively calm during the first eight months of 1982. The devaluation of the krone vis-à-vis the ECU as part of the EMS realignments in February and June 1982 were small and were undertaken when the krone was well inside the EMS band. During September and October, uncertainty over the future course of economic policy sparked a severe foreign exchange crisis. However, confidence was restored after the economic policy program of the new Government had been passed, and there was a sizable reflow of capital in November. Between early November 1982 and end-February 1983, the krone stayed in the upper part of the EMS band but fell to the lower part in mid-March. Gross official reserves, which had declined by SDR 0.4 billion during the foreign exchange crisis to SDR 1.6 billion at end-October, rose to SDR 2.1 billion at end-1982, still slightly lower than a year earlier.

The declining trend of the real effective exchange rate (measured by relative labor costs) over the previous two years was arrested during 1982, as a result of the appreciation of the nominal effective exchange rate during the fourth quarter of the year. The effective rate (MERM) of the Danish krone depreciated by 6 per cent during the first three quarters but appreciated by 4 per cent during the last quarter of the year, owing largely to the depreciation of the Swedish krona and the weakening of the U.S. dollar.

3. France

France's current account deficit trebled in 1982 to an estimated 2.3 per cent of GNP as both the trade and invisible balances deteriorated. The large deterioration in the trade balance began in late 1981 and reflected the combined effects of the appreciation of the dollar on the energy balance, a sharp drop in the volume of exports, and a resumption in the growth of non-oil imports caused by a relatively strong domestic demand and by precautionary stockbuilding. In the last quarter of 1982, the trade account improved, and exports appeared to have regained some of the earlier losses of market shares. Preliminary figures for January, however, did not confirm the improvement.

The large current account deficit was compounded by heavy capital outflows for the financing of export credits, direct investment, and the servicing of external borrowing, while speculative capital movements have at times also been important. In addition to the long-established practice of borrowing through the public enterprises, the Government negotiated in September a US$4 billion bank consortium loan and, in December, a line of credit with the Saudi Arabian Monetary Agency.

Government policies provided a strong demand stimulus from mid-1981 through mid-1982. Much of the impulse originated in the public sector, notably as a result of stepped-up social transfers, as the borrowing requirement of the Central Government, which had been eliminated in 1980, exceeded 2 per cent of GDP in 1981 and reached an estimated 3 per cent of GDP in 1982 and was financed in part by a rapid expansion of domestic credit.

After the June 1982 devaluation, policy shifted from an expansionary stance to concern for reducing the external deficit and inflation. The new orientation was most evident in the field of public finance and incomes policy.

In contrast with most partner countries, real GDP, led by consumer demand, rose in 1982 and unemployment increased only slowly to 8.6 per cent. Most of the growth, however, took place before the shift to a more restrained policy stance following the June 1982 devaluation. Thereafter, real growth and all major components of domestic demand showed signs of weakness. Inflation, after averaging 13.5 per cent at an annual rate in the first half of 1982, decelerated sharply with the imposition of the wage and price freeze from July to October 1982 but rebounded to 12 per cent in the period from November to January 1983 in spite of strict price controls introduced at the expiration of the freeze. Hourly wage costs, which had risen rapidly earlier in 1982 also slowed with the freeze, and unit labor costs showed broadly the same pattern, rising by 11.7 per cent through the year. Profitability of enterprises is estimated to have fallen in the second half of 1982 to its lowest level in more than a decade. Official targets call for consumer prices to increase by 8 per cent through 1983. To reach these objectives and in a significant departure from earlier practice, the authorities have urged the adoption of wage settlements designed to compensate for target inflation rather than past inflation.

Except for a short period following the devaluation of June 14, 1982 the franc has frequently been under pressure in the past year. Interventions were particularly heavy from end-March to mid-June 1982, in August, and in the last six weeks of 1982. Pressure abated somewhat in January 1983 but resumed in the weeks preceding the March municipal elections, with Eurofranc interest rates rising to a range of 20-25 per cent. The June 1982 realignment had restored relative cost competitiveness vis-à-vis Germany in the third quarter of 1982 to its mid-1979 level. However, since the expiration of the freeze the inflation differential tended to widen and, on the basis of unchanged exchange rates, the competitiveness gap in favor of Germany would have opened again in 1983.

4. Germany

Germany's external position strengthened in 1982. The current account of the balance of payments recorded a surplus equal to 0.5 per cent of GNP, compared with a deficit of 2 per cent of GNP in 1980 and 1.1 per cent in 1981.

Export growth in volume terms slowed to about 2 per cent on average, but with a substantial decline during the second half of the year. This increase, however, was higher than market growth abroad. Import volume grew by less than 1 per cent. The improvement in the trade balance in 1982 accounted for virtually the full strengthening of the current account. It was largely attributable to a 4 1/2 per cent improvement in the terms of trade, although Germany's trade performance may also have profited from the delayed effects of the large improvement in cost competitiveness that took place in 1981.

The strengthening of the current account balance also reflected some change in the relative cyclical position of the German economy. Real GNP fell in 1982 for the second year in a row. The rate of unemployment rose throughout the year to 7.7 per cent (seasonally adjusted) in January 1983 compared with 6.0 per cent a year earlier. Early in 1983, however, there were signs indicating some pickup in activity.

During the first half of 1982 private long-term capital exports expanded strongly, as foreign borrowers took advantage of the declining long-term interest rates, roughly offsetting short-term capital inflows.

Both private short-term and long-term capital registered small outflows in the second half year. Net official reserves rose modestly during the course of the year.

The rate of inflation continued to decline. In 1982 consumer prices rose by 5.3 per cent against 5.9 per cent in 1981. At the beginning of 1983 the annual rate of rise of consumer prices was below 4 per cent. The deceleration in inflation mirrored modest wage settlements (just over 4 per cent in the pivotal metals industry), but also a strong rise in productivity as firms reduced their work forces. Unit labor costs in the whole economy increased by only 3 1/2 per cent in 1982. However, the slowing of the rate of rise of import unit values to 1 per cent in 1982 against 12 1/2 per cent the year before also played an important role. Wage negotiations for 1983 may result in wage settlements of about 3 per cent, in response to lower inflationary expectations and the rise in unemployment.

Monetary policy started easing in the third quarter of 1981, as the external position improved, the rate of inflation abated, and economic activity remained sluggish. In the fourth quarter of 1982 central bank money stood 6 per cent higher than a year before, representing an increase, as intended, in the upper part of the target range of 4-7 per cent. A similar target range for the growth of central bank money has been established for 1983. In February central bank money considerably exceeded the top of the range, increasing at an annual rate of 11 per cent over the base period; this was partly the result of heavy intervention in the exchange markets which continued also in March. Fiscal policy has been characterized by efforts to contain the budget deficit through cuts in social benefits and increases in private social security contributions. This objective, however, has been impeded by the protracted weakness of economic activity and by programs to stimulate investment. The fiscal deficit of the General Government in 1982 (3.9 per cent of GNP) was unchanged in nominal terms from a year earlier.

Despite the substantial improvement in the current account balance, the deutsche mark depreciated against the dollar by almost 7 per cent in 1982. In effective terms (MERM), however, it appreciated by 4 per cent, partly as a result of the February and June EMS realignments. Intervention both vis-à-vis the dollar and within the EMS tended to be moderate in 1982. The continued weakness of the deutsche mark until November 1982 took place despite a substantial narrowing in interest rate differentials and was related in part to increasing political uncertainty in Germany culminating in the change of Government in October. Since mid-November the deutsche mark has strengthened markedly against the U.S. dollar and vis-à-vis the other EMS currencies, except for a temporary period of weakness at the beginning of 1983 when U.S. interest rates rebounded, and the March elections in Germany cast uncertainty on future policies. The deutsche mark again strengthened immediately after the elections.

5. Ireland

Ireland's external position improved markedly in 1982, following a sharp deterioration in the previous three years, although it remained weak by comparison with most other industrial countries. The steep fall in the terms of trade in the aftermath of the second oil price shock, the weakness of demand in the United Kingdom and other export markets, and the large and rapidly expanding borrowing requirement of the Central Government led to a widening of the current external deficit from 4 per cent of GNP in 1978 to almost 14 1/2 per cent in 1981. In 1982 the external current account deficit fell to 8 1/2 per cent of GNP, reflecting a strong growth in industrial exports, largely accounted for by newly established manufacturing firms, a small improvement in the terms of trade, and a substantial fall in the volume of imports due to a weakening of domestic demand. The financing of the current account deficit over the last few years has necessitated substantial foreign borrowing by the Government and various state-sponsored bodies. External public debt rose from 22 per cent of GNP in 1978 to more than 50 per cent in 1982.

Unit wage costs in the manufacturing sector have been rising faster than in Ireland's partners during the last few years. The effects of this development on external competitiveness relative to the main trading partners were more than offset by the depreciation of the effective exchange rate of the Irish pound in 1981. In contrast, however, cost competitiveness vis-à-vis the other EMS countries continued to deteriorate. During the second half of 1982 and the first months of 1983, Ireland's competitive position deteriorated relative to all trading partners, as unit labor cost increases continued to be higher, while the depreciation of the effective exchange rate was arrested owing to the weakening of the pound sterling. In the previous EMS realignments, the Irish pound had either moved with the currency group in the center or maintained its value against the stronger currencies. As a result, exchange rate changes vis-à-vis EMS partners since 1979 tended to exacerbate the adverse impact on competitiveness of movements in relative unit labor costs measured in local currency. Exports of manufactures have continued to grow more rapidly than export markets through the end of 1982, but this was mainly due to the coming on stream of production in "new" high technology and export-oriented industries.

Since mid-1981, the Irish authorities have stepped up their efforts to promote external adjustment through measures to contain the budget deficit and restrain credit expansion and through negotiations with the social partners to achieve moderation in wage increases. In 1982 the Exchequer Borrowing Requirement declined marginally to 16 1/2 per cent of GNP. The budget for 1983 provides for a further decline to 13 per cent of GNP, to be achieved through discretionary increases in direct and indirect taxes, and cuts in capital expenditure.

The measures contributed to a sharp contraction of domestic demand in real terms in 1982, with real GNP falling by 1/2 per cent, and to a decline in the rate of inflation which remains, however, well above that in the other EMS participants. Real wages declined in 1981 and 1982, reflecting the effects of large increases in net indirect taxes and the Government's efforts to achieve some moderation of wage claims. Unemployment continued to rise, reaching 14 per cent of the labor force by the end of 1982.

6. Italy

The initial policy stance for 1982 was shaped by the objectives of securing a moderation of inflation and an improvement in the current account deficit of the balance of payments. The authorities targeted the containment of the public sector deficit to Lit 50,000 billion (about 10.5 per cent of GDP) and of the growth of domestic credit to the private sector to 13 per cent. However, efforts to moderate the growth of public spending proved largely unsuccessful and the public deficit rose to the equivalent of over 15 per cent of GDP, leading to an increase in total domestic credit of nearly 21 per cent, despite the maintenance of credit to the private sector in line with the target. The rising financing requirements of the public sector were reflected in persistently high levels of interest rates which could only in part follow the downward trend abroad.

Following a temporary revival in the early months of the year, output declined in the second and third quarters and stagnated in the last quarter of 1982, in reflection of a marked weakening of both domestic demand and exports. Unemployment continued to rise, reaching an average for the year of 9.1 per cent, compared with 8.4 per cent in 1981. The rate of inflation decelerated to just over 15 per cent by June 1982, compared with 21 per cent at the end of 1981. Subsequently, however, the rate of increase in prices reaccelerated to over 16 per cent by year-end. Cost developments in 1982 were moderated by the decline in international prices and by the absence of contractual wage increases. Unit labor costs in manufacturing decelerated to 16 per cent in 1982 compared with over 18 per cent in the previous year.

The external position improved, as evidenced by a decline in the current account deficit of the balance of payment from Lit 9.2 trillion in 1981 (2.3 per cent of GDP) to Lit 7.4 trillion in 1982 (1.6 per cent of GDP). The improvement mainly reflected a large gain in the terms of trade and a strong performance of receipts from tourism. The real trade balance showed a slight deterioration, as exports registered a small loss in market shares.

For 1983 the authorities are trying to secure some further moderation in labor costs, to stem the escalation of the public sector deficit and to maintain a relatively tight stance of monetary policy. On January 22, 1983 an agreement was reached between the Government, the unions and the employers' association, to reduce the degree of wage indexation in exchange for measures to moderate the fiscal drag. At the same time nationwide guidelines were set for contractual wage increases over the next three years. A package of measures mainly consisting of increases in revenues has been introduced, with the intent of containing the public sector deficit at the same absolute level as in 1982, which would imply a reduction in terms of GDP to below 14 per cent. It is, however, recognized that the attainment of this objective would require additional measures, equivalent to at least 1 1/2 per cent of GDP, which are currently under consideration. The prospective level of the public deficit will severely constrain the scope for a reduction in interest rates in 1983 as in 1982.

A wave of speculative pressure on the lira in October 1982 followed the reacceleration of inflation and the failure to contain the budget deficit. The authorities countered speculation by tightening the scope for leads and lags in foreign exchange transactions, by raising the three-month Treasury bill rate by nearly 2 percentage points, and by intervening heavily in the exchange market. Subsequently, the lira strengthened, moving to the top of the EMS and remaining there early in 1983, while official foreign exchange reserves (including holdings of ECUs) recovered from about SDR 11 billion at end-November 1982 to SDR 12.3 billion by end-February 1983, equivalent to some eight weeks of 1982 merchandise imports.

During the year, the lira depreciated on average by 19 per cent vis-à-vis the U.S. dollar and by 8.2 per cent in effective terms. The lira's ECU central rate in the EMS was devalued by 3.3 per cent on June 14, 1982. As a result of these developments Italy's competitiveness in terms of unit labor costs improved overall at an annual average rate of 5.8 per cent during the first three quarters of 1982 and at a rate of 4.4 per cent relative to its partner countries in the EMS, reflecting in particular the realignment of exchange rates in June. On a bilateral basis, Italy's competitiveness deteriorated by 2.1 per cent vis-à-vis France but improved by 3.4 per cent vis-à-vis Germany. However, this improvement in 1982 was insufficient to offset the loss in competitiveness that had occurred in previous years. From the inception of the EMS to the third quarter of 1982 inclusive, Italy's competitiveness in manufacturing worsened by about 11 per cent relative to all other EMS partners.

7. The Netherlands

Following the strong turnaround in the external current account of the Netherlands in 1981, the surplus is estimated to have widened further in 1982 to the equivalent of some 2.5 per cent of GDP. The strengthening in the current account can be ascribed to weak demand conditions domestically, especially the sluggishness of fixed capital expenditures, but also to continued improvements in competitiveness in the early 1980s and the associated export market gains. Compared with the Netherlands' EMS partners, unit labor costs adjusted for exchange rate changes fell by 7 per cent between 1980 and 1981. During 1982 they rose, however, by an estimated 4 per cent. Favorable terms-of-trade developments also contributed to the trade surplus, which accounted for the bulk of the current account surplus in 1982. Substantial capital outflows took place in the first half of 1982 but were reversed in the second half. Official reserves declined by SDR 1.1 billion in 1981 and rose by SDR 1.2 billion in 1982.

For the second year in a row, real GNP fell by 1.1 per cent in 1982, and all components of domestic demand declined. The decline in economic activity has been accompanied by record levels of unemployment, reaching 12.4 per cent of the dependent labor force in 1982. Prospects for 1983 do not suggest major changes in the trends observed in 1982. Further growth in unemployment will be inevitable under these circumstances.

The more positive aspect of the current situation consists of the good price performance and the moderation of wages. During 1982 consumer prices rose by an average of 5.9 per cent, and the deceleration was especially pronounced during the last months of that year. In February 1983 prices stood only 3.3 per cent above their level a year earlier. Compensation of employees was limited to 4 per cent in 1982 and is projected to decline further in 1983. Sustained growth in productivity together with the projected increase in wages imply that unit labor costs will remain roughly unchanged.

The weakness of the domestic economy and the strength of the balance of payments prompted authorities to ease monetary policy. The money stock (M2) grew by 10.5 per cent during the first 11 months of 1982, and short-term interest rates fell rapidly during 1982 and the beginning of 1983. The official lending rate on advances fell from 10 per cent at the end of 1981 to 4 per cent as of March 18, 1983. Compared with Germany, the decline in short-term interest rates has been more rapid, leading to a differential in favor of Germany. By contrast, long-term rates in the Netherlands have remained above comparable rates in Germany.

Notwithstanding the authorities' intention to contain the public sector deficit in proportion to national income, the public sector borrowing requirement reached 10 per cent of national income in 1982 instead of the intended 6.5 per cent. The main causes for the deterioration in public finances were shortfalls in revenues and additional expenditures linked to fast-rising unemployment. The continued depressed state of the economy and the expected weakness in revenue from sales of natural gas will make the original plan to limit the PSBR to 10.8 per cent of national income in 1983 difficult to realize without further expenditure cuts.

The Netherlands guilder has generally been firm against the other EMS currencies. During 1982 brief periods of weakening coincided with the February and June realignments. In effective terms (MERM) the guilder depreciated markedly in the first nine months of 1981. In the five ensuing quarters, the guilder's effective exchange rate rose, however, by some 9 per cent and stood at the end of 1982 at approximately the same level as at the end of 1980.