DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

SM/87/51

CONTAINS CONFIDENTIAL
INFORMATION

February 20, 1987

To: Members of the Executive Board

From: The Secretary

Subject: European Monetary System - Realignment of Exchange Rates

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

Mr. Mayer (ext. 8863) is available to answer technical or factual questions relating to this paper.

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL
INFORMATION

INTERNATIONAL MONETARY FUND

European Monetary System - Realignment of Exchange Rates

Prepared by the European Department

(In consultation with the Exchange and Trade Relations, Research, and Treasurer's Departments, and the Office in Europe)

Approved by L.A. Whittome

February 19, 1987

I. Introduction

On January 12, 1987 the Ministers of Finance and Economics and the Central Bank Governors of the member countries of the European Community decided on an adjustment of central rates within the European Monetary System (EMS) which became effective on the same day. Notifications to the Fund of this adjustment by the countries participating in the exchange rate mechanism of the EMS (ERM countries) 1/ have been distributed to the Board. The communiqué issued following the realignment (presented as Appendix I) sets out the following relative percentage changes in bilateral central rates:

Deutsche mark	+3.0
Netherlands guilder	+3.0
Belgian franc	+2.0
Luxembourg franc	+2.0
Danish krone	0.0
French franc	0.0
Irish pound	0.0
Italian lira	0.0

Table 1 compares this realignment with the ten preceding ones and sets out the new ECU central rates. The notional ECU central rates 2/ for the pound sterling and the Greek drachma were devalued to reflect developments in the market rates of these currencies since the realignment of August 1986. The new bilateral central rates and

1/ The United Kingdom, Greece, Portugal, and Spain are at present not participating in the exchange rate mechanism of the EMS, even though the first two countries are members of the system and their currencies are included in the ECU (European Currency Unit).

2/ Notional rates for these currencies are established for purposes of the Common Agricultural Policy and the calculation of the Divergence Indicator.

intervention limits for ERM currencies which came into effect on January 12, 1987 are shown in Table 2. Section II of the paper gives the background to the realignment; 1/ Section III describes the developments leading to the realignment and some of its implications; and Section IV presents the Staff Appraisal. Brief country notes are contained in Appendix II of the paper.

II. Background

1. Recent exchange rate developments

The nine-month period following the last general realignment of ERM currencies in April 1986 was characterized by repeated tensions in the exchange rate mechanism. Initially these tensions reflected substantial capital reflows in the wake of the April realignment. More recently, they have been triggered in the context of the decline of the U.S. dollar vis-à-vis European currencies (Chart 1) by the unequal distribution of portfolio capital inflows among ERM countries in favor of deutsche mark assets. 2/

For about three months after the April realignment, the French franc remained strong vis-à-vis the deutsche mark and the Netherlands guilder (Chart 2), which provided room for some reduction in French short-term interest rates but also required, at times, sizable obligatory exchange market interventions in support of the deutsche mark. The Belgian/Luxembourg franc and the Danish krone remained in the lower part of the narrow band in the three months after the realignment; the Italian lira remained almost unchanged in the upper part of the wide band (Chart 3) while the Irish pound, which had moved to the upper part of the narrow band, weakened subsequently. In July, with the depreciation of the U.S. dollar continuing, the deutsche mark and the Netherlands guilder moved abruptly to the upper part of the narrow band.

With effect from August 4, 1986, the Irish pound was devalued by 8 percent vis-à-vis the other currencies participating in the ERM. The realignment was carried out at the request of the Irish authorities who had viewed with concern the decline in external competitiveness stemming from the sizable appreciation of the Irish pound against the currencies of the United Kingdom and the United States, which together account for

---

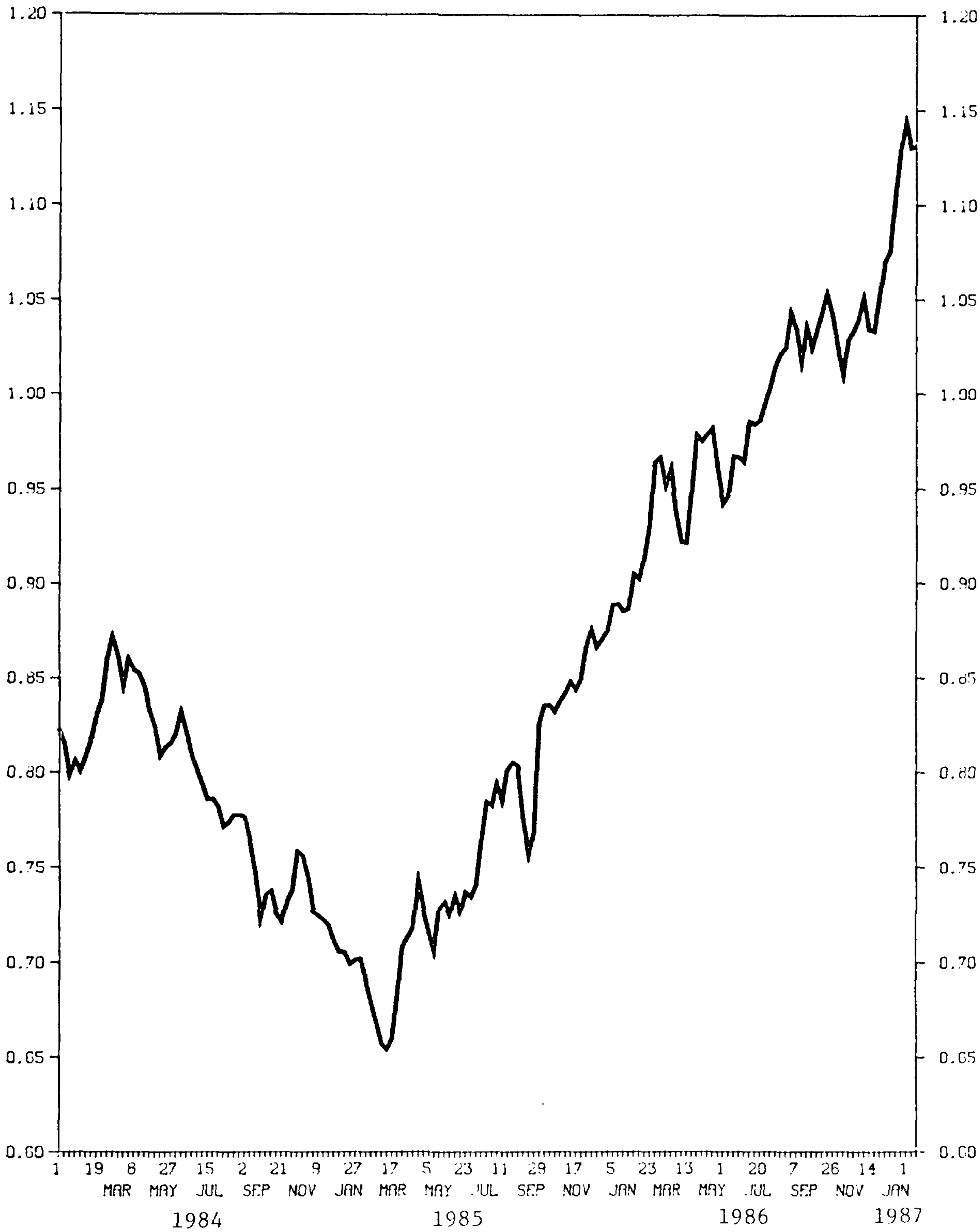
1/ For a more comprehensive analysis of recent developments in the EMS covering the period from 1983 to mid-1986 see Occasional Paper No. 48 (December 1986).

2/ The high degree of price stability, the relatively well developed financial markets, and the absence of capital controls in Germany, make the deutsche mark a sought-after reserve and investment currency, in particular at time of U.S. dollar weakness.

CHART 1

MOVEMENTS OF THE U.S. DOLLAR
AGAINST THE EUROPEAN CURRENCY UNIT

(U.S. dollars per ECU, weekly averages)

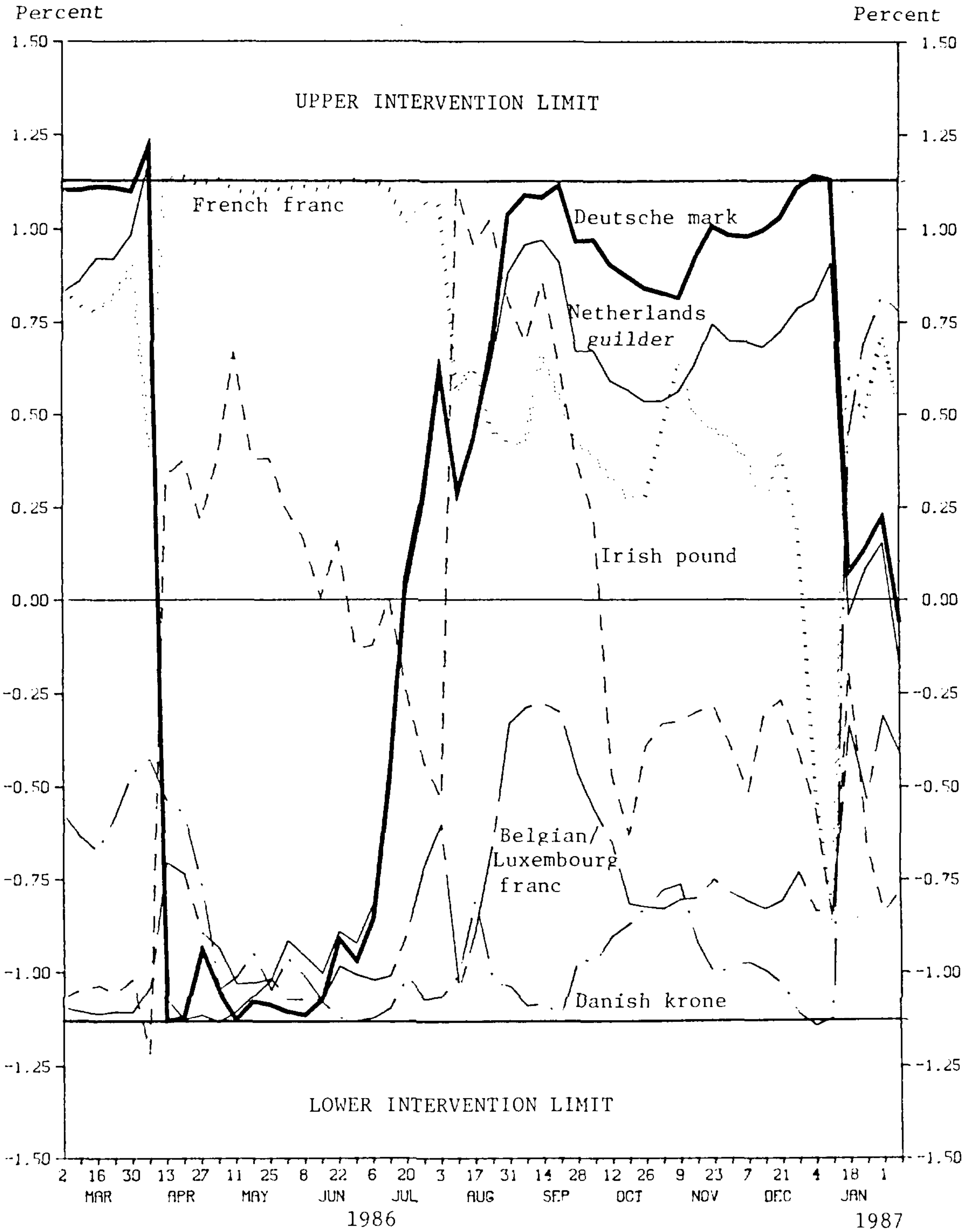


Source: IMF, International Financial Statistics.

CHART 2

EMS
EXCHANGE RATE DEVELOPMENTS IN THE NARROW BAND 1/

(On the basis of weekly data)



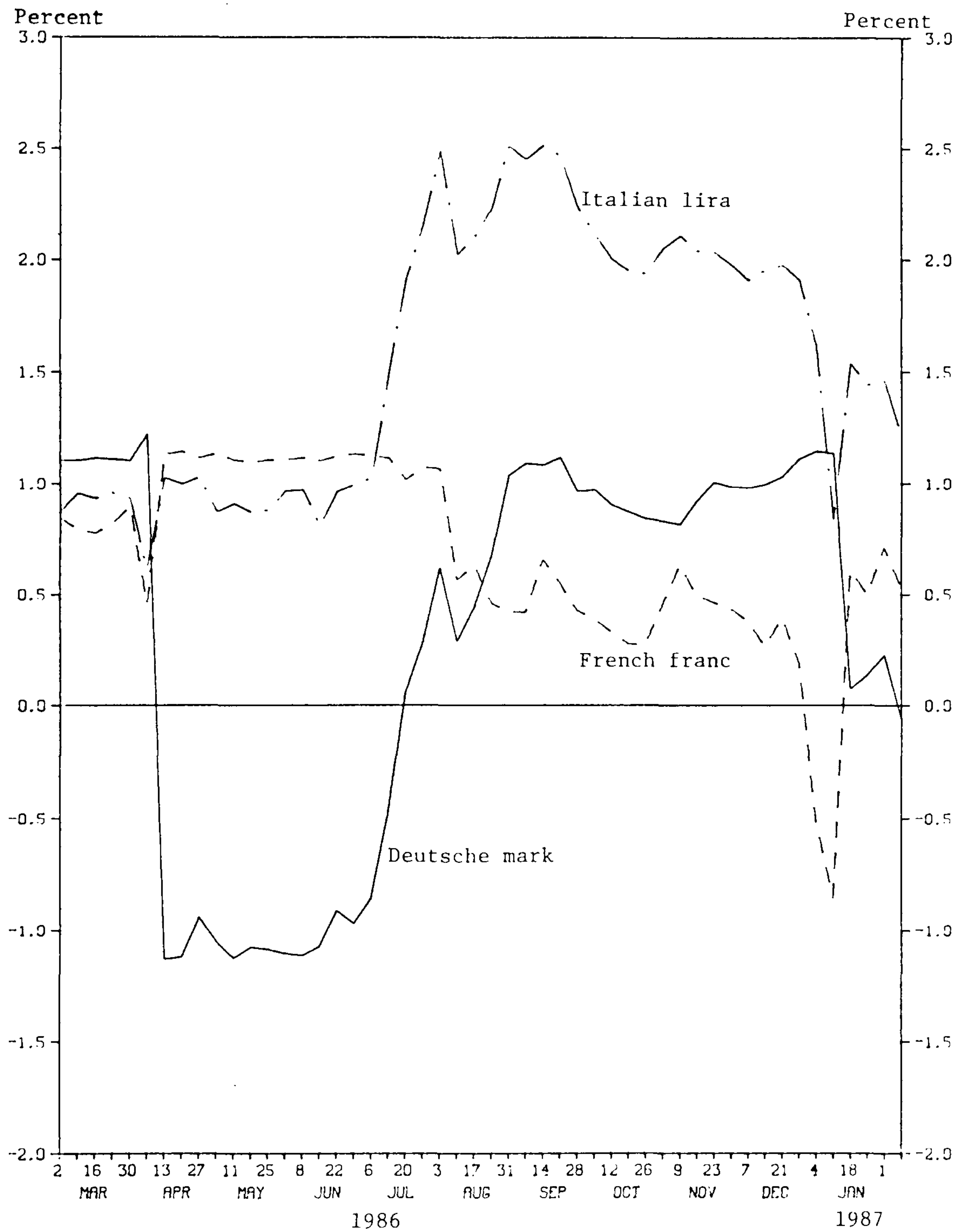
Sources: IMF, International Financial Statistics, various issues; and staff estimates.

1/ Italian lira not included. The chart measures deviations of currencies from their bilateral central rates in terms of logarithmic differences between spot exchange rates and bilateral central rates multiplied by 100.

CHART 3

EMS
EXCHANGE RATE DEVELOPMENTS IN THE
WIDE AND NARROW BAND 1/

(On the basis of weekly data)



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

1/ The chart measures deviations of currencies from their bilateral central rates in terms of logarithmic differences between spot exchange rates and bilateral central rates multiplied by 100.

about 50 percent of Ireland's total external trade. 1/ Subsequently, the deutsche mark and the Netherlands guilder continued their upward movement while the French franc began to weaken. By mid-September, the system was again under tension with the deutsche mark at the top and the Danish krone, supported by obligatory interventions, at the bottom of the narrow band.

Concerned over the difficulties that the weakness of the U.S. dollar and the associated capital flows had created in the ERM, EC Ministers of Finance and Economics and Central Bank Governors decided at an informal meeting on September 19-20 on joint intervention to halt the slide of the dollar. The interventions were temporarily successful--indeed, by September 22, the dollar had recovered appreciably--and tensions in the ERM eased (Charts 1 and 2). In early December, however, the French franc came under pressure. The Bank of France reacted by increasing short-term interest rates and by exchange market interventions. The franc had recovered by mid-December, but toward the end of the year labor unrest in France coincided with a renewed weakening. In early January 1987, the French franc dropped to the bottom of the narrow band. Changes in the positions of the other currencies appeared to reflect the market's expectation of another realignment: the deutsche mark remained at the top of the narrow band and the Netherlands guilder moved upward, while the Danish krone and the Irish pound moved downward, and the Italian lira weakened in its wide band.

2. Developments in economic fundamentals in ERM countries

While a considerable degree of divergence in economic developments and policies between ERM countries still exists, it appears that divergences in relative costs and prices have by and large not significantly increased since the last general realignment in April 1986. As is clear from the table below, however, in 1986 the decline in oil prices and appreciation of the ERM currencies vis-à-vis the U.S. dollar affected the ERM countries differently (see also Table 3). In Germany, Belgium/Luxembourg, Ireland and Italy, the terms of trade gains in 1986 contributed to positive shifts in the current account equivalent to about 2 percentage points of GNP/GDP. In France the improvement was somewhat smaller (about 1/2 percentage point of GNP) owing to a poor performance of the non-oil trade account (see Appendix II), while in Denmark and the Netherlands the current account position weakened slightly in relation to GNP.

1/ See European Monetary System - Realignment of Exchange Rates, SM/86/209, 8/20/86.

Current Account Developments in EMS Countries, 1985-86

(In percent of GDP/GNP)

	1985	1986 1/
Belgium/Luxembourg	0.3	3.2
Denmark	-4.6	-5.0
France	--	0.5
Germany	2.1	4.0
Ireland	-3.6	-1.4
Italy	-1.2	0.9
Netherlands	4.2	3.9

Source: Derived from Table 3.
1/ Estimated.

Differences in the development of bilateral trade flows between ERM countries were even more pronounced (Table 4). The trade deficits of France and Denmark with other ERM countries, in particular Germany, increased substantially in 1986 while Belgium and Ireland recorded an improvement in their trading positions vis-à-vis other ERM countries. The Netherlands experienced a decline in its trade surplus with other ERM countries largely as a result of falling energy prices.

There was, however, some convergence of cost and price developments among ERM countries in 1986. In the previous year, the difference between the highest and lowest consumer price inflation rates had been 7 percentage points; in 1986 the maximum spread declined to 6 percentage points (Table 5). More importantly, the maximum spread in unit labor cost increases amounted to only 5 percentage points in 1986, down from 8 percentage points in the previous year. 1/ As indicated by the following table, this was partly due to a relatively strong increase in unit labor cost in Germany, while in some countries, most notably France, with a historically higher growth of unit labor cost, increases in costs diminished.

1/ Standard deviations of inflation rates and unit labor cost growth rates in ERM countries declined also in 1986.

Movements in Relative Unit Labor Costs in Manufacturing
Between 1985 and 1986 1/

(In percent)

	Belgium	Denmark	France	Germany	Ireland	Italy	Nether-lands
Belgium	--	-3.1	0.7	-2.8	-1.6	-4.2	0.9
Denmark 2/	3.2	--	3.9	0.3	1.6	-1.1	4.1
France	-0.7	-3.8	--	-3.5	-2.3	-4.9	0.2
Germany	2.9	-0.3	3.6	--	1.3	-1.4	3.8
Ireland	1.6	-1.5	2.3	-1.3	--	-2.7	2.5
Italy 3/	4.4	1.2	5.1	1.4	2.7	--	5.3
Netherlands	-0.9	-3.9	-0.2	-3.7	-2.4	-5.0	--

Source: Derived from Table 5.
1/ Unadjusted for exchange rate changes. A negative figure indicates a lower unit labor cost increase in the row country than in the column country.
2/ Based on sales in manufacturing rather than output.
3/ Unit labor costs for Italy refer to "Industria in Senso Stretto," which includes the manufacturing and energy sectors.

Although, since the inception of the system, divergence in price and cost developments between ERM member countries have not been fully offset by exchange rate adjustments (Tables 6 and 7), since 1985 competitiveness in manufacturing of some countries with historically higher unit labor cost increases, (e.g., France) has improved vis-à-vis ERM partner countries (Table 8). On the other hand, Germany, which experienced relatively low unit labor cost increases in the early 1980s, has lost competitiveness vis-à-vis both its ERM partner countries and the larger group of industrial countries since 1985 (Tables 8 and 9).

In contrast to the progress toward price and cost convergence, divergences in fiscal policies appear to have persisted through 1986, even though some countries have made progress toward fiscal consolidation (Table 10). The continuing large spread between the ratios of government fiscal balances to GNP among ERM countries raises the question as to whether the convergence of monetary policies 1/ and inflation rates among most countries will prove sustainable over time. Large government deficits may undermine the effectiveness of monetary

1/ See Tables 11 and 12 for convergence in the growth of monetary aggregates and a narrowing of nominal short-term interest rate differentials.

policy and affect longer-term expectations of inflation and exchange rates. It seems likely that the divergences which remain between ERM countries (e.g., fiscal policies, external trade and labor market performance) have influenced market perceptions and thus the allocation of capital flows from the U.S. dollar area among ERM member countries. The capital controls still in effect in several ERM countries are also likely to have influenced international investors' decisions. 1/

III. The Realignment of January 1987

International foreign exchange markets were unsettled at the beginning of 1987. The dollar continued to fall vis-à-vis the deutsche mark and the Japanese yen and there were sizable interventions by the Bundesbank and by the Bank of Japan. Portfolio capital continued to flow into Germany. The French franc came under pressure at a time when strikes might have been regarded as endangering the policy of wage restraint. The Bank of France reacted initially by intervening substantially and raising interest rates (see Appendix II). When these measures failed to calm speculation about a realignment, and pressure on the franc intensified, the Bank of France allowed the franc to fall to its lower intervention limit vis-à-vis the deutsche mark. This triggered sizable obligatory interventions in the system to keep these two currencies, and also at times the Danish krone, from breaching their respective limits.

Following discussions in the Monetary Committee on January 10, 1987, the EC Ministers of Finance and Economics and the Central Bank Governors agreed on an adjustment of exchange rates on January 12, 1987. No specific policy measures in support of the realignment were announced, but the Ministers and Governors asked the Monetary Committee and Committee of Central Bank Governors to examine measures to strengthen the operating mechanisms of the system.

The changes in nominal effective exchange rates implied by the realignment are illustrated in Table 14. If it were to be assumed that the effects of the ERM exchange rate adjustment on exchange rates vis-à-vis third currencies were to be symmetrically distributed (i.e., that the deutsche mark and the Netherlands guilder appreciated by 1 1/2 percent vis-à-vis third currencies and the Belgian franc by 1/2 percent, while the Danish krone, French franc, Irish pound, and Italian lira depreciated by about 1 1/2 percent), the realignment is estimated

---

1/ Some countries, most notably France, have recently taken steps to liberalize international capital movements. These measures are part of an EC program to remove remaining capital restrictions in EC member countries by 1992. Notwithstanding the progress achieved so far, remaining capital controls are still significant and tend to deter international investors from certain currencies.

to imply a nominal effective depreciation of the Danish krone, French franc, Irish pound, and Italian lira of about 1 1/2 percent against the currencies of all major trading partners. Given the same assumption, the deutsche mark and the Netherlands guilder would appreciate by about 1 1/2-2 percent while the Belgian franc would appreciate by about 1/2 percent. Actual changes in effective rates will, of course, depend on movements of market exchange rates of the European currencies within the ERM band and vis-à-vis third currencies.

When foreign exchange markets reopened after the realignment, the French franc moved immediately to the top of the narrow band and the Belgian/Luxembourg franc to the bottom (Chart 4). The deutsche mark and the Netherlands guilder took a middle position in the narrow band. This development was somewhat different from that after previous realignments, when the appreciating currencies moved to the bottom of the band, and this probably reflects the relatively small changes in central rates, and, perhaps, some doubts about the sustainability of the new central rates in view of continued U.S. dollar weakness. Also, the spread in the narrow band between the strongest and weakest currency declined considerably thus narrowing the scope for divergent exchange rate developments of ERM currencies within the present parity grid in the months ahead.

The realignment does not have immediate consequences for the Common Agricultural Policy of the EC since negative Monetary Compensatory Amounts (MCAs) for countries other than Germany and the Netherlands offset the devaluation of currencies of these countries vis-à-vis the deutsche mark and the Netherlands guilder. 1/ The upcoming price negotiations for the agricultural marketing year 1987/88, however, could give rise to some devaluation of the "green" exchange rates in Belgium, Denmark, France, Ireland, and Italy, and thus increases in agricultural prices in domestic currencies in these countries.

In connection with the realignment of ERM exchange rates, the notional central values of sterling and the drachma, which do not participate in the EMS exchange rate mechanism but are included in the ECU, 2/ were lowered by 8.2 percent and 9.2 percent, respectively. 3/

1/ Monetary Compensatory Amounts are needed to offset the effects of changes in central rates on common agricultural prices, unless "green" exchange rates, used to convert common prices in ECU into national currencies, are changed along with central rates. Under new regulations introduced in March 1984, agricultural prices in appreciating currencies (deutsche mark and Netherlands guilder) establish the benchmark for the computation of negative MCAs required to offset the effects of the devaluation of other currencies.

2/ The currencies of the new members of the EC--Portugal and Spain--are not yet included in the ECU basket.

3/ This reflects changes in market rates between August 4, 1986 and January 12, 1987.

Furthermore, the EMS realignment affects the currencies which are pegged to one of the partner currencies (the CFA franc) or have a historically close link to an ERM currency (e.g., the Austrian schilling). 1/

IV. Staff Appraisal

The recent realignment of exchange rates among the currencies participating in the exchange rate mechanism of the EMS became unavoidable in the face of serious tensions--and in the end massive speculative capital movements--in exchange markets. It was different in character from the preceding exchange rate adjustments since the inception of the system. It was not triggered by changes in cost competitiveness among participating countries but rather was a move to adjust to pressures emanating from diverse capital flows associated with the weakness of the U.S. dollar. Market perceptions may have been influenced by continued divergences between ERM countries in external current account performance and the stance of fiscal policy. Divergences in these areas had not significantly affected exchange rate stability in the ERM during the period when the dollar was appreciating, but they gained more weight as the dollar weakened rapidly and there was renewed interest in other currencies as a hedge. Social unrest in France and the public international debate on German monetary policy helped crystallize market sentiments.

The German authorities were confronted with the dilemma of choosing between a loss of control over their monetary aggregates because of large capital inflows, and an appreciation of their exchange rates in response to market expectations about their future economic performance. The authorities of the other participating countries had to choose between a further tightening of their domestic policies that might have appeared excessive in light of recent economic developments, and a depreciation of their currencies vis-à-vis the deutsche mark that would raise some prices and perhaps retard progress on inflation. This dilemma was addressed by a modest revaluation of the deutsche mark and the Netherlands guilder with the currencies of Belgium/Luxembourg staying closer to the revaluing currencies than other countries.

It is important that policies be conducted so as to confirm the authorities' commitment to the new parity grid. This requires adherence to a strategy of maintaining domestic financial stability as well as efforts to ensure policy compatibility within the EMS.

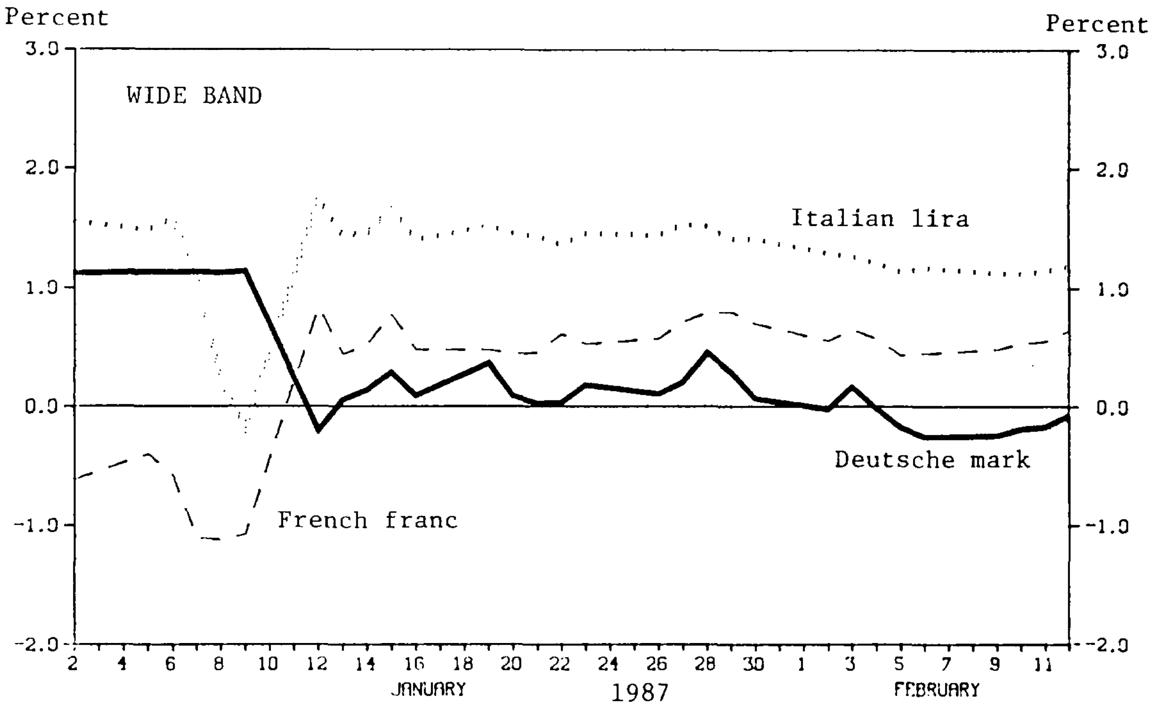
In reviewing developments in the international exchange markets over the last few months, it is clear that EMS developments are symptomatic of worldwide concerns about the pattern and evolution of exchange rates.

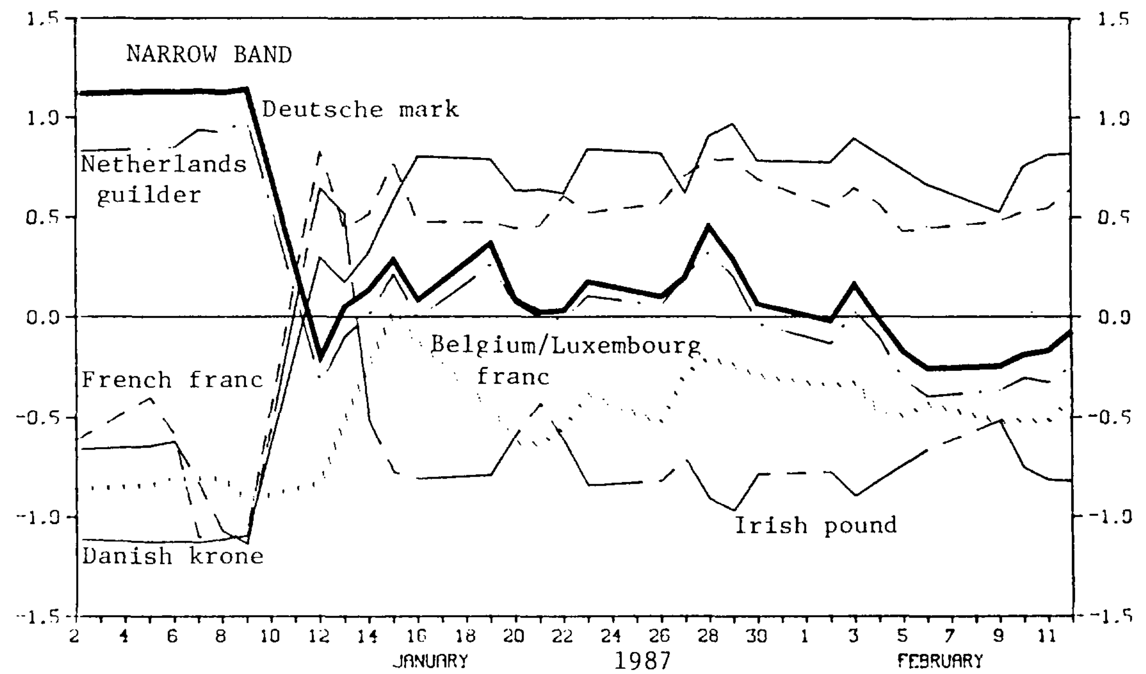
1/ The CFA franc, which is pegged to the French franc, was devalued by the same amount as the French franc against the Belgian/Luxembourg franc, deutsche mark, and Netherlands guilder. The Austrian authorities maintained the link of the schilling to the deutsche mark which implied a revaluation against other ERM currencies.

CHART 4

EMS

POSITION IN THE WIDE AND NARROW BAND 1/





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

1/ Daily data; the charts measure deviations of currencies from their bilateral central rates in terms of logarithmic differences between spot exchange rates and bilateral central rates multiplied by 100.

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	7/20/85	4/6/86	8/4/86	1/12/87
Percentage changes in bilateral central rates 1/											
Belgian-Luxembourg franc					-8.5		1.5	2.0	1.0		2.0
Danish krone	-2.9	-4.8			-3.0		2.5	2.0	1.0		
Deutsche mark	2.0			5.5		4.25	5.5	2.0	3.0		3.0
French franc				-3.0		-5.75	-2.5	2.0	-3.0		
Italian lira			-6.0	-3.0		-2.75	-2.5	-6.0			
Irish pound							-3.5	2.0		-8.0	
Netherlands guilder				5.5		4.25	3.5	2.0	3.0		3.0

	ECU Central Rates		Central Rate Change in terms of ECU per currency (percent)
	Previous	New	
Realignment of January 12, 1987			
Belgian-Luxembourg franc	43.1139	42.4582	1.5
Danish krone	7.81701	7.85212	-0.4
Deutsche mark	2.11083	2.05853	2.5
French franc	6.87316	6.90403	-0.4
Italian lira	1,476.95	1,483.58	-0.4
Irish pound	0.764976	0.768411	-0.4
Netherlands guilder	2.37833	2.31943	2.5
Pound sterling 2/	0.679256	0.739615	-8.2
Greek drachma 2/	137.049	150.792	-9.1

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 realignments of March 21, 1983 and July 20, 1985, when, all currencies having moved, bilateral shifts need to be derived by combining the relative movements of the two currencies concerned.

2/ The pound sterling and the Greek drachma are included in the calculation of the ECU; a notional central rate has to be ascribed to sterling and the drachma for purposes of the Common Agricultural Policy and the calculation of the divergence indicator.

Table 2. EMS: Bilateral Central Rates and Intervention Limits

(Effective January 12, 1987)

		100 Belgian/ Luxembourg francs	100 Danish kroner	100 deutsche marks	100 French francs	1000 Italian lire	1 Irish pound	100 Netherlands guilders
Belgian/ Luxembourg franc	L	...	553.0	2109.50	628.97	30.387	56.5115	1872.15
	C	...	540.723	2062.55	614.977	28.6187	55.2545	1830.54
	U	...	528.70	2016.55	601.295	26.953	54.0250	1789.85
Danish krone	L	18.9143	...	390.16	116.32	5.620	10.4511	346.24
	C	18.4938	...	381.443	113.732	5.29268	10.2186	338.537
	U	18.0831	...	373.00	111.20	4.985	9.9913	331.02
Deutsche mark	L	4.959	26.810	...	30.495	1.4735	2.740	90.770
	C	4.84837	26.2162	...	29.8164	1.38754	2.67894	88.7526
	U	4.740	25.630	...	29.150	1.3065	2.619	86.780
French franc	L	16.6310	89.925	343.05	...	4.9410	9.1890	304.44
	C	16.2608	87.9257	335.386	...	4.65362	8.98480	297.661
	U	15.8990	85.97	327.92	...	4.3830	8.7850	291.04
Italian lira	L	3710.2	20062.0	76540.0	22817.0	...	2050.03	67912.0
	C	3494.21	18894.0	72069.9	21488.6	...	1930.71	63963.1
	U	3290.9	17794.0	67865.0	20238.0	...	1818.34	60241.0
Irish pound	L	1.8510	10.0087	38.1825	11.3830	0.549952	...	33.8868
	C	1.80981	9.78604	37.3281	11.1299	0.517943	...	33.1293
	U	1.7695	9.56830	36.4964	10.8825	0.487799	...	32.3939
Netherlands guilders	L	5.5870	30.21	115.235	34.36	1.660	3.0870	...
	C	5.46286	29.5389	112.673	33.5953	1.56340	3.01848	...
	U	5.3415	28.8825	110.1675	32.8475	1.4725	2.9510	...

Source: EC Commission.

Legend: L = Lower intervention limit; C = Bilateral central rate; and U = Upper intervention limit.

Table 3. EMS: Current Account Developments in EMS Countries, 1977-87

	Average 1977-81	1982	1983	1984	1985	1986 1/	1987 2/
				(In billions of U.S. dollars)			
Trade balance 3/							
Belgium/Luxembourg	-2.8	-2.3	-0.7	-0.3	0.6	3.8	5.1
Denmark	-2.3	-0.8	0.2	-0.2	-0.8	-1.3	-0.4
France	-6.0	-15.9	-8.4	-4.5	-5.4	-2.8	-4.7
Germany	18.1	26.4	22.5	23.0	28.9	57.6	60.6
Ireland	-1.7	-1.1	-0.2	0.3	0.7	1.4	1.6
Italy	-5.0	-8.0	-3.1	-6.2	-7.1	1.1	-1.1
Netherlands	-0.1	4.6	4.2	5.4	5.4	7.3	6.5
Services and private transfers							
Belgium/Luxembourg	0.8	0.8	1.3	0.9	0.6	0.6	0.7
Denmark	-0.1	-1.4	-1.5	-1.7	-1.9	-2.6	-2.9
France	8.2	6.4	5.8	5.6	6.6	8.4	10.4
Germany	-15.8	-16.3	-12.9	-9.6	-9.5	-12.6	-16.3
Ireland	-0.7	-1.5	-1.7	-2.0	-2.3	-3.0	-3.3
Italy	5.1	3.1	4.1	3.4	3.2	4.0	4.9
Netherlands	0.6	0.2	0.3	0.1	0.4	0.3	0.4
Official transfers							
Belgium/Luxembourg	-0.7	-1.0	-1.0	-0.7	-0.5	-0.9	-1.0
Denmark	0.3	-0.1	-0.1	0.1	-0.1	-0.1	-0.1
France	-1.7	-2.7	-2.1	-1.9	-1.3	-2.0	-2.4
Germany	-5.0	-6.1	-5.4	-6.9	-6.1	-9.2	-11.0
Ireland	0.8	0.8	0.8	0.8	1.0	1.2	1.2
Italy	-0.8	-0.6	-0.2	-0.2	-0.3	-0.4	-0.5
Netherlands	-0.4	-0.8	-0.4	-0.5	-0.5	-0.8	-1.0
Current account balance 4/							
Belgium/Luxembourg	-2.7	-2.4	-0.4	--	0.7	3.6	4.8
Denmark	-2.1	-2.3	-1.4	-1.8	-2.7	-4.0	-3.3
France	0.6	-12.1	-4.7	-0.8	-0.2	3.6	3.3
Germany	-2.8	4.1	4.1	6.5	13.2	35.8	33.4
Ireland	-1.6	-1.9	-1.2	-1.0	-0.6	-0.3	-0.3
Italy	-0.7	-5.5	0.8	-2.9	-4.2	4.7	3.3
Netherlands	--	4.1	4.1	5.0	5.3	6.8	5.9
				(In percent of GNP/GDP)			
Current account balance 4/							
Belgium/Luxembourg	-2.5	-2.8	-0.5	-0.1	0.3	3.2	3.8
Denmark	-3.6	-4.1	-2.5	-3.4	-4.6	-5.0	-3.7
France	0.2	-2.2	-0.9	-0.2	--	0.5	0.4
Germany	-0.3	0.6	0.6	1.0	2.1	4.0	3.3
Ireland	-10.4	-10.6	-6.9	-6.2	-3.6	-1.5	-1.5
Italy	0.1	-1.6	0.2	-0.8	-1.2	0.9	0.6
Netherlands	0.1	3.0	3.0	4.0	4.2	3.9	3.1

Source: IMF, World Economic Outlook.

1/ Partly staff estimates.
2/ Staff projections excluding realignment effects.
3/ F.o.b. basis.
4/ Including official transfers.

Table 4. EMS: Bilateral Trade Balances for the EMS Countries, 1985-86 1/

(In millions of U.S. dollars)

			Belgium/ Luxembourg	Denmark	France	Germany	Ireland	Italy	Netherlands	EMS 2/
Belgium/ Luxembourg	1985	I		61.6	311.7	-521.6	-27.3	222.3	-851.0	-804.3
		II		77.2	386.4	-406.6	-24.1	246.4	-525.4	-246.1
		III		77.1	439.4	-255.8	-38.2	117.7	-535.7	-195.5
		IV		81.1	604.2	-630.3	-25.3	334.0	-867.1	-503.4
	1986	I		118.5	725.6	-707.7	-26.9	322.9	-592.8	-160.4
		II		102.4	745.1	-428.7	-40.6	278.0	-453.6	202.6
		III		104.6	542.9	-517.9	-42.8	63.5	-423.8	-273.5
Denmark	1985	I	-68.2		-2.8	-208.5	3.6	6.3	-79.5	-349.1
		II	-59.8		-31.7	-231.4	1.31	1.4	-76.9	-387.1
		III	-83.2		-1.8	-284.2	13.3	17.9	-74.2	-412.2
		IV	-86.1		-20.4	-428.6	13.8	-9.9	-102.0	-633.2
	1986	I	-97.6		-4.3	-381.6	6.7	13.3	-119.2	-582.7
		II	-112.3		-20.7	-488.7	-2.8	45.5	-116.2	-695.2
		III	-108.1		-9.3	-443.8	0.2	-6.8	-76.8	-644.6
France	1985	I	-276.7	-1.4		-616.6	-58.1	151.1	-418.5	-1,220.2
		II	-237.5	29.7		-815.1	-87.0	-39.6	-588.8	-1,738.3
		III	-174.6	9.3		-796.1	-100.9	-185.1	-297.2	-1,544.6
		IV	-229.1	24.4		-989.6	-70.7	-107.6	-467.8	-1,840.4
	1986	I	-310.1	10.8		-1,146.9	-60.6	76.6	-392.5	-1,822.7
		II	-350.6	17.7		-1,433.3	-133.4	-330.6	-512.5	-2,742.7
		III	-283.8	20.6		-1,341.6	-154.8	-464.6	-328.3	-2,552.5
Germany	1985	I	749.8	231.9	1,111.2		-47.9	548.5	-1,080.9	1,512.6
		II	720.2	279.4	1,433.5		-50.2	495.6	-955.9	1,922.6
		III	460.2	378.6	981.0		-36.8	102.1	-839.7	1,045.4
		IV	738.7	424.3	1,492.3		-41.2	392.3	-1,243.9	1,762.5
	1986	I	918.3	503.5	1,526.6		-49.2	657.8	-842.3	2,714.7
		II	747.5	530.7	1,990.2		-79.7	608.7	-737.1	3,060.3
		III	892.9	530.7	1,553.9		-46.3	117.8	215.2	3,264.2
Ireland	1985	I	59.2	-3.8	84.9	67.6		42.3	49.2	299.4
		II	50.9	-1.3	102.8	67.5		42.1	103.3	365.3
		III	45.9	-0.9	116.0	61.8		35.7	114.3	372.8
		IV	43.5	-2.4	82.0	74.3		37.4	57.6	292.4
	1986	I	94.4	0.2	113.8	71.8		38.1	37.4	355.7
		II	100.6	-0.7	177.0	78.5		43.3	74.8	473.5
		III	90.1	0.7	190.9	72.6		21.6	83.3	459.2
Italy	1985	I	-230.0	-34.6	-141.5	-639.9	-36.2		-638.1	-1,720.3
		II	-307.7	-24.6	-197.9	-889.9	-55.6		-537.6	-2,013.3
		III	-158.2	-11.4	74.1	-135.1	-29.6		-287.4	-547.6
		IV	-343.3	-51.0	-10.3	-729.2	-62.9		-730.9	-1,927.6
	1986	I	-386.9	-20.4	-45.2	-765.4	-32.0		-799.5	-2,049.4
		I	-411.5	-33.3	249.0	-790.5	-46.8		-632.8	-1,665.9
		III	-156.8	-24.6	325.0	-302.3	-28.5		-465.0	-652.2
Nether- lands	1985	I	628.1	102.6	666.4	1,623.2	-36.8	580.8		3,564.3
		II	495.7	124.9	760.0	1,217.8	-62.8	446.9		2,982.5
		III	666.8	93.2	541.3	1,356.7	-56.8	351.0		2,952.2
		IV	710.9	101.5	726.7	1,675.2	-34.2	573.4		3,753.5
	1986	I	484.3	156.6	860.2	1,402.9	-14.3	705.2		3,594.9
		II	118.8	122.7	959.0	1,227.6	-49.5	532.4		2,911.0
		III	-26.2	117.5	794.3	501.9	-47.9	396.5		1,736.1

Source: IMF, Direction of Trade.

1/ A positive number indicates that the row country has a trade surplus vis-à-vis the column country or country group; a negative number indicates a trade deficit.
2/ EMS countries participating in the exchange rate mechanism.

Table 5. EMS: Cost and Price Developments in EMS Countries, 1977-87

(In percent at annual rates)

	Average 1977-81	1982	1983	1984	1985	1986 1/	1987 2/
GNP/GDP deflators							
Belgium	5.0	6.9	6.3	5.5	5.2	4.1	2.3
Denmark	9.1	10.5	7.6	5.7	5.3	4.5	4.2
France	10.6	12.5	9.6	7.2	5.8	4.6	3.1
Germany	4.2	4.4	3.3	1.8	2.2	3.3	2.1
Ireland	13.9	16.1	11.6	6.2	5.4	6.8	4.2
Italy	17.6	17.8	14.9	10.8	8.8	9.1	5.5
Luxembourg	5.7	7.9	7.6	6.8	5.3	5.0	2.0
Netherlands	5.4	6.3	1.8	2.2	2.5	0.4	-0.9
Consumer prices							
Belgium	6.1	8.7	7.7	6.3	4.9	1.3	2.0
Denmark	11.0	10.1	6.9	6.3	4.7	3.5	4.0
France	11.3	11.8	9.6	7.4	5.8	2.5	2.3
Germany	4.3	5.3	3.3	2.4	2.2	-0.2	1.1
Ireland	14.0	17.1	10.4	8.6	5.4	3.9	3.3
Italy	16.8	16.3	14.6	10.8	9.2	6.1	4.7
Luxembourg	5.8	9.4	8.7	5.6	4.1	1.0	1.5
Netherlands	5.7	5.9	2.8	3.3	2.3	0.2	-1.1
Unit labor costs in manufacturing							
Belgium	3.3	-4.7	4.1	4.9	4.1	0.6	1.5
Denmark 3/	7.3	8.4	4.7	6.1	3.5	3.8	4.4
France	9.3	11.1	7.6	3.4	2.0	-0.2	-0.4
Germany	4.4	4.1	-1.1	-1.0	--	3.5	1.6
Ireland	12.0	10.0	-2.3	-3.6	0.8	2.2	2.1
Italy 4/	14.8	18.4	14.9	4.3	7.5	5.0	4.5
Luxembourg	...	3.7	-3.0	-5.0	1.0	1.5	2.5
Netherlands	2.7	4.3	-1.5	-6.7	-0.8	-0.3	-0.9
Export unit values							
Belgium/Luxembourg	6.9	14.1	6.4	7.6	1.8	-9.1	1.0
Denmark	9.4	11.9	8.9	8.2	4.5	-3.1	-0.1
France	9.7	14.2	10.5	11.4	4.8	-4.8	2.3
Germany	4.9	4.5	1.3	3.5	3.9	-3.5	-0.5
Ireland	11.1	11.1	8.6	8.4	2.8	-4.3	1.2
Italy	17.3	15.9	7.6	9.6	8.1	-4.0	2.7
Netherlands	7.9	4.3	-0.8	7.5	2.3	-16.0	-3.0

Sources: IMF, World Economic Outlook.

1/ Partly staff estimates.
2/ Staff projections excluding realignment effects.
3/ Based on sales in manufacturing rather than output.
4/ Unit labor costs refer to "Industria in Senso Stretto" which includes the manufacturing and energy sectors.

Table 6. EMS: Changes in Relative Consumer Prices Adjusted for Exchange Rate Developments in the EMS Countries from 1979-I to 1986-III 1/

(In percentage points)

	Belgium	Denmark	France	Germany	Ireland	Italy	Netherlands
Belgium		-11.4	-13.5	-8.7	-32.9	-30.8	-7.0
Denmark	12.9		-2.3	3.1	-24.2	-21.9	5.0
France	15.6	2.4		5.6	-22.4	-20.0	7.5
Germany	9.5	-3.0	-5.3		-26.5	-24.3	1.8
Ireland	49.0	32.0	28.9	36.1		3.1	38.6
Italy	44.6	28.0	25.0	32.1	-3.0		34.4
Netherlands	7.5	-4.8	-7.0	-1.8	-27.8	-25.6	

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

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 the respective column country. A devaluation would lower all the figures in the row of the devaluing country.

Table 7. EMS: Movements in Relative Costs and Exchange Rates Since the Inception of the EMS 1/

(In percent)

		Belgium	Denmark	France	Germany	Ireland	Italy	Nether-lands
Belgium	(a)		3.3	7.3	-30.9	0.6	14.0	-25.4
	(b)		-24.9	-30.9	-7.9	-31.0	-50.8	14.3
Denmark 2/	(a)	-3.4		4.2	-35.3	-2.8	11.1	-29.6
	(b)	33.1		-8.0	22.7	-8.1	-35.1	52.1
France	(a)	-7.9	-4.3		-41.2	-7.2	7.2	-35.2
	(b)	44.7	8.7		33.3	-0.1	-28.9	65.4
Germany	(a)	23.6	26.1	29.2		24.0	34.3	4.2
	(b)	8.5	-18.5	-25.0		-25.0	-46.6	24.0
Ireland	(a)	0.6	2.7	6.8	-31.7		13.5	-26.1
	(b)	44.9	8.8	0.1	33.5		-28.8	65.5
Italy 3/	(a)	-16.2	-12.4	-7.8	-52.2	-15.6		-45.7
	(b)	103.4	54.0	40.6	87.4	40.4		132.5
Netherlands	(a)	20.2	22.8	26.1	-4.4	20.7	31.4	
	(b)	-12.5	-34.3	-39.5	-19.4	-39.6	-57.0	

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

1/ Changes between 1979-I and 1986-III. (a): Changes in spot rates. A negative number indicates a depreciation of the row country vis-à-vis the column country. (b): Changes in unit labor costs in domestic currency in the row country relative to unit labor costs in the column countries. A negative figure indicates a gain in "competitiveness" unadjusted for exchange rate changes.

2/ Unit labor costs for Denmark based on sales in manufacturing rather than output.

3/ Partly estimated. Unit labor costs for Italy refer to "Industria in Senso Stretto," which includes the manufacturing and energy sectors.

Table 8. EMS: 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 2/	France	Germany	Ireland	Italy 3/	Nether-lands
1979	97.8	99.3	101.4	99.1	106.4	103.5	95.9
1980	93.1	88.7	105.8	98.4	121.3	105.1	92.2
1981	88.9	89.3	107.9	96.3	126.5	111.8	87.1
1982	75.0	87.2	104.6	99.3	133.7	118.9	90.8
1983	70.3	87.8	101.1	98.8	122.0	130.5	88.8
1984	72.5	91.3	102.2	99.7	113.1	129.9	81.2
1985	74.5	94.1	103.3	98.1	112.3	130.3	80.2
1982 I	82.3	88.3	108.0	96.1	131.3	115.6	89.2
II	74.2	88.3	108.2	97.8	135.8	118.2	89.0
III	72.4	85.7	101.6	102.1	135.7	119.9	91.1
IV	71.2	86.3	100.8	101.3	132.1	121.9	94.0
1983 I	70.7	87.0	103.4	98.4	123.8	125.8	91.4
II	70.5	88.1	99.8	99.9	123.3	129.3	90.0
III	70.2	87.6	100.7	98.7	122.6	132.2	87.1
IV	69.7	88.4	100.4	98.3	118.3	134.6	86.5
1984 I	69.9	89.5	101.3	101.6	117.6	129.0	82.4
II	72.2	89.8	102.8	100.1	110.5	128.7	81.4
III	73.9	92.3	102.1	98.2	115.6	131.6	81.6
IV	74.0	93.5	102.9	99.0	108.9	130.3	79.5
1985 I	75.3	93.2	103.8	96.5	109.4	132.4	79.8
II	75.0	94.1	103.2	97.3	112.0	131.7	79.7
III	74.3	94.8	103.5	98.6	116.1	129.1	80.0
IV	73.3	94.5	102.5	99.9	111.7	128.0	81.4
1986 I	75.3	93.2	102.7	101.0	108.2	126.7	77.9
II	73.4	94.3	98.2	102.7	111.9	129.8	80.4
III	72.2	93.0	95.3	105.2	104.6	131.1	80.3

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

1/ Unit labor costs against the weighted average of unit labor costs of the other countries participating in the EMS exchange rate mechanism (in common currency).
2/ Unit labor costs for Denmark based on sales in manufacturing rather than output.
3/ Partly staff estimates. Unit labor costs for Italy refer to "Industria in Senso Stretto" which includes the manufacturing and energy sectors.

Table 9. EMS: Indicators of Competitiveness in Manufacturing as Measured by Unit Labor Costs Adjusted for Exchange Rate Changes in Relation to 17 Industrial Partner Countries 1/

(1979 I = 100)

	Belgium	Denmark 2/	France	Germany	Ireland	Italy 3/	Netherlands
1979	97.0	98.3	100.4	98.6	102.7	102.5	95.1
1980	90.7	85.6	102.7	96.6	107.3	102.9	89.4
1981	82.2	80.0	98.0	88.0	102.1	102.6	79.6
1982	69.1	78.8	94.3	89.1	108.1	107.4	82.0
1983	65.2	81.4	92.5	89.5	102.1	117.9	80.7
1984	66.1	82.3	91.6	88.1	92.8	115.3	72.7
1985	67.3	83.3	91.5	85.9	90.1	114.5	71.1
1982 I	75.7	79.2	97.2	87.0	106.1	104.8	80.8
II	68.2	78.9	96.9	87.7	109.2	106.8	80.1
III	66.6	77.2	91.7	90.8	109.5	108.1	82.0
IV	65.8	79.8	91.5	90.9	107.6	110.1	85.0
1983 I	66.7	82.3	96.1	91.0	107.3	116.1	84.5
II	65.5	82.1	91.6	90.6	103.0	117.2	82.0
III	64.7	80.4	91.6	88.7	101.1	118.6	78.6
IV	63.9	80.6	90.7	87.7	97.1	119.7	77.6
1984 I	64.2	81.4	91.3	90.0	96.7	115.2	74.1
II	66.6	82.0	93.2	89.6	92.1	115.8	73.7
III	67.1	82.5	91.1	86.6	94.2	116.2	72.7
IV	66.7	83.1	90.8	86.2	88.1	114.1	70.3
1985 I	67.4	82.0	90.7	83.8	88.5	114.7	70.1
II	67.3	82.7	90.7	84.7	88.7	114.7	70.1
III	67.0	83.8	91.6	86.2	91.8	113.5	70.8
IV	67.4	84.9	92.9	89.1	91.5	115.0	73.4
1986 I	70.9	87.0	95.9	92.9	93.7	117.2	72.4
II	69.0	88.0	91.9	93.7	96.5	119.4	74.5
III	69.2	89.6	91.4	97.7	95.0	122.9	76.1

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

1/ Unit labor costs against the weighted average of unit labor costs of 17 industrial partner countries; weights are those used to calculate relative unit labor costs for 17 industrial countries.
2/ Unit labor costs for Denmark based on sales in manufacturing rather than output.
3/ Partly staff estimates. Unit labor costs for Italy refer to "Industria in Senso Stretto" which includes the manufacturing and energy sectors.

Table 10. EMS: Indicators of the Stance of Fiscal Policy, 1983-87 1/

(In percent of GNP/GDP)

	1983	1984	1985	1986	1987 2/
Central government fiscal balance					
Belgium	-12.6	-11.2	-12.0	-11.0	-8.0
Denmark	-10.5	-7.8	-4.3	1.1	-0.1
France	-3.3	-3.4	-3.3	-2.9	-2.6
Germany	-1.9	-1.6	-1.2	-1.2	-1.1
Ireland	-13.1	-12.6	-13.2	-13.0	-12.0
Italy	-16.4	-15.5	-16.3	-14.2	-13.2
Luxembourg	-2.6	0.7	0.5	0.3	-0.1
Netherlands	-9.1	-8.2	-4.4	-6.1	-7.1
General government fiscal balance					
Belgium	-15.2	-12.5	-12.9	-12.1	-9.0
Denmark	-7.2	-4.1	-1.8	3.1	2.3
France	-3.1	-2.9	-2.6	-2.9	-2.8
Germany	-2.5	-1.9	-1.1	-1.0	-0.8
Ireland 3/	-17.0	-16.6	-16.0	-15.5	-14.5
Italy	-11.7	-13.0	-14.0	-12.7	-11.9
Luxembourg	...	...	...	...	...
Netherlands	-8.6	-7.7	-6.8	-6.8	-7.7

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

1/ The data are not comparable across countries since some are on a cash or administrative basis while others are on a national accounts basis. The government concept may also differ between countries.
2/ Staff projections.
3/ Public sector borrowing requirement.

Table 11. EMS: Money and Credit Developments in EMS Countries, 1977-86

(Percentage changes over the same period of the previous year)

	Average 1977-81	1982	1983	1984	1985	1986 I	1986 II	1986 III
Domestic credit expansion 1/								
Belgium	13.0	10.7	14.3	6.6	9.7	9.1	9.4	9.7 2/
Denmark	9.5	13.3	22.2	24.7	13.8	27.3	26.8	21.6 2/
France	13.8	15.0	13.3	9.5	3.5	3.6	2.5	...
Germany	10.3	4.6	5.9	5.9	5.2	4.3	4.2	4.3
Ireland	21.8	13.4	12.2	13.5	4.0	9.7	5.4	...
Italy	18.9	20.9	20.7	20.4	18.0	16.4	15.3	15.8
Luxembourg	...	...	...	...	...	...	...	...
Netherlands	15.0	5.3	5.0	5.3	5.0	4.8	7.0	6.7
Expansion of broad money 1/ 3/								
Belgium	6.3	7.2	8.3	4.5	5.1	6.5	6.1	6.5 2/
Denmark	9.7	11.1	19.7	25.1	18.4	20.0	16.0	12.1 2/
France	12.1	12.1	13.7	9.6	5.9	7.9	6.2	6.2
Germany	6.8	6.9	5.7	5.6	7.6	5.4	5.3	6.7
Ireland 4/	20.0	13.0	10.0	10.5	6.2	1.6	-0.6	...
Italy 4/	17.6	18.0	12.3	12.1	11.1	9.3	8.4	8.3
Luxembourg	14.2	1.2	7.3	0.6	12.6	...	...	...
Netherlands	9.8	5.3	4.9	6.5	6.8	4.9	6.0	6.0

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

1/ From end of period one year before.
2/ Partly staff estimates.
3/ Broad money is defined as the sum of money and quasi-money in the IFS definition.
4/ National authorities' definition.

Table 12. EMS: Interest Rate Developments in EMS Countries, 1984-86

(Period averages in percent per annum)

	Belgium	Denmark	France	Germany	Ire-land	Italy	Luxem-bourg 1/	Nether-lands
Call money rate								
1984 I	8.7	11.6	12.4	5.5	12.5	17.8	8.7	5.9
II	9.9	11.5	12.1	5.5	12.1	17.1	9.9	5.7
III	9.8	11.3	11.4	5.5	12.8	16.9	9.8	5.9
IV	9.5	12.0	11.1	5.6	14.3	17.3	9.5	5.7
1985 I	9.1	12.0	10.6	5.7	14.6	16.2	9.1	6.4
II	8.8	10.3	10.3	5.6	12.4	15.5	8.8	6.9
III	7.6	9.4	9.7	4.8	10.4	14.7	7.6	6.1
IV	7.6	9.5	9.1	4.6	10.1	14.7	7.6	5.8
1986 I	7.9	9.1	8.7	4.7	14.6	16.4	7.9	5.8
II	6.8	9.1	7.6	4.5	10.6	13.8	6.8	6.1
III	6.2	9.2	7.1	4.5	10.0	12.0	6.2	5.7
Government bond yield								
1984 I	12.1	12.3	13.0	8.0	14.1	16.0	10.0	8.5
II	12.2	13.8	13.0	8.0	14.4	15.1	10.3	8.5
III	12.0	15.0	12.6	7.9	14.9	14.4	10.5	8.5
IV	11.7	14.0	11.6	7.2	15.1	14.3	10.1	7.8
1985 I	11.5	13.5	11.4	7.4	14.3	12.5	9.8	7.8
II	10.9	11.8	11.0	7.1	12.7	13.3	9.7	7.6
III	10.5	11.1	10.8	6.5	11.6	13.2	9.4	7.0
IV	9.6	9.9	10.6	6.5	11.9	13.0	9.3	7.0
1986 I	9.1	9.5	9.5	6.1	10.6	12.7	9.2	6.7
II	7.7	10.2	8.0	5.7	9.0	10.6	8.9	6.3
III	7.4	11.1	7.8	5.7	11.2	...	8.3	6.1
IV	...	...	...	5.9	...	...	...	...

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

1/ Staff estimates.

Table 13. EMS: Unemployment Rate and GNP/GDP Growth Rate in EMS Countries, 1977-87

(In percent)

	Average 1977-81	1982	1983	1984	1985	1986 1/	1987 2/
Unemployment rate 3/							
Belgium	8.8	13.0	14.3	14.4	13.6	12.9	13.0
Denmark	7.6	9.8	10.5	10.1	9.0	7.7	8.2
France	6.2	8.4	8.6	10.0	10.4	10.7	11.0
Germany	3.9	6.8	8.2	8.1	8.2	7.9	7.6
Ireland	8.5	12.1	14.8	16.2	17.8	18.2	18.5
Italy	7.6	9.1	9.9	10.4	10.6	11.2	11.2
Luxembourg	0.7	1.2	1.6	1.7	1.6	1.3	1.3
Netherlands	5.8	12.4	15.0	15.7	15.1	14.2	13.5
Growth rate of real GNP/GDP							
Belgium	1.4	1.5	-0.2	1.9	1.4	2.2	1.8
Denmark	1.1	3.0	2.5	3.5	3.9	3.3	0.8
France	2.3	1.8	0.7	1.6	1.4	2.0	1.7
Germany	2.3	-1.0	1.8	3.0	2.5	2.5	2.5
Ireland	4.1	-1.6	-3.4	1.8	0.2	0.8	1.6
Italy	2.7	-0.5	-0.2	2.8	2.3	2.8	2.9
Luxembourg	2.1	0.9	1.9	2.5	2.0	2.3	2.5
Netherlands	1.4	-1.5	1.7	2.1	2.1	1.7	1.4

Sources: National sources; and staff calculations.

1/ Partly preliminary.
2/ Staff projections.
3/ These figures are not strictly comparable across countries.

Table 14. EMS: Illustrative Changes in Effective Exchange Rates Due to EMS Realignment of January 12, 1987

(In percent)

	Change vis-à-vis deutsche mark	Change in Effective Exchange Rate vis-à-vis	
		All countries 1/	EMS countries 2/
Belgian/Luxembourg franc	-0.97	0.45	0.42
Danish krone	-2.91	-1.44	-1.33
Deutsche mark	...	1.82	2.27
French franc	-2.91	-1.63	-1.78
Irish pound	-2.91	-1.49	-1.47
Italian lira	-2.91	-1.62	-1.75
Netherlands guilder	--	1.57	1.62

Source: Staff calculations.

1/ Illustrative calculation (using MERM weights) on the basis of changes in bilateral central rates. It is assumed that effects of the EMS exchange rate adjustment on exchange rates vis-à-vis third currencies are symmetrically distributed, i.e., the deutsche mark and the Netherlands guilder appreciate by 1 1/2 percent vis-à-vis third currencies and the Belgian franc by 1/2 percent, while the Danish krone, the French franc, the Irish pound and the Italian lira depreciate by 1 1/2 percent. A negative number indicates an effective depreciation.

2/ Countries participating in the exchange rate mechanism of the EMS. Calculated using MERM weights.

European Communities, Brussels, January 12, 1987

Communiqué

On 12 January 1987, the Ministers and Central Bank Governors of EC 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 (EMS).

The new bilateral central rates result from the following relative changes:

- German Mark:	up 3.0 percent
- Dutch guilder:	up 3.0 percent
- Belgian franc:	up 2.0 percent
- Luxembourg franc:	up 2.0 percent
- Danish krone:	0.0 percent
- French franc:	0.0 percent
- Italian lira	0.0 percent
- Irish pound:	0.0 percent

The new ECU central rates are the following:
(in units of national currency per ECU)

Deutsche mark:	2.05853
Dutch guilder:	2.31943
Belgian franc:	42.4582
Luxembourg franc:	42.4582
Danish krone:	7.85212
French franc:	6.90403
Italian lira:	1483.58
Irish pound:	0.768411
British pound:	0.739615
Greek drachma:	150.792

The new bilateral central rates and the compulsory intervention rates will be communicated by the monetary authorities in time for the opening of foreign exchange markets on 12 January 1987.

Having conducted a thorough examination of the monetary situation, the Ministers of Finance and the Central Bank Governors of the countries of the European Community have agreed to pursue the coordination of the policies which are necessary for maintenance and consolidation of monetary stability, for the control of inflation and for economic growth in Europe, and which will contribute to greater stability of the exchange rates of the major international currencies.

The realignment which has been decided upon today is consistent with this overall outlook and will establish the conditions which will permit the orderly functioning of the EMS.

With a view to improving economic and monetary operation among member countries, the Ministers have asked the Monetary Committee and the Committee of Central Bank Governors to examine measures to strengthen the operating mechanisms of the European Monetary System.

The agrimonetary consequences of the present realignment will be examined by the competent bodies. The monetary compensatory amounts resulting from the present realignment will be dealt with at the next agricultural price-fixing round. At the request of the Finance Ministers, the Commission declares that it will seek the agreement of member states before proposing in certain special cases agrimonetary measures which flow from the present realignment. This will not affect relevant decisions already taken by the Agricultural Ministers.

Country Notes

1. Belgium

The latest EMS realignment finds the Belgian economy in an improved position compared with the April 1986 parity adjustment. After recording a surplus equivalent to 0.3 percent of GNP in 1985, Belgium's and Luxembourg's combined current account balance of payments surplus is estimated to have widened to 3.2 percent of GNP in 1986. This was largely offset, however, by sizable private capital outflows which reached BF 70 billion (net) in the first seven months of 1986. Output has also strengthened; real GNP is estimated to have risen by 2.2 percent in 1986, compared with 1.4 percent in 1985. Terms of trade gains have been instrumental in lowering the rate of growth of consumer prices to 1.3 percent in 1986 from 4.9 percent in 1985, with the divergence between the consumer price and GNP deflators estimated at nearly 3 percentage points. On the policy front, the authorities have put in place a fiscal program designed to lower the fiscal deficit by 3 percentage points to 8 percent of GNP in 1987, and further to 7 percent by 1989.

This improved overall position masks, on the external side, a steady erosion since 1984 in international competitiveness, and considerable variability in the capital account linked to conflicting long- and short-term interest rate management objectives. Domestically, Belgium still faces an underlying rate of inflation on the order of 3-4 percent, while, even after taking the adjustment measures into account, the fiscal position is still much weaker than in most other EMS countries. Nevertheless, the authorities' apparent preference for a "hard currency policy" as signaled by the franc's position in the recent realignments underscores their commitment to greater internal economic discipline.

The more than two percentage point swing in the current account surplus in 1986 was largely due to terms of trade gains and the persistence of a negative cyclical growth differential of around 1 percent with respect to major trading partners, despite the upturn in economic activity. Export performance in 1986 was not affected by the continued erosion of competitiveness as measured by relative unit labor costs, linked to the slow growth of productivity and in 1986 to a jump in relative wage costs. Belgium in fact recorded a small gain in export market shares in 1986. This reflects the fact that although competitiveness deteriorated over 1984-86 and is expected to worsen further in 1987, it has still not offset the major gain scored in 1981-83 through exchange rate depreciation and wage restraint.

Short-term interest rates held firm in the first quarter of 1986. Thereafter, in the wake of the April realignment short-term rates came down rapidly in line with those abroad. With the abatement of exchange market tensions, the Treasury took advantage of declining domestic inflation and the easier international climate to push down long-term interest rates by as much as 200 basis points in the second quarter of 1986. This led to a sharp deterioration in after-tax differentials vis-à-vis foreign rates in the latter half of the year, provoking heavy long-term capital outflows which left the Central Bank no choice but to once again pursue a firm short-term interest rate policy, which even so had to be supplemented at times by intervention on the exchange markets. As a result, foreign exchange holdings declined by US$683 million over June-November 1986, and the exchange rate of the franc within the EMS drifted down toward the lower limit of its intervention band.

This year's ambitious fiscal adjustment program, which entails major expenditure cuts, will contribute to slowing the rate of growth of GNP to around 1.8 percent in 1987. The rate of growth of consumer prices could accelerate somewhat to 2.0 percent, reflecting waning terms of trade gains and some acceleration in unit labor cost growth. A continued negative cyclical growth differential and further terms of trade gains are expected to raise the current account surplus in 1987 to 3.8 percent of GNP.

2. Denmark

Facing growing internal and external imbalances, in late 1982 the Danish authorities adopted a strategy aimed at protecting a strong competitive position through firm incomes and exchange rate policies, and shifting resources to the private sector through tight fiscal and accommodating monetary policies. This strategy was remarkably successful in achieving a rapid economic recovery, centered on the industrial sector, and a slowdown in the rate of inflation. Surging industrial output and investment reduced unemployment to less than 8 percent in 1986, despite rapid growth in the labor force. Consumer price inflation fell from more than 10 percent in the early eighties to 3 1/2 percent in 1986. However, by late 1985, labor market bottlenecks and cost pressures had emerged in some sectors.

The costs of this rapid recovery have been most apparent in the continued deterioration of the external current account. After an initial improvement in 1983, the current account deficit rose steadily to an estimated 5 percent of GDP in 1986.

In an attempt to curb the mounting demand pressures, the authorities introduced a fiscal package in December 1985. When it became clear that the current account continued to deteriorate despite the strong improvement in public savings, the authorities adopted further fiscal measures in March 1986, consisting mainly of increased energy taxes. However, domestic demand grew more strongly than expected at an estimated rate of 5 1/2 percent in 1986, still driven by private consumption and investment. The third fiscal package within a year was introduced in October 1986 with the aim of curbing consumption through taxing net interest payments on consumer loans. By late 1986, domestic demand may have reached a turning point.

The fiscal adjustment achieved in recent years has been impressive, and the most substantial among industrial countries. The public sector balance shifted from a deficit of 9 percent of GDP in 1982 to a surplus of over 3 percent in 1986. Over half of the improvement was accomplished through expenditure restraint, including restraint of social transfers. The public sector surplus is projected to decline to 2 1/2 percent of GDP in 1987, largely as a result of a tax reform that became effective in the beginning of the year. The reform lowers income tax rates and reduces various tax deductions.

Monetary policy was accommodating throughout, with domestic credit rising particularly strongly in 1986. Part of the excess liquidity leaked abroad in 1986. However, interest rates have been raised recently in response to pressures in the exchange market, while the effectively reduced deductibility of interest payments has raised after tax interest rates for households further.

While Danish wage costs have increased at about the same rate as those of its trading partners, 1/ competitiveness has worsened recently because of an effective appreciation of the krone, related to the decline in the U.S. dollar. The krone's position in the ERM was weak during most of 1986. At times the krone came under heavy selling pressure requiring extensive intervention support and a rise in interest rates.

Partly due to the October fiscal package and the recent tax reform, it is expected that domestic demand will weaken in 1987 and GDP growth will slow down to less than 1 percent facilitating an improvement in the current account deficit, projected at 3 1/2 percent of GDP. Inflation is officially projected to average about 3 3/4 percent in 1987, provided that there is continued wage restraint after the lapse of the statutory incomes policy in March 1987.

3. France

The complementary policies of moderately restrictive fiscal policy and public sector wage moderation in place since 1982-83 have helped both to bring about a substantial improvement in France's external accounts since 1982, and to eliminate the inflation differential between France and the average of its major trading partners. The current account, having been in deficit to the equivalent of 2.2 percent of GDP in 1982, was restored to approximate balance in 1985, and is estimated to have increased to a surplus F 25 billion or 0.5 percent of GDP in 1986. However, the swing in the current account of F 25 billion was considerably less than the decline in the deficit in energy trade of F 70 billion.

1/ Unit labor costs data suggest a worsening in the relative cost position; there are, however, some problems with Danish productivity data, which are based on industrial sales rather than output.

France's cost competitive position is good with respect both to the average of its EMS partners and to its principal trading partner Germany. Its export price and cost competitiveness have both improved since the realignment of April, 1986. Nonetheless, the deterioration of the non-oil current account that took pace in 1986, and the failure of real GDP, which grew by 1.4 percent in 1985 and an estimated 2.0 percent in 1986 to keep pace with domestic demand in France and in her major trading partners suggests that the economy is impeded by constraints on supply.

In contrast to most of her European trading partners, France has lost export market shares since 1984. This loss is at least partly explained by a deterioration in overall export price competitiveness of over 7 1/2 percent between 1983 and the first quarter of 1986, prior to the April 1986 EMS realignment. France's export price competitiveness vis-à-vis its EMS partners also deteriorated by a similar amount over this period, and it deteriorated by as much as 8 percent against Germany. In all cases, the decline in export price competitiveness exceeded the decline in unit labor cost competitiveness, which was small by comparison.

The fact that this loss of price competitiveness was unaccompanied by any significant loss of labor cost competitiveness suggests that French exporters sought to increase profit margins at the expense of market shares. This suggests in turn that the supply of exports was constrained by its insufficient profitability.

The April realignment, and the subsequent intramarginal depreciation of the franc between April and December 1986 resulted in a substantial improvement in France's overall export price competitiveness as well as vis-à-vis its EMS partners, notably Germany, and reversed the decline in labor cost competitiveness that had taken place since 1983. However, these developments did not bring about any immediate improvement in the non-oil trade balance. At the same time, the consumer price inflation differential between France and Germany, having fallen to 2.4 percent in June 1986, widened to over 3 percent in December. Finally, the strikes in the public sector in late December and early January raised doubts in the foreign exchange market regarding the Government's policy of public sector wage moderation.

These developments and the increased attractiveness of the deutsche mark vis-à-vis the dollar contributed to heavy speculative pressure on the franc in December. The pressures intensified in January, in spite of the increase in the intervention rate of the Bank of France from 7 1/4 percent to 8 percent and in the seven-day repurchase rate to 8 3/4 percent on January 2 and increases in the interbank rate from 7 1/2 percent in December to over 9 percent in early January. The gap between Eurofranc and domestic interest rates also increased from about 1 percentage point in early December to about 4 percentage points in early January, although this increase was less than the increase seen in previous periods of speculation against the franc, in part because of the recent liberalization of capital market controls.

Barring a further and significant shift in parities or any substantial modification of present wage policy, the recent improvement in France's competitive position should be conserved in 1987. Nominal wage increases have continued to decelerate, and are lower than those of France's major trading partners, including Germany. The stance of fiscal policy is expected to remain moderately tight, which together with the policy of wage moderation in the public sector should restrain the growth of domestic demand, in spite of the fairly strong growth projected for private business investment. As a result, no further loss of export market shares is expected. However, the modest growth of demand addressed to French exporters and a decline in the rate of growth of domestic demand are expected to prevent GDP growth from exceeding 2 percent in 1987.

As of January 1987, French monetary policy will be conducted by managing short-term interest rates, and these will be heavily influenced by the position of the franc within the ERM. With short-term interest rates at 8 1/2 percent shortly after the realignment, the real rate should be close to 6 percent. However, the present climate of uncertainty in the foreign exchange markets would allow little room for maneuver.

4. Germany

In 1986, Germany's external current account surplus increased to US$36 billion (4 percent of GNP), about twice the level of the previous year. This was entirely due to a sharp improvement of the trade surplus, reflecting a substantial increase in the terms of trade (about 14 percent) as a result of the decline in oil prices and appreciation of the deutsche mark. In price adjusted terms, however, the external surplus (on a national accounts basis) declined by one fifth, reflecting a sharp slowdown in the growth of exports of goods and services and sustained import growth. The current account surplus was accompanied by sizable net long-term capital inflows resulting in a large surplus of the basic balance; this was offset by net short-term capital outflows and an increase in reserves.

The deutsche mark came under increasing revaluation pressure in the course of 1986. It rose by about 26 percent against the U.S. dollar and by about 9 percent in nominal effective terms. Against the currencies of EMS partner countries, the deutsche mark appreciated by about 4 percent reflecting its revaluations within the ERM in April and August 1986. Considerable Bundesbank intervention in the foreign exchange market sought on some occasions to slow down the decline of the U.S. dollar, and on others to support ERM currencies in the band. Concerted intervention with other European central banks (following an informal meeting of EC Ministers of Finance and Economics and Central Bank

Governors on September 19-20, 1986) halted the drop in the U.S. dollar and eased tensions in the ERM, but this lasted only for a short time. Subsequently, at the end of the year and in early 1987, despite sizable interventions, the dollar fell sharply and helped trigger the EMS realignment.

The substantial appreciation of the deutsche mark since early 1985 was in part responsible for the relatively modest growth of the German economy in spite of the stimulus given by the oil price decline and tax cuts in early 1986 (estimated at about 3 percent of GNP in total). Domestic demand grew by about 4 percent in 1986, but the foreign balance weakened substantially so that GNP grew by only 2 1/2 percent. The consumer price level declined in 1986 for the first time since the early 1950s owing to lower oil prices and the stronger deutsche mark. Prices of goods with high domestic content, however, are estimated to have increased by 1 1/2 - 2 percent and the GNP deflator rose by 3 1/2 percent. A large increase in employment, especially in the services sector, led to a slight fall in the unemployment rate despite greater labor force participation. With nominal wage increases higher in 1986 than in the preceding year, unit labor costs in manufacturing rose by 3 1/2 percent and wages grew strongly in real terms.

Monetary policy in 1986 appeared looser than had been envisaged. For the first time since 1978, central bank money growth was permitted to exceed its target range by a wide margin; it rose by more than 7 1/2 percent on a fourth-quarter-to-fourth-quarter basis compared with a target of 3 1/2 percent to 5 1/2 percent. The broader aggregates also accelerated; the growth of M1 rose from 5 percent in 1985 to 8 percent in 1986 and that of M3 from 5 to 6 percent. Both short- and long-term interest rates fell by about 80-100 basis points in 1986 from their average levels of 1985.

The success of fiscal consolidation efforts differed by level of government in 1986. Local government deficits (states and municipalities) exceeded the amount proposed in the Finance Plan by a substantial margin, owing to both higher expenditures and some revenue shortfalls. The Federal Government succeeded in meeting its deficit target, but, because of unexpected increases in subsidies to agriculture, coal, and shipbuilding, greater stringency in administrative spending was necessary. With the surplus of the social security system--owing to a surplus of the pension fund and to an increase in long-term unemployment aid funded by local governments rather than by the unemployment insurance--the general government deficit remained at about 1 percent of GNP.

In 1987, real GNP is projected to grow again by about 2 1/2 percent. Domestic demand is expected to contribute about 3 1/2 percentage points, with net foreign demand reducing growth by 1 percentage point. Consumer prices are expected to increase somewhat in 1987, as the price-reducing effects of lower commodity prices and the stronger exchange rate taper off. The current account surplus is projected to decline to about 3 1/4 percent of GNP, owing to continued strong real growth of imports and weak growth of real exports.

5. Ireland

Economic developments in Ireland during 1986 were characterized by further progress in lowering the external current account deficit and inflation, but public sector imbalances remained acute. A marked improvement in the terms of trade contributed to an increase in the trade surplus and a further reduction in the current account deficit to 1 1/2 percent of GNP from 3 1/2 percent in the previous year. Consumer price inflation fell further from 5.4 percent in 1985 to 4 percent in 1986 and just over 3 percent by the last quarter of 1986. However, the fall in inflation was lower than expected given the sharp fall in oil and other commodity prices, suggesting that there may have been some rebuilding of profit margins. Real GNP is estimated to have increased by close to 1 percent in 1986, reflecting mainly growth in private consumer spending. This increase was inadequate to sustain employment and unemployment rose further to more than 18 percent of the labor force.

On the fiscal front, a shortfall in government revenue and an overrun in expenditure resulted in a current budget deficit and an Exchequer borrowing requirement of 8 1/2 percent and 13 percent of GDP, respectively. These percentages were about the same as in 1985 but 1 percentage point higher than budgeted for. While private sector credit grew by 7 3/4 percent in the year to mid-November 1986, the broad money stock declined by about 3 percent mainly as a result of large speculative capital outflows associated with exchange rate uncertainties, especially in the period preceding the April 1986 EMS realignment. In response to these outflows and due also to the high domestic financing needs of the Exchequer, domestic interest rates increased sharply during the first quarter of 1986 and, after easing markedly in the summer, rose again toward the end of the year. Exchange rate developments during 1986 were strongly influenced by the weakening of the pound sterling and, to a lesser extent, of the U.S. dollar. In effective terms, the Irish pound appreciated during the first half of the year but fell back during the second half, reflecting the 8 percent downward adjustment of the Irish pound vis-à-vis the other currencies participating in the exchange rate mechanism of the EMS in August 1986. In real effective terms, the Irish pound is estimated to have depreciated by 2.2 percent during 1986, even though in domestic currency terms the growth in average wage earnings in the private sector (6 1/2 percent) remained significantly higher than in the main trade partner countries.

A strengthening of consumer demand, some recovery in investment spending, and a marked pickup in export growth are expected in 1987, leading to an acceleration in the growth of real GNP to 2 1/2 percent but with little change in total employment and a marginal further increase in the unemployment rate. The higher growth in exports is expected to be offset in part by a faster growth in imports and, with a further rise in net factor payments abroad, the current account deficit is expected to remain at about 1 1/2 percent of GDP. Consumer price inflation is expected to slow down somewhat to 3 1/2 percent, while increases in average earnings are expected to remain relatively large at 5 1/2 percent as a result mainly of a significant carry-over from pay settlements reached in 1986. However, the growth in unit labor costs in manufacturing is expected to slow down to about 2 percent on account of further growth in productivity. As the budget for 1987 has not yet been tabled, the forecasts given above are based on the working assumption of constant real government spending and an unchanged tax burden, which imply a small fall in the budget deficit as a ratio to GDP.

6. Italy

Following two years of deficits equivalent to around 1 percent of GDP, in 1986 Italy's external current account is estimated to have registered a surplus of around US$4 3/4 billion (just under 1 percent of GDP). The shift in the external position was entirely accounted for by the large improvement in the terms of trade, which more than compensated for the marked deterioration in the real trade balance. Real domestic demand is estimated to have grown broadly in line with Italy's main trading partners--around 3 1/2 percent--and the rate of growth of GDP to have accelerated by one half of a percentage point as compared to 1985, to 2.8 percent. Inflation in consumer prices fell by around 3 percentage points to just over 6 percent, chiefly on account of the marked decline in import prices. Developments in financial policies were mixed. The state sector borrowing requirement is estimated to have fallen in relation to GDP by just over 2 percentage points, to 14.2 percent of GDP, but the main domestic credit targets are estimated to have been exceeded by significant margins.

Following the difficulties experienced in late 1985 and early 1986, the lira strengthened after the April 1986 EMS realignment, and it remained close to or above the upper limit of the narrow ERM band through most of the second half of the year. In the course of 1986, the lira appreciated by 24 percent vis-à-vis the U.S. dollar and by 7 3/4 percent in effective (MERM weighted) terms. The real effective exchange rate (adjusted by relative unit labor costs) is estimated to have appreciated by around 7 percent during the first three quarters of 1986. Contrary to other major industrial countries, real interest rates in Italy did not fall on average in 1986. Indeed, the average short-term (three months) real interest rate 1/ rose by over one half of a percentage point as compared to 1985. Real short-term interest rate differentials consequently generally widened: around 1.7 percentage points on average relative to the United States and close to 1.2 percen-

1/ Deflated by an estimate of the expected rate of consumer price inflation.

tage points relative to Germany. Following the large losses suffered in late 1985 and early 1986, official reserves recovered and, by the end of December 1986, gross reserves (excluding gold) amounted to just over US$20 billion, about US$4.4 billion more than in December 1985.

The likely stance of financial policies in 1987 is as yet unclear. On the basis of an assumed modest tightening of fiscal policy and a relatively accommodating monetary policy, domestic demand is projected to rise by about 4 percent on average in 1987, and GDP by around 3 percent. Inflation is projected to fall on average to 4 3/4 percent, despite a modest acceleration in the course of the year. Italy's projected relative cyclical position, as well as the delayed impact of the strong real effective appreciation of the lira registered in 1986, are expected to contribute to a slowdown in the rate of growth of real exports and to a modest acceleration in the rate of increase of real imports.

The Italian authorities' decision to keep the central parity of the lira unchanged in the context of the latest EMS realignment was not prompted by any significant weakening of the external position. The lira remained well within the upper half of the wide ERM band up to and through the first week of January 1987; official foreign exchange reserves (measured in U.S. dollars) remained largely unchanged in the course of December 1986 and the moderate losses suffered in the few days preceding the realignment appear to have been quickly recovered. The Italian authorities attribute the weakening of the lira/DM rate which took place in late 1986 to the impact on the German currency of the weakening of the U.S. dollar rather than to bilateral factors such as relative cost and price developments. Furthermore, and despite some possible worsening as compared to 1986, the external current account is likely to remain in surplus in 1987. Domestic demand and unit labor costs, however, are expected to grow at rates in excess of those of Italy's trading partners, and as such the improvement in competitiveness which may result from the latest realignment would give the Italian authorities some welcome room for maneuver.

7. Luxembourg

Real GDP rose by an estimated 2.3 percent in 1986, compared with 2 percent in 1985, due to buoyant private consumption and strong investment growth. Higher activity was accompanied by a reduction in the unemployment rate to 1.3 percent from 1.6 percent in 1985, while terms of trade gains lowered the rate of growth of consumer prices to 1 percent, compared with 4.1 percent in 1985. Unit labor costs accelerated somewhat in 1986, reflecting the impact on wages of tighter labor markets and a generally easier wage policy. A dip in steel exports and strong import demand weakened the external balance, and its contribution to growth in 1986 was negligible.

With the completion of the restructuring program for the steel industry, fiscal policy turned expansionary in 1986 and is programmed to play a major role in boosting domestic demand in 1987. Tax pressure was reduced by 1 percent of GDP in 1986 and a further 2 percent reduction is planned for 1987. Combined with higher expenditure, this reduced the fiscal surplus in 1986, and a small deficit is budgeted for 1987. Monetary and exchange rate policies are circumscribed by the monetary association agreement with Belgium.

Reflecting the expansionary turn of fiscal policy as well as further gains in real income GNP growth could accelerate further to 2.5 percent in 1987, with the unemployment rate stabilizing at just above 1 percent. Consumer prices are projected to accelerate to around 1.5 percent reflecting higher unit labor costs and smaller terms of trade gains. The strength of domestic demand and weak export growth are expected to lead to a renewed deterioration in the foreign balance in 1987.

8. Netherlands

Stability of the exchange rate of the guilder to the deutsche mark has remained the primary objective of monetary policy in the Netherlands. This exclusive assignment of monetary policy to the exchange rate has been reflected in a modest positive interest rate differential vis-à-vis the deutsche mark and has allowed the guilder to occupy a generally strong position in the ERM band in recent years. It has also been instrumental in eradicating inflation, which was on average some 2.5 percentage points less than in partner countries during the period 1982-86. Effective exchange rate movements of the guilder have been dominated in recent years by sharp fluctuations vis-à-vis the U.S. dollar. In 1986, the guilder appreciated in nominal terms by about 11 percent and in real terms by about 9 percent, mainly as a result of the dollar's depreciation.

Expanding export markets have provided an important stimulus to real growth in the economy which was slightly in excess of 2 percent in 1984 and 1985. More recently, domestic demand has picked up somewhat, while export growth has slackened. Nevertheless, in 1986 the current account has remained substantially in surplus, at close to 4 percent of GNP. This surplus was mainly generated in the trade account. Import volumes have grown faster than export volumes in recent years, so that the widening of the trade surplus primarily reflected gains in the terms of trade.

The authorities embarked on a program of public sector deficit reduction in 1982. This program was implemented through expenditure cuts, rather than revenue increases, and its main objectives have been achieved. Nevertheless, the public sector deficit still amounted to close to 7 percent of GNP in 1986, and another program has been announced to reduce it further by 1990. Initially, however, the deficit is expected to rise somewhat, due to a sharp fall in natural gas revenues in 1987 amounting to close to 3 percent of GNP. The Government has committed itself to a package of revenue measures of f. 6.8 billion

(1.6 percent of GNP) and of expenditure cuts of f. 5.4 billion (1.3 percent of GNP) in 1987, in order to offset most of the impact of the fall in gas revenues in the coming year.

Real growth is expected to continue in 1987 at a moderate pace of about 1 1/2 percent, with export demand providing a renewed stimulus while domestic demand is expected to slacken somewhat. Unemployment will continue to decline, but at a slow pace, as profitability of enterprises will improve further and business investment is sustained at a moderate level. Consumer prices are projected to decline by about 1 percent, reflecting mainly lower import and energy prices in 1986 and 1987. Also, wage moderation should continue as many wage agreements in the Netherlands cover a two-year period and the more influential ones were signed in 1986. This development, coupled with further productivity gains, is expected to lead to a decline in unit labor costs of about 1 percent. Present projections indicate a narrowing of the current account surplus from 4 percent of GNP in 1986 to about 3 percent in 1987. Import volumes are again expected to grow somewhat faster than export volumes. In addition, after several years of gains, the terms of trade are projected to worsen in 1987 by about 1 percentage point, reflecting a sharp drop in natural gas export prices.