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April 21, 1986

To: Members of the Executive Board

From: The Acting Secretary

Subject: European Monetary System - Realignment of Exchange Rates

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

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

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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 L.A. Whittome

April 18, 1986

I. Introduction

On April 6, 1986 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 following day. Notifications to this effect have been received by the Fund from the countries participating in the exchange rate mechanism of the EMS 1/ 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	+3.0
Netherlands guilder	+3.0
Belgian franc	+1.0
Luxembourg franc	+1.0
Danish krone	+1.0
Irish pound	0.0
Italian lira	0.0
French franc	-3.0

Table 1 compares this ninth realignment with the eight preceding ones and sets out the new ECU central rates. The new bilateral central rates and intervention limits, which came into effect as of April 7, 1986, are shown in Table 2. Section II of the paper provides a brief background; Section III discusses the rationale for and describes some implications of the realignment; and Section IV presents the Staff Appraisal; details of exchange rate developments within the EMS since early 1985 are provided in Appendix II; country notes are contained in Appendix III.

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.

II. Background

1. Recent exchange rate developments

From its inception in March 1979 until March 1983, the EMS went through frequent periods of exchange market strain and there were seven realignments of central rates. The situation changed in the two years following the realignment of March 1983 during which the U.S. dollar steadily appreciated against European currencies and the EMS experienced a period of relative internal stability. In spite of favorable current account and price developments in Germany, the deutsche mark did not come under upward pressure within the EMS largely because of the strength of capital flows to the U.S. The exchange rates of other participants did not fall under pressure either, in spite of considerable, though significantly reduced, divergences in cost and price performance among EMS countries.

Since end-February 1985, the U.S. dollar has been depreciating vis-à-vis the European currencies. However, the continuous decline of the dollar did not affect the relative position of EMS currencies until about December 1985, when foreign exchange market participants apparently became convinced of the determination of G-5 central banks to lower the dollar and also realized the improved growth prospects for Europe, in particular for Germany. As has often been the case when the U.S. dollar has depreciated, the deutsche mark, together with the Netherlands guilder, moved sharply upward in the narrow band. 1/ The currencies of the smaller members of the EMS, such as the Danish krone and Irish pound, weakened significantly, while the Belgian franc remained in the lower part of the narrow band. The French franc remained strong, reflecting the improvement of the external position of the French economy, increased confidence in the anti-inflationary policies of the French government, and an expectation that no realignment would take place until after the parliamentary elections in France in March 1986.

On Friday, April 4, 1986, EMS central banks suspended their official currency dealings after the Banque de France had informed them that it would not continue to support the franc. This created considerable movements in foreign exchange markets and caused the French franc and the Irish pound to fall sharply below their lower intervention limits while the deutsche mark and the Netherlands guilder broke the upper intervention limits. However, trading was rather thin on that day and the spread between buying and selling rates widened sharply. When foreign exchange markets reopened after the realignment, the deutsche

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1/ The rules of the EMS stipulate that the deutsche mark, Netherlands guilder, Belgian and Luxembourg francs, Danish krone, Irish pound, and French franc may fluctuate around their bilateral central rates within a margin of 2 1/4 percent ("narrow band"), while the Italian lira may fluctuate within a margin of 6 percent ("wide band").

mark and the Netherlands guilder moved to the lower part of the narrow band--as usual in these circumstances--while the Italian lira, the French franc and the Irish pound moved to the upper part of the wide and narrow bands. The Belgian franc and the Danish krone remained in the lower part of the narrow band.

2. Developments in external current accounts, prices, and costs

While the weakening of the U.S. dollar and the resulting redirection of international capital flows in favor of the deutsche mark may have paved the way for a realignment, the fundamental causes were the differences in external and domestic developments among EMS countries, even though considerable progress toward convergence in economic performance among participating countries has taken place since 1983. With the exception of Italy and Denmark, the external current account improved in all EMS countries during 1983-85 (Table 3). However, while Germany and the Netherlands had substantial current account surpluses over the whole period, Belgium and France achieved modest surpluses more recently. On the other hand, Italy, Denmark, but also Ireland still recorded substantial external current account deficits in 1985. A similar pattern exists in bilateral trade balances among EMS countries, with Germany and the Netherlands running substantial trade surpluses with other EMS countries and Italy and also France recording sizeable deficits (Table 4).

Since the last general realignment in 1983, there has been a considerable improvement in the cost-price performance of EMS countries, as well as significant progress toward a narrowing of cost and price differentials (Table 5). In 1983, the maximum spread between the highest and lowest inflation rate among participants was about 12 percentage points; by 1985, the maximum spread had declined to about 7 percentage points. The convergence of unit labor cost developments was no less pronounced; in 1983, the maximum spread of unit labor cost changes amounted to almost 17 1/2 percentage points, but by 1985 it had declined to 10 percentage points. Nevertheless, the accumulated divergences in cost and prices remained substantial.

The eight previous realignments since the inception of the EMS approximately offset or more than offset the accumulated inflation differentials of Denmark and Belgium vis-à-vis Germany and the Netherlands (Table 6). The realignments did not, however, compensate the large accumulated inflation differentials of Ireland, Italy, and France vis-à-vis Germany. Relative developments in unit labor costs in manufacturing, adjusted for exchange rate changes, reveal a broadly similar situation, although for France the realignments compensated a large part of the differential vis-à-vis Germany (Tables 7-8). On a weighted average basis and using unit labor costs, Italy, Ireland, and

France lost competitiveness against the EMS partner countries since the inception of the system until the third quarter of 1985, while Belgium, Denmark, Germany, and the Netherlands gained competitiveness. 1/

Divergences in cost, price and current account performances reflect to a large extent incomplete convergence of economic policies among EMS countries. Thus, the relatively higher inflation rate and weaker current account position of Italy reflect the maintenance of large fiscal deficits as well as some easing of monetary policy in the last two years. In Denmark, the fiscal position improved considerably though monetary conditions were eased markedly; inflation slowed, but the current account position worsened. Tightening of fiscal and monetary policies contributed to an improvement in the price performance and the external position of France, but also of Belgium and Ireland; however, differences in performance among these countries and the two stronger participants, Germany and the Netherlands, remain substantial.

While significant divergences remain in fiscal performances (Table 10), domestic credit and broad money expansion decelerated since 1983 in all countries (Table 11). The tightening of monetary policy was particularly sharp in France, but monetary expansion also slowed significantly in Belgium, Ireland, and, from a high level, in Denmark and Italy. In the latter two countries, however, monetary expansion has remained relatively high. Reflecting the still significant divergences in the developments of monetary aggregates and inflation rates, nominal interest rate differentials also have remained sizeable (Table 12). Relatively large differences in real GNP growth and unemployment rates also remain among all participating countries, although convergence in these areas has increased since 1983 (Table 13).

III. The Realignment of April 1986

The realignment took place at the initiative of the French authorities, who sought a devaluation of the French franc as part of a package of measures designed to liberalize the French economy and strengthen its competitiveness. In support of the exchange rate adjustment, France took steps to slow nominal wage growth and to reduce the budget deficit. The authorities have announced that the noninterest component of the central government deficit will be eliminated in the course of the next three years. The target of containing the growth of M3 below 5 percent throughout the year has been reasserted, and the authorities have indicated their intention to support this target with a prudent interest rate policy, even though this may imply continued

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1/ The appreciation of the U.S. dollar between 1980 and February 1985 vis-à-vis all EMS currencies led to an improvement in each EMS country's overall competitiveness except Italy's (Table 9). As a result of the depreciation of the dollar since March 1985, the earlier improvement in competitiveness of the currency bloc was partly reversed.

relatively high real interest rates. Exchange controls are to be further relaxed, especially for business transactions, and the remaining price controls on industrial products are to be abolished.

The changes in nominal effective exchange rates implied by the realignment are illustrated in Table 14. On the basis of changes in bilateral central rates and on the assumption that the exchange rates between third currencies and the deutsche mark would remain unchanged at their level immediately prior to the realignment, the realignment is estimated to imply a nominal effective depreciation of the French franc of about 5 1/2 percent against the currencies of all major trading partners. On the same assumptions, the deutsche mark and the Netherlands guilder would appreciate by about 1 1/2 percent in nominal effective terms, while the other EMS currencies would depreciate by between 1/2 and 2 percent. Actual changes in effective exchange rates will, of course, depend on the relative exchange rate movements of the European currencies within the EMS band and vis-à-vis third currencies.

In the wake of the realignment, interest rates fell in several countries as speculative trends have been halted or reversed. The Central Bank of Ireland lowered the interest rate at which it provides short-term support to the money market by 1 1/4 percentage points immediately after the realignment, thus partly reversing an earlier increase. In Belgium, official rates were reduced in two steps. Effective April 8, both the discount and the advances rates were taken back by 1/2 percentage point, and effective April 10, the discount rate was reduced by a further 1/2 percentage point, while the advances rate was reduced by 3/4 percentage point. In Italy, the authorities lifted the foreign exchange restrictions introduced earlier to defend the lira and took additional measures to liberalize international capital movements.

The realignment has consequences for the Common Agricultural Policy of the EC. Under new regulations introduced in March 1984, the appreciation of the deutsche mark and the guilder do not lead to positive Monetary Compensatory Amounts (MCAs) for Germany and the Netherlands. 1/ Rather, agricultural prices in deutsche mark or guilder establish the benchmark for the computation of negative MCAs required to offset the effects of the devaluation of the other currencies against the deutsche mark and the guilder. The EMS countries agreed that the negative MCAs modified or created by the realignment will not be changed before the end of the current agricultural price fixing round for the market year 1986/87.

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 expressed in ECU into national currencies, are changed along with central rates.

The realignment of EMS exchange rates also affects the notional central rates of sterling and the drachma, which are not included in the EMS exchange rate mechanism but are included in the European Currency Unit (ECU). 1/ The notional central rates of the pound and the drachma were decreased by about 12 and 26 percent, respectively. Furthermore, the EMS realignment automatically affects the currencies which are pegged to one of the partner currencies (the CFA franc) or have an historically close link to an EMS currency (e.g., the Austrian schilling). 2/

IV. Staff Appraisal

The countries participating in the exchange rate mechanism of the EMS need to maintain a balance between keeping stable exchange rate relationships within the EMS and safeguarding their external competitiveness, which over time may be eroded by divergences in cost and price developments. EMS countries are keenly aware of the disciplinary effect that stable exchange rates exert on their policies; indeed, adherence to the EMS exchange rate discipline has acted increasingly as a stimulant to adjustment. The fact that the realignment of April 6, 1986 was the first general realignment in three years following a period of more frequent exchange rate adjustments, is indicative of the progress made toward better convergence of economic policies and performances between the EMS countries.

This latest realignment took place at the request of the French authorities, and the largest shift in bilateral central rates, amounting to about 6 percent, occurred between the deutsche mark and the Netherlands guilder on the one hand, and the French franc on the other. The changes were, however, significantly smaller than the shifts in the realignments of June 1982 and March 1983. The devaluation of the French franc against the deutsche mark offsets about half of the price increase differential between France and Germany since the last general realignment and approximately matches the difference in unit labor cost increases. 3/ The challenge facing the French authorities is to reconcile the devaluation of the franc with a continued lowering of the rate of inflation in France. The French authorities' anti-inflationary strategy relies on both incomes and financial policies. The authorities must above all strive to prevent a pass-through of the higher import

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

2/ The CFA franc, which is pegged to the French franc, is devalued by the same amount as the French franc against other EMS currencies. The Austrian schilling, which is closely linked to the deutsche mark, is revalued against other EMS currencies along with the deutsche mark.

3/ Between March 1983 and March 1986 the differentials in price and unit labor cost increases between France and Germany amounted to about 12 percentage points and 6 percentage points, respectively.

prices to wages. The exchange rate adjustment and the intention to maintain a prudent interest rate policy will facilitate the successful liberalization of exchange controls.

In view of the record of Germany in controlling the increase in domestic costs, the revaluation of the deutsche mark should not unduly affect the competitiveness of German goods, but it should reinforce the shift under way from external to domestic demand as the main engine of growth, a shift which, given Germany's strong external position, is fully appropriate. The Netherlands authorities decided to keep the relationship of the guilder to the deutsche mark unchanged, a move which appears justified in view of Netherlands' price performance and external position.

The Belgian, Luxembourg, and Danish authorities opted for only a modest devaluation against the deutsche mark. This underlines their intentions to follow in the future more closely the stronger currencies within the EMS. In the Danish case, two recent fiscal packages will move the public sector into significant surplus in 1986, but the available room for a tighter monetary policy stance needs to be utilized. In Belgium, substantial further efforts are needed in fiscal adjustment.

The Italian and Irish authorities decided to stay midway between the French and German moves. Both countries have large public sector deficits, which if not significantly lowered over time, will endanger domestic as well as external stability. At the same time, both countries have made appreciable gains in lowering the rate of inflation. It remains essential for both countries to continue with their efforts to reduce fiscal deficits, and particularly for Italy, to keep a tight reign on domestic cost developments.

Since the previous general realignment in 1983, there has been a clear trend toward stability-oriented policies in all EMS countries, resulting in increased convergence in economic performance. However, divergences continue to exist with eventual implications for exchange rate stability. With further progress in controlling cost and price inflation in those countries where it is still a problem, the frequency and extent of exchange rate realignments could be minimized.

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
Percentage changes in bilateral central rates 1/									
Belgian-Luxembourg franc					-8.5		1.5	2.0	1.0
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
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	
Netherlands guilder				5.5		4.25	3.5	2.0	3.0

	ECU Central Rates		Central Rate Change in terms of ECU per currency (percent)
	Previous	New	
Realignment of April 6, 1986			
Belgian-Luxembourg franc	44.8320	43.6761	2.65
Danish krone	8.12857	7.91896	2.65
Deutsche mark	2.2384	2.13834	4.68
French franc	6.86402	6.9628	-1.42
Italian lira	1520.6	1496.21	1.63
Irish pound	0.724578	0.712956	1.63
Netherlands guilder	2.52208	2.40935	4.68
Pound sterling 2/	0.555312	0.630317	-11.90
Greek drachma 2/	100.719	135.659	-25.76

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. (For example, the devaluation of the French franc against the deutsche mark on April 6, 1986 will be given by 0.97/1.03 = 0.942 or -5.8 percent).

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 the calculation of the divergence indicators, 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 April 7, 1986)

		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	...	564.10	2089.00	641.55	31.0	62.6550	1854.05
	C	...	551.536	2042.52	622.278	29.1912	61.2606	1812.78
	U	...	539.30	1997.20	613.35	27.490	59.8975	1772.45
Danish krone	L	18.543	...	378.76	116.32	5.6120	11.3599	336.16
	C	18.1312	...	370.332	113.732	5.29268	11.1072	328.676
	U	17.727	...	362.09	111.20	4.985	10.8601	321.36
Deutsche mark	L	5.007	27.615	...	31.41	1.5175	3.068	90.770
	C	4.8959	27.0028	...	30.7109	1.42917	2.99926	88.7526
	U	4.787	26.400	...	30.030	1.3460	2.933	86.78
French franc	L	16.305	89.925	333.03	...	4.940	9.9885	295.57
	C	15.9419	87.9257	325.617	...	4.65362	9.7661	288.991
	U	15.5870	85.97	318.37	...	4.3830	9.5490	282.56
Italian lira	L	3637.4	20062.0	74295.0	22817.0	...	2228.29	65941.0
	C	3425.7	18894.0	69970.6	21488.6	...	2098.60	62100.2
	U	3226.3	17794.0	65898.0	20238.0	...	1976.46	58480.0
Irish pound	L	1.6695	9.208	34.1000	10.4725	0.505956	...	30.2645
	C	1.63237	9.00315	33.3416	10.2395	0.476508	...	29.5912
	U	1.5960	8.8029	32.6000	10.0115	0.448775	...	28.9329
Netherlands guilders	L	5.6420	31.1175	115.235	35.39	1.710	3.4560	...
	C	5.51640	30.4251	112.673	34.6032	1.61030	3.37938	...
	U	5.3935	29.7475	110.1675	33.8325	1.5165	3.3040	...

Source: EC Commission.

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

Table 3. Current Account Developments in EMS Countries, 1977-86

	Average 1977-81	1982	1983	1984	1985 1/	1986 2/
	(In billions of U.S. dollars)					
Trade balance 3/						
Belgium/Luxembourg	-2.8	-2.3	-0.7	-0.1	0.7	2.5
Denmark	-2.3	-0.8	0.2	-0.2	-0.7	0.4
France	-6.0	-15.9	-8.4	-4.6	-4.2	3.2
Germany	18.3	26.7	23.3	23.4	29.3	49.1
Ireland	-1.7	-1.1	-0.2	0.3	0.7	1.2
Italy	-5.0	-8.0	-3.1	-6.1	-6.9	-2.7
Netherlands	-0.1	4.6	4.3	5.6	5.5	6.5
Services and private transfers						
Belgium/Luxembourg	0.8	0.8	1.2	0.8	0.7	0.3
Denmark	-0.1	-1.3	-1.3	-1.5	-1.8	-2.4
France	8.2	6.4	5.8	5.7	6.4	8.6
Germany	-15.3	-16.6	-13.3	-10.2	-9.9	-14.6
Ireland	-0.7	-1.5	-1.7	-2.0	-2.1	-2.7
Italy	5.1	3.1	4.1	3.4	3.2	5.1
Netherlands	--	-0.2	-0.1	-0.1	0.1	-0.1
Official transfers						
Belgium/Luxembourg	-0.7	-1.0	-0.9	-0.7	-0.6	-0.8
Denmark	0.3	-0.1	-0.1	0.1	-0.1	-0.1
France	-1.7	-2.7	-2.1	-1.9	-1.9	-2.8
Germany	-5.8	-6.7	-5.9	-6.4	-6.2	-8.9
Ireland	0.8	0.8	0.8	0.8	0.9	1.0
Italy	-0.8	-0.6	-0.2	-0.2	-0.3	-0.4
Netherlands	-0.4	-0.8	-0.4	-0.5	-0.6	-0.7
Current account balance 4/						
Belgium/Luxembourg	-2.7	-2.5	-0.4	--	0.7	2.0
Denmark	-2.1	-2.3	-1.2	-1.6	-2.6	-2.1
France	0.6	-12.1	-4.7	-0.8	0.4	9.0
Germany	-2.8	3.4	4.1	6.8	13.2	25.5
Ireland	-1.6	-1.9	-1.2	-0.9	-0.5	-0.4
Italy	-0.7	-5.5	0.8	-2.9	-4.1	2.1
Netherlands	-0.6	3.6	3.8	4.9	4.9	5.7
	(In percent of GNP/GDP)					
Current account balance 4/						
Belgium/Luxembourg	-2.6	-2.7	-0.4	--	0.9	2.0
Denmark	-3.6	-4.1	-2.5	-3.2	-4.6	-2.8
France	0.1	-2.2	-0.9	-0.2	0.1	1.3
Germany	-0.3	0.5	0.6	1.1	2.1	2.9
Ireland	-10.2	-10.6	-6.8	-5.8	-3.3	-2.5
Italy	0.1	-1.6	0.2	-0.8	-1.1	0.4
Netherlands	-0.3	2.6	2.8	4.0	3.9	3.6

Source: IMF, World Economic Outlook Database.

1/ Partly estimated.
2/ Staff projections excluding realignment effects.
3/ On an f.o.b. basis.
4/ Including official transfers.

Table 4. Bilateral Trade Balances for the EMS Countries, 1984-85 1/

(In billions of U.S. dollars)

		Belgium/ Luxembourg	Denmark	France	Germany	Ireland	Italy	Netherlands	EMS 2/	World
Belgium/	1984		198.5	1,444.1	-796.3	-60.4	676.9	-3,189.9	-1,727.1	-3,607.4
Luxembourg	1985		297.0	1,741.7	-1,814.3	-114.9	920.4	-2,779.2	-1,749.3	-2,539.2
Denmark	1984	-216.3		-32.9	819.0	24.0	25.8	-361.2	-1,379.5	-677.8
	1985	-297.3		-56.6	-1,152.8	32.0	25.8	-332.4	-1,781.4	-1,154.1
France	1984	-529.2	21.1		-3,190.5	-215.8	-70.4	-1,904.9	-5,889.7	-6,171.0
	1985	-917.9	62.0		-3,217.4	-316.7	-181.2	-1,772.3	-6,343.5	-6,080.0
Germany	1984	1,818.9	1,028.9	5,397.9		-192.4	1,231.2	-3,906.4	5,378.1	18,720.0
	1985	2,668.9	1,314.2	5,018.0		-176.1	1,538.5	-4,120.4	6,243.1	25,421.0
Ireland	1984	207.9	-16.2	340.8	241.7		67.7	311.9	1,153.8	-35.4
	1985	199.5	-8.5	385.7	271.1		157.5	324.2	1,329.5	329.4
Italy	1984	-975.8	-80.8	-162.7	-1,555.3	-74.4		-2,009.7	-4,858.7	-10,913.2
	1985	-1,051.6	-106.2	-248.7	-2,393.2	-172.2		-2,119.2	-6,091.1	-12,518.3
Netherlands	1984	1,995.7	454.5	2,800.8	5,919.4	-187.7	1,851.7		12,834.4	3,483.5
	1985	2,501.5	422.2	2,694.4	5,872.9	-190.6	1,952.1		13,252.5	3,248.5

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

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. Trade balances are reported on an f.o.b./c.i.f. basis.
2/ EMS countries participating in the EMS exchange rate mechanism.

Table 5. Cost and Price Developments in EMS Countries, 1977-86

(In percent at annual rates)

	Average 1977-81	1982	1983	1984	1985 1/	1986 2/
GNP/GDP deflators						
Belgium	5.0	7.1	6.3	5.5	4.7	3.3
Denmark	8.9	10.5	8.2	5.6	5.0	4.3
France	10.6	12.6	9.5	7.1	5.9	4.3
Germany	4.1	4.3	3.3	1.9	2.1	2.5
Ireland	13.8	16.4	11.1	4.2	6.3	4.5
Italy	17.6	17.8	14.9	10.8	8.8	8.6
Luxembourg	5.7	7.9	7.6	6.8	5.3	3.5
Netherlands	5.3	6.3	1.6	2.6	2.3	0.3
Consumer prices						
Belgium	6.1	8.7	7.7	6.3	4.9	2.5
Denmark	11.0	10.1	6.9	6.3	4.7	2.5
France	11.3	11.8	9.6	7.4	5.8	2.2
Germany	4.3	5.3	3.3	2.4	2.2	--
Ireland	14.0	17.1	10.5	8.6	5.4	4.5
Italy	16.6	16.5	14.7	10.8	9.2	6.0
Luxembourg	5.8	9.4	8.7	5.6	4.1	2.5
Netherlands	5.7	5.9	2.8	3.3	2.3	--
Unit labor costs in manufacturing						
Belgium	3.9	3.3	1.8	3.9	3.1	1.2
Denmark	7.1	9.3	3.7	3.7	6.0	3.0
France	9.5	11.0	7.6	1.9	1.5	0.6
Germany	4.3	4.0	-1.0	-0.8	-0.6	1.6
Ireland	12.9	6.8	-2.1	-3.4	1.0	1.5
Italy	14.8	18.4	14.5	4.2	7.5	6.0
Luxembourg	...	3.7	-3.0	-5.0	1.0	1.5
Netherlands	2.7	4.2	-2.3	-5.6	-2.7	--
Export unit values						
Belgium/Luxembourg	6.8	13.8	6.5	7.5	3.3	-3.3
Denmark	10.0	11.4	3.9	7.6	4.2	-1.6
France	9.6	14.2	10.5	11.4	4.6	-9.5
Germany	4.8	4.4	1.3	3.5	3.9	-2.3
Ireland	11.0	11.1	8.8	8.4	4.4	-2.5
Italy	17.3	15.9	7.6	9.6	8.9	--
Netherlands	7.6	4.3	-0.8	7.5	1.8	-12.6

Sources: IMF, World Economic Outlook Database.

1/ Partly estimated.
2/ Staff projections excluding realignment effects.

Table 6. Changes in Relative Consumer Prices Adjusted for Exchange Rate Developments in the EMS Countries from 1979-I to 1985-IV 1/

(In percentage points)

	Belgium	Denmark	France	Germany	Ireland	Italy	Nether-lands
Belgium		-10.6	-16.7	-8.1	-35.7	-28.8	-7.1
Denmark	11.9		-6.8	2.8	-28.0	-20.3	4.0
France	20.1	7.3		10.3	-22.8	-14.5	11.5
Germany	8.8	-2.8	-9.4		-30.0	-22.5	1.1
Ireland	55.5	38.9	29.5	42.9		10.7	44.4
Italy	40.4	25.5	16.9	29.0	-9.7		30.4
Netherlands	7.7	-3.8	-10.3	-1.1	-30.8	-23.3	

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

Table 7. 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)		1.6	3.4	-28.0	-6.8	13.0	-22.8
	(b)		-13.4	-25.4	3.8	-28.0	-42.4	23.6
Denmark	(a)	-1.6		1.9	-30.0	-8.4	11.6	-24.8
	(b)	15.6		-13.8	20.0	-16.7	-33.4	42.8
France	(a)	-3.5	-1.9		-32.5	-10.5	9.9	-27.2
	(b)	34.1	16.0		39.3	-3.4	-22.7	65.7
Germany	(a)	21.8	23.1	24.5		16.6	32.0	4.0
	(b)	-3.7	-16.7	-28.2		-30.6	-44.5	19.0
Ireland	(a)	6.3	7.8	9.5	-19.9		18.5	-15.1
	(b)	38.9	20.1	3.5	44.2		-20.0	71.6
Italy	(a)	-14.9	-13.1	-11.0	-47.1	-22.7		-41.2
	(b)	73.5	50.1	29.4	80.2	25.0		114.4
Netherlands	(a)	18.6	19.9	21.4	-4.2	13.1	29.2	
	(b)	-19.1	-30.0	-39.7	-16.0	-41.7	-53.4	

Source: IMF staff estimates.

1/ Changes between 1979-I and 1985-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.

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	Nether-lands
1979	98.0	97.1	101.6	98.2	106.5	105.2	96.3
1980	93.5	87.0	106.6	97.3	121.1	105.6	92.8
1981	90.5	87.3	108.7	95.5	125.7	111.9	87.3
1982	79.6	85.7	103.5	98.8	134.2	117.0	90.3
1983	76.4	84.6	99.9	98.4	123.6	127.0	88.6
1984	77.8	85.7	99.6	99.6	116.4	128.3	82.3
1985 2/	79.9	91.0	101.7	97.9	116.3	128.2	80.5
1982 I	85.7	88.1	108.0	95.4	130.4	114.6	89.0
II	78.3	87.2	107.4	97.5	135.6	115.7	88.6
III	77.3	85.5	99.9	101.5	137.3	117.5	90.5
IV	77.2	82.1	98.7	100.6	133.5	120.2	93.3
1983 I	76.7	85.2	101.5	97.8	123.9	124.2	90.7
II	76.7	85.0	99.1	98.1	125.3	127.4	90.4
III	76.3	83.7	99.5	99.0	124.4	127.6	86.8
IV	76.0	84.5	99.4	98.8	120.8	128.6	86.4
1984 I	75.7	83.9	98.8	102.4	120.9	124.7	82.2
II	78.3	86.1	100.3	99.1	113.4	128.3	82.0
III	79.2	86.1	99.1	98.0	119.8	131.0	83.3
IV	78.2	86.8	100.3	98.9	111.7	129.2	81.7
1985 I	80.1	91.4	101.1	97.0	112.2	131.2	80.5
II	79.7	90.6	101.2	98.3	116.3	128.1	80.4
III	80.0	91.1	102.7	98.3	120.4	125.3	80.5

Source: IMF Datafund; 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/ First three quarters only.

Table 9. 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 = 100)

	Belgium	Denmark	France	Germany	Ireland	Italy	Nether-lands
1979	97.6	96.5	101.1	98.2	103.1	104.5	95.9
1980	91.6	84.0	103.6	95.6	108.4	103.0	90.8
1981	85.1	78.0	97.5	86.7	103.8	100.4	80.4
1982	75.3	77.6	93.0	88.3	109.9	104.1	82.5
1983	72.7	78.1	90.6	88.5	103.7	112.3	81.0
1984	72.8	76.1	87.2	86.0	94.3	109.5	73.3
1985 2/	73.5	78.3	86.1	82.1	100.0	106.0	70.0
1982 I	80.9	79.2	96.5	86.1	107.8	102.0	81.5
II	73.8	78.1	95.6	87.0	110.9	102.5	80.6
III	73.1	77.1	90.1	90.0	111.4	104.6	82.5
IV	73.4	75.9	89.8	90.2	109.6	107.4	85.5
1983 I	74.2	80.9	94.2	90.5	108.4	112.9	84.8
II	73.0	78.6	90.1	88.5	104.7	112.9	82.7
III	72.3	76.5	89.6	88.0	102.7	111.9	78.8
IV	71.5	76.4	88.4	86.8	98.8	111.4	77.7
1984 I	71.2	75.7	87.8	89.1	98.7	108.3	74.0
II	73.9	77.7	89.3	87.2	93.8	111.4	74.0
III	73.7	75.7	86.1	84.1	96.1	110.5	73.6
IV	72.3	75.3	85.7	83.4	88.7	107.6	71.5
1985 I	73.8	78.5	85.1	80.9	88.9	107.3	69.7
II	73.1	77.6	85.4	82.1	90.2	105.6	69.7
III	73.7	78.8	87.8	83.3	93.8	105.0	70.6

Source: IMF Datafund, and staff calculations.

1/ Unit labor costs against the weighted average of unit labor costs of 17 industrial partner countries in common currency; weights are those used to calculate IFS relative unit labor costs for 17 industrial countries.

2/ First three quarters only.

Table 10. Indicators of the Stance of Fiscal Policy, 1983-86 1/

(In percent of GNP/GDP)

	1983	1984	1985	1986 2/
Central government fiscal balance				
Belgium	-12.7	-11.5	-12.0	-11.5
Denmark	-10.5	-7.7	-4.3	0.2
France	-3.3	-3.4	-3.3	-3.0
Germany	-1.9	-1.6	-1.3	-1.3
Ireland	-13.8	-12.4	-12.9	-11.8
Italy	-16.4	-15.5	-15.9	-14.9
Luxembourg	-2.6	0.7	0.5	0.3
Netherlands	-9.1	-8.2	-5.9	-5.4
General government fiscal balance				
Belgium	-15.2	-12.6	-13.0	-12.1
Denmark	-7.1	-4.2	-1.5	3.3
France	-3.1	-2.8	-2.5	-2.5
Germany	-2.5	-1.9	-1.1	-0.8
Ireland 3/	-17.7	-16.4	-15.7	-14.2
Italy	-11.7	-13.0	-14.1	-12.9
Luxembourg	...	...	...	...
Netherlands	-9.6	-8.3	-6.5	-6.0

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

(In percent)

	Average 1977-81	1982	1983	1984	1985 1/	1986 2/
Domestic credit expansion 3/						
Belgium	13.0	10.7	14.3	6.6	6.0	5.0
Denmark	9.5	13.3	22.2	24.7	15.1	...
France	11.3	15.6	13.6	8.5	6.1	4.8
Germany	9.7	6.6	6.5	6.0	5.3	5.5
Ireland	22.3	15.5	12.3	13.6	3.2	5.0
Italy	18.8	20.9	20.7	20.3	18.0	14.0
Luxembourg	...	...	...	...	...	...
Netherlands	15.5	4.3	4.6	5.8	5.0	4.0
Expansion of broad money 3/ 4/						
Belgium	6.3	7.2	8.3	4.5	4.5	4.5
Denmark 5/	9.3	11.8	25.5	17.0	15.8	...
France	11.3	10.8	11.2	8.3	7.0	6.0
Germany	7.6	7.1	5.3	4.7	5.0	5.5
Ireland 5/	17.8	12.9	5.6	10.1	7.8	8.5
Italy 5/	17.6	18.0	12.3	12.1	10.7	10.5
Luxembourg 5/	14.2	1.2	7.3	0.6	12.6	...
Netherlands	9.9	5.3	5.0	7.6	5.5	3.5

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

1/ Partly estimated by staff.
2/ Staff projections.
3/ From end of period one year before.
4/ Broad money is defined as the sum of money and quasi-money in the IFS definition, unless otherwise indicated.
5/ National authorities' definition of broad money; for Denmark, data exclude certain deposits and include treasury bills held by nonbanks; for Ireland, figures refer to M3.

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

(Period averages in percent per annum)

	Belgium	Denmark	France	Germany	Ireland	Italy	Luxembourg	Netherlands
Call money rate 1/								
1984 I	8.7	11.0	12.4	5.5	12.2	17.8	8.7	5.9
II	9.9	11.7	12.1	5.5	11.5	17.1	9.9	5.7
III	9.8	11.2	11.4	5.5	12.3	16.9	9.8	5.9
IV	9.5	12.2	11.1	5.6	13.5	17.3	9.5	5.7
1985 I	9.1	8.5	10.6	5.7	15.0	16.2	9.1	6.4
II	8.7	10.2	10.3	5.6	12.4	15.5	8.7	6.9
III	7.6	9.3	9.7	4.8	10.5	14.7	7.6	6.1
IV	7.6	9.4	9.2	4.6	9.9	14.7	7.6	5.8
1986 I 2/	8.5	...	8.8	4.6	...	16.2	8.5	5.8
Government bond yield								
1984 I	12.1	13.4	12.5	8.0	14.1	16.3	10.0	8.5
II	12.2	14.2	12.8	8.0	14.4	15.7	10.3	8.5
III	12.0	14.5	12.4	7.9	14.9	15.4	10.5	8.5
IV	11.7	14.1	11.5	7.2	15.1	15.0	10.1	7.8
1985 I	11.6	13.2	11.4	7.4	14.3	13.4	9.8	7.8
II	11.3	12.0	10.9	7.1	12.7	13.8	9.7	7.6
III	10.4	10.7	10.8	6.5	11.6	14.0	9.4	7.0
IV	9.6	10.4	10.6	6.5	11.9	13.7	9.3	7.0
1986 I 2/	9.5	9.5	9.7	6.1	11.9	13.5	...	6.7

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

1/ For Denmark, one month interbank rate.
2/ Partly staff estimates.

Table 13. Unemployment Rate and GNP/GDP Growth Rate in EMS Countries, 1977-86

(In percent)

	Average 1977-81	1982	1983	1984	1985 1/	1986 2/
Unemployment rate 3/						
Belgium	8.8	13.1	14.4	14.3	14.3	14.4
Denmark	7.2	9.8	10.5	10.0	9.0	7.8
France	6.2	8.4	8.6	10.1	10.8	11.1
Germany	3.9	6.8	8.2	8.1	8.2	7.8
Ireland	8.6	12.1	14.7	16.3	17.5	18.0
Italy	7.6	10.0	9.9	10.4	10.6	10.8
Luxembourg	0.7	1.2	1.6	1.7	1.6	1.5
Netherlands	7.3	14.2	17.1	17.2	15.6	14.7
Growth rate of real GNP/GDP						
Belgium	1.4	1.1	--	1.5	1.4	1.6
Denmark	1.3	3.0	2.1	3.5	3.0	2.6
France	2.3	1.8	0.7	1.6	1.1	2.4
Germany	2.2	-1.0	1.5	3.0	2.4	3.7
Ireland	4.4	-2.3	-1.8	2.4	0.5	2.0
Italy	2.7	-0.5	-0.2	2.8	2.3	2.3
Luxembourg	2.1	0.9	1.9	2.5	2.0	1.8
Netherlands	1.4	-1.8	1.4	1.8	2.1	2.1

Sources: National sources; and IMF staff estimates.

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

Table 14. Illustrative Changes in Effective Exchange Rates Due to EMS Realignment of April 6, 1986

(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	-1.94	-0.56	0.31
Danish krone	-1.94	-1.12	0.41
Deutsche mark	...	1.47	3.49
French franc	-5.83	-5.56	-4.84
Irish pound	-2.91	-2.03	-0.61
Italian lira	-2.91	-1.83	-0.64
Netherlands guilder	--	1.34	2.43

Source: Staff calculations.

1/ Illustrative calculation (using MERM weights) on the assumption that the exchange rates of third currencies vis-à-vis the deutsche mark remain at their levels immediately prior to the realignment. A negative number indicates an effective depreciation.

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

APPENDIX I

European Communities, Brussels, April 6, 1986

Communiqué

On 6 April 1986, 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.

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

- German Mark:	+3.0 percent
- Dutch guilder:	+3.0 percent
- Belgian franc:	+1.0 percent
- Luxembourg franc:	+1.0 percent
- Danish krone:	+1.0 percent
- Irish pound:	0.0 percent
- Italian lira:	0.0 percent
- French franc:	-3.0 percent

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

DM	2.13834
HFL	2.40935
BFR	43.6761
LFR	43.6761
DKR	7.91896
IRL	0.712956
LIT	1496.21
FF	6.9628
UKL	0.630317
DRA	135.659

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 7 April 1986.

The Ministers have requested that the agri-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 negative monetary compensatory amounts are created or modified by these central rates adjustments will not request changes in the compensatory amounts now introduced before the end of the current agricultural price fixing round, and it is noted that the Commission will not make any proposal to that effect.

Exchange Rate Developments in the European Monetary System in 1985-86

After reaching a peak of DM 3.47 per US$1 on February 26, 1985, the U.S. dollar has been depreciating vis-à-vis the European currencies (Chart 1). The gradual depreciation of the dollar did not significantly affect the relative position of EMS currencies within the EMS band in the first half of 1985: the Danish krone and the Irish pound remained in the upper half of the narrow band, while the Netherlands guilder and the deutsche mark remained in the lower half (Chart 2); however, the French franc appreciated gradually and moved into the upper half of the narrow band in the second quarter of 1985, while the Italian lira, which had been in the upper half of the wide band in January-February 1985, moved to the lower part in March and remained there until July (Chart 3).

The performance of the Italian economy deteriorated significantly in the first half of 1985, especially in the fiscal and external accounts. The marked worsening of the current account reflected primarily the maintenance of a rate of growth in domestic demand higher than that of Italy's partners as well as the lagged effects of a significant loss of competitiveness vis-à-vis other EMS countries over the previous two years. To halt the deterioration of the external position, in July 1985 the Italian authorities called for a realignment of exchange rates within the EMS. Effective July 22, the lira was devalued by 6 percent and the other participating currencies revalued by 2 percent, implying a devaluation of the lira by 7.8 percent in terms of foreign currency per lira. 1/

The July 22 realignment was not preceded by substantial pressures on the exchange rate of the lira or on reserves, except on July 19, 1985 when, with the Bank of Italy abstaining from intervention in anticipation of a realignment over the weekend, a thin market was temporarily upset by a sizeable transaction; at this point, the authorities decided to close the market early.

Following the realignment, the Italian lira was kept in the upper half of the wide band until April, 1986. Toward the end of July 1985 and in early August, there was some speculation of a further realignment, directed against the French and Belgian francs. This speculation pushed up the forward discounts of those two currencies substantially and the respective central banks intervened to support their currencies. Despite these periods of tension, the French franc continued its upward movement in the band, but the Belgian franc remained at the bottom of the narrow band, though well within the permitted range, reflecting the continuing policy of intramarginal intervention. In contrast to developments after previous general realignments, the deutsche mark and the Netherlands guilder moved to the upper part of the narrow band in August.

1/ See SM/85/213 (7/29/85).

The exchange market reaction to the G-5 communiqué of September 22, 1985 was swift. The EMS currencies appreciated by 6 percent against the U.S. dollar on September 23, and by a further 1/2 percent the following day. By the end of September, the joint float had appreciated by 7 1/2 -8 percent against the dollar compared with September 20. The continuous downward movement of the dollar did not affect the relative position of EMS currencies until about December 1985, when the deutsche mark, together with the Netherlands guilder, moved sharply upward in the narrow band and the currencies of the smaller EMS members, such as the Danish krone and the Irish pound, weakened significantly.

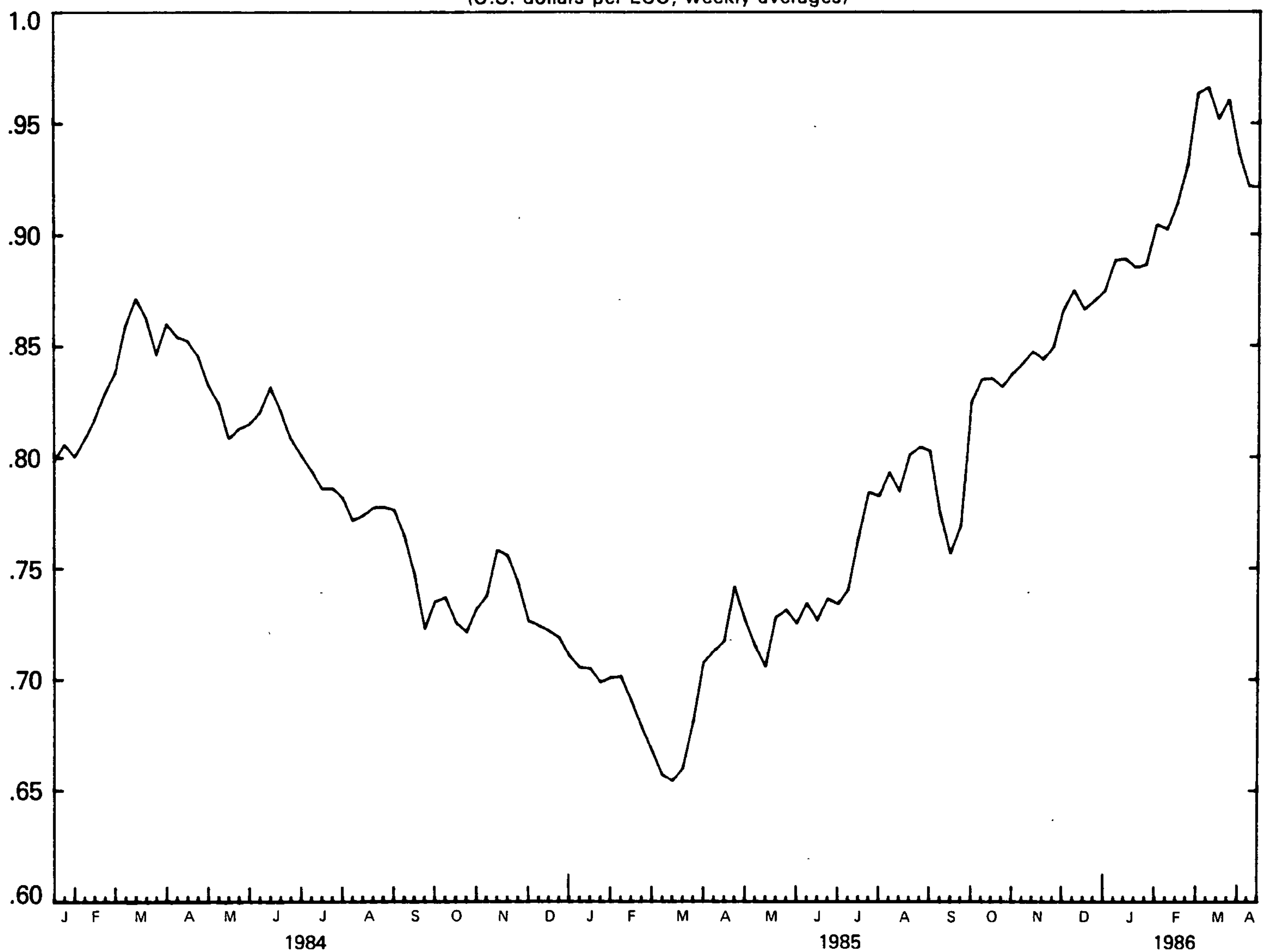
During the last few weeks of 1985 and early 1986, the Belgian franc, the Irish pound, and the Italian lira came under renewed downward pressure. To defend the franc, which has been at the bottom of the narrow band since March, 1985, the Belgian National Bank increased interest rates in December 1985 and intervened substantially in foreign exchange markets. The Italian authorities tightened monetary policy and reinstated some recently abolished foreign exchange control measures in January 1986 to ease pressure on the lira. To stem the private capital outflows and relieve pressures against the Irish pound, the Central Bank of Ireland raised the interest rate at which it provides short-term support to the money market in the course of the first quarter of 1986. As a result of these measures, as well as continuing sizeable intra-marginal intervention, the Belgian franc and the Irish pound remained above the lower intervention limit while the lira remained in the upper half of the wide band throughout the first quarter of 1986.

Exchange markets were generally calm in the month preceding the April realignment. The French franc weakened somewhat but remained in the upper half of the narrow band, while the Belgian franc and the Irish pound alternated at the bottom of the band. The Danish krone stabilized somewhat below its central rate, but well above the lower intervention limit. The deutsche mark and the Netherlands guilder were at the top of the band. The Italian lira, too, remained in the upper part of the wide band. Following the French elections on March 16, it appeared that markets considered an early exchange rate realignment, and a devaluation of the French franc, unlikely, as the three-month forward discount of the franc fell from an average of 6 percent per annum during the week before the elections to 4 percent per annum in the week thereafter.

CHART 1

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

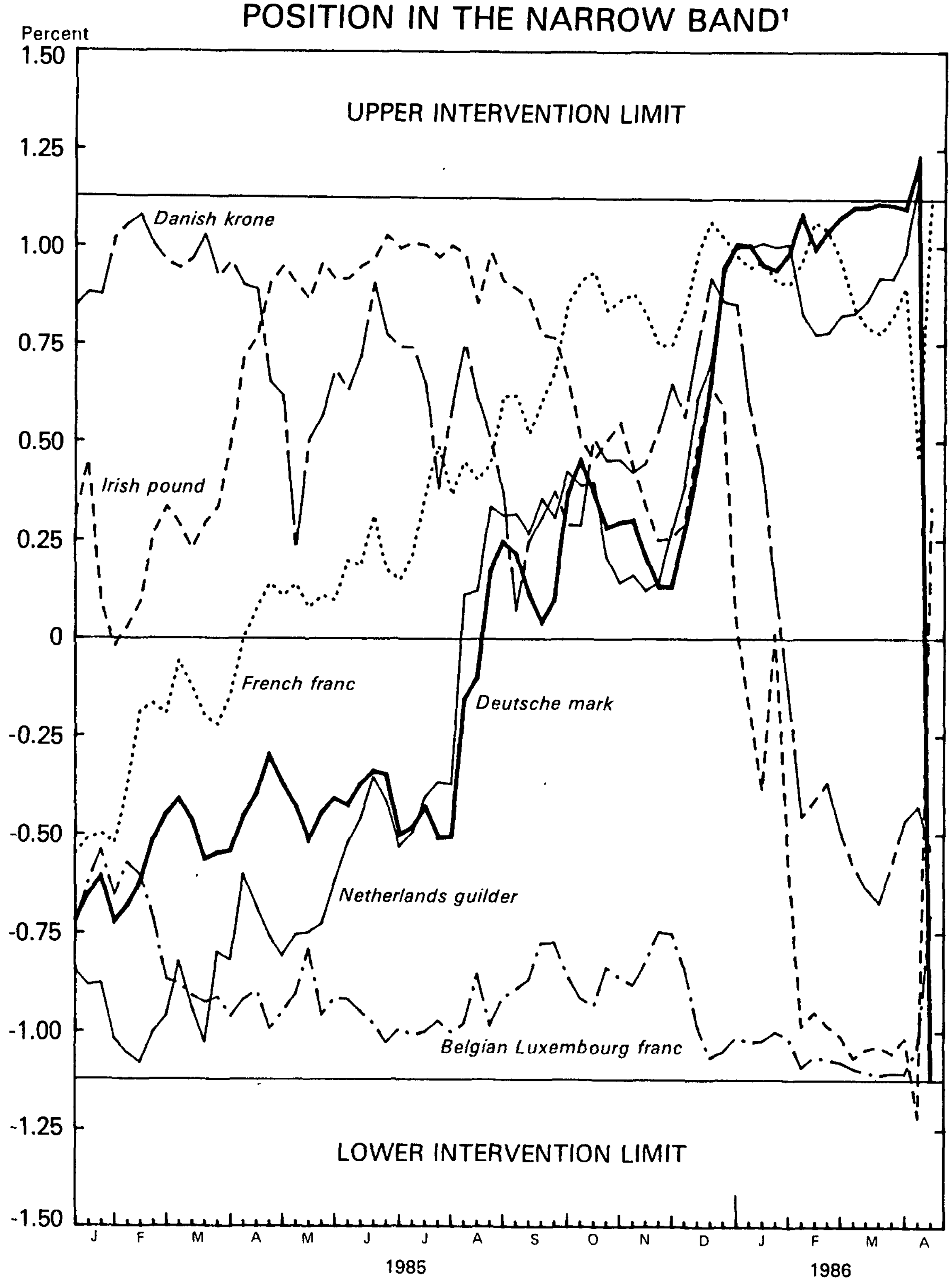
(U.S. dollars per ECU, weekly averages)



Source: IMF, *Data Fund.*

CHART 2

EMS
POSITION IN THE NARROW BAND[1]

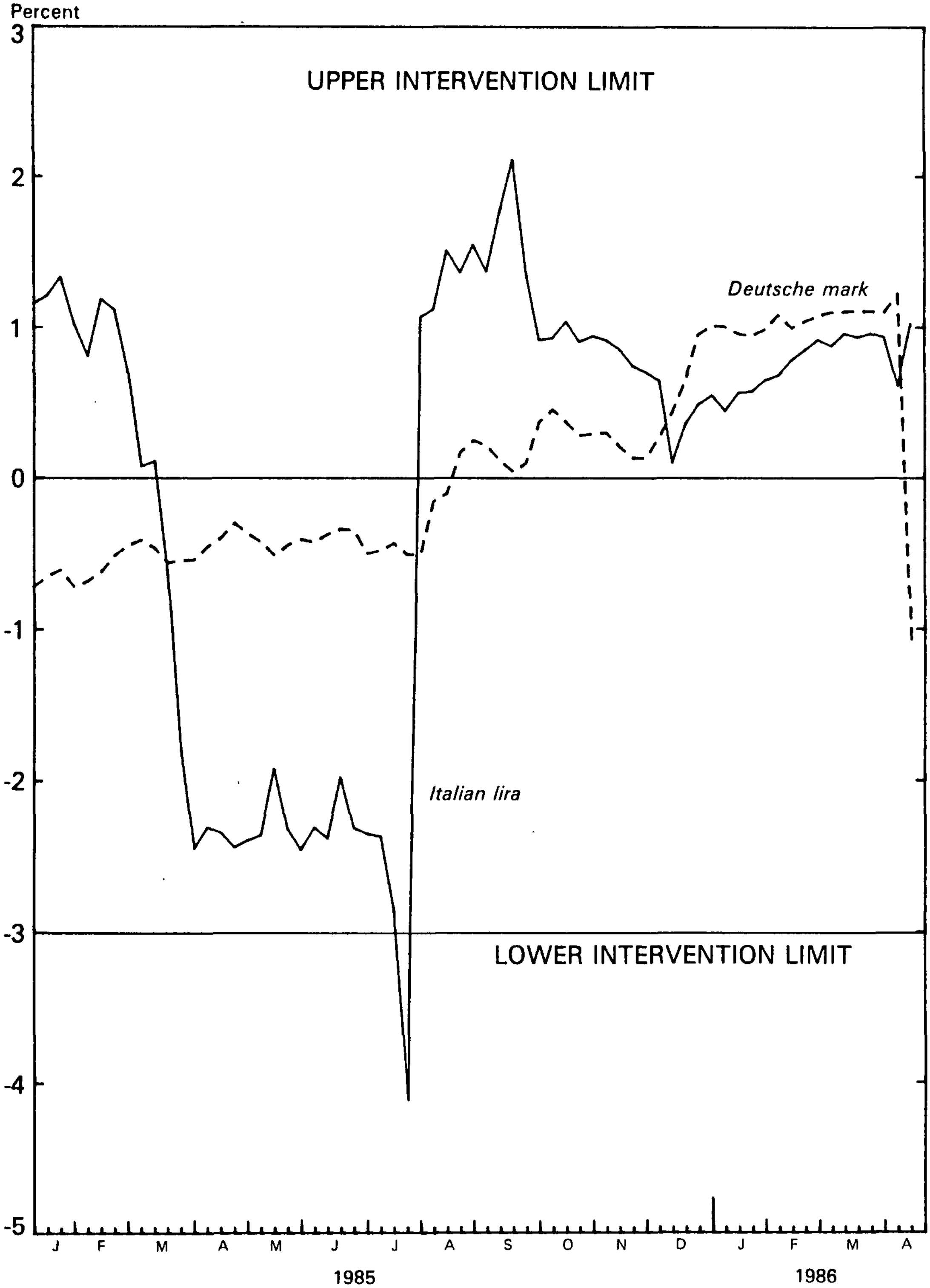


Sources: IMF, *Data Fund;* and staff calculations.

[1]Weekly averages; 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 hundred.

CHART 3

EMS
POSITION IN THE WIDE BAND[1]



Sources: IMF, *Data Fund;* and staff calculations.
[1]Weekly averages; 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 hundred

Country Notes

1. Belgium

Belgium's current account balance has improved markedly since 1981, moving from a deficit of around 4 percent of GNP in 1981 to a small surplus equivalent to 0.7 percent of GNP in 1985. The current account surplus is expected to strengthen in 1986 to around 2 percent of GNP. Autonomous capital outflows, which reached BF 199 million on a net basis in 1981, were reduced to BF 74 billion in 1985, reflecting a firmer interest rate policy. Taken together, these developments allowed the authorities to sharply cut compensatory borrowing from BF 241 billion in 1981 to BF 31 billion in 1985. Virtually all of this was concentrated in the final months of the year, as capital outflows once again widened. Compensatory borrowing to defend the Belgian franc continued during the opening months of 1986.

Most of the improvement in the current account during 1984-85 was due to terms of trade gains and to a cyclical growth differential between Belgium and its main trading partners averaging 1.3 percent. Unit labor cost developments point to a loss of competitiveness since 1984 vis-à-vis Belgium's three most important trading partners, especially Germany. However, this deterioration followed sizeable gains in competitiveness in the previous two years.

The firm interest rate policy pursued after the first quarter of 1984, together with the steady improvement in the current account, kept the Belgian franc relatively strong within the EMS through the opening months of 1985. Thereafter, reflecting declining inflation and favorable external trends, interest rates were permitted to decline and the treasury bill rate dropped from 11.1 percent in the first quarter to 9.1 percent in November 1985. As the decline in rates gathered momentum, the franc returned to its traditional position as the weakest currency in the system in the second half of the year. To arrest the franc's slide, short-term rates were increased at year-end and stood at 9.75 percent at the time of the realignment, slightly above the long-term government bond yield. After holding steady over the first half of 1985, the Belgian franc weakened somewhat against the deutsche mark in the final months of the year, and remained soft with respect to the mark in the opening months of 1986. Mainly reflecting the falling dollar, the franc's effective (MERM) exchange rate appreciated in the second half of 1985, and this appreciation reached 5.2 percent on a year-on-year basis in January 1986.

Price developments have been positive in recent months as the rate of inflation, as measured by consumer prices, fell to 1.5 percent in March 1986 on a year-on-year basis. This compares with an average inflation rate of 6.3 percent in 1984 and 4.9 percent in 1985. At 1.4 percent, GNP growth in 1985 remained well below the EEC average, but employment was stabilized, thanks to work-sharing schemes. The outlook for 1986 is that GNP may rise by around 1.6 percent, while inflation will remain moderate and employment will continue to be buoyed by labor sharing.

Fiscal developments continue to be a source of concern. The general government borrowing requirement remains at 13 percent of GNP, while total public debt has risen to close to 130 percent of GNP. The Government is preparing a package of measures designed to cut the fiscal deficit to 7 percent of GNP by 1989.

2. Denmark

The current account deficit, which had fallen to 2 percent of GDP in 1983, rose to 3 percent of GDP in 1984 and 4 1/2 percent of GDP in 1985, at a time when other EMS participants (except Italy) were improving their current account positions. Despite the weakening current account position, there was an overall payments surplus in both 1984 and 1985, on account of large private capital inflows. Net external debt increased to some 40 percent of GDP by the end of 1985.

Real GDP increased by 3 1/2 percent in 1984 and a further 3 percent in 1985, with real domestic demand rising by more than 4 percent in each year. Private sector employment rose strongly and the rate of unemployment dropped to 8 percent at end-1985. Wage inflation has fallen to about 5 percent, which, although above official targets, has been consistent with a decline in consumer price inflation to 2 percent in the 12 months to February 1986, aided by the declining dollar and falling oil prices. Nevertheless, official concern has emerged about the rate of wage inflation in construction and other key sectors.

The rapid deterioration in the external accounts in 1984 and 1985 was especially attributable to more rapid growth of demand than in partner countries, and in particular to the boom in investment and consumer durable spending--each of which has high import content--following the decline in bond yields from a peak of 22 percent in the autumn of 1982 to 10 percent at the end of 1985. The Danish policy mix has combined tight fiscal policy with a marked easing of monetary conditions. The public sector deficit declined from 9 percent of GDP in 1982 to 1 1/2 percent in 1985, with a 3 1/4 percent of GDP surplus forecast for 1986; this impressive fiscal adjustment has been made possible by firm expenditure restraint, some discretionary tax increases, and a pronounced cyclical pickup in revenue.

The strength of the economic recovery has continued to surprise the authorities and force midcourse adjustments. In April 1985, a statutory incomes policy intervention was needed to resolve a deadlock in the biennial wage negotiations and prevent a continuation of widespread labor market disruptions. In December 1985, when it became clear that the desired moderation of the pace of demand and the expected turnaround in the current account were not taking place, a package of fiscal measures was introduced, taking the opportunity provided by lower oil prices to raise energy taxes, and cutting back public construction in the hope of curbing wage overheating in that sector. After the December package was introduced, it became clear that the economy in 1985 and the beginning of 1986 had been even more buoyant, and the current account deficit wider than earlier thought. The authorities therefore introduced an additional package of revenue measures in mid-March with an expected full year yield of 1 1/2 percent of GDP, designed to curb the growth of domestic demand and to ensure that the oil price induced terms of trade gain generates a substantial reduction in the external current account deficit. A current account deficit of 2 3/4 percent of GDP is now expected for 1986.

The krone, which had traded in the upper half of the EMS narrow band for most of 1985, had been in the lower half of the band in 1986 up to the realignment, though not close to its intervention limits. Private capital inflows were strong in the last quarter of 1985 but weakened in the early months of 1986. Gross official reserves rose by SDR 1.9 billion to SDR 5 billion (13 weeks of merchandise imports) in 1985, before falling to SDR 4.5 billion at end-February 1986.

By February 1986, the nominal effective exchange rate (MERM) was 12 percent higher than in February 1985, and 9 percent above the 1984 average. At the end of 1984, the real effective exchange rate stood 18 percent below its 1979 average, but by the third quarter of 1985 it had risen by 4 1/2 percent (reflecting the weakening of the dollar) and no doubt has increased further since then, though firm figures are not yet available.

3. France

France's external accounts have strengthened considerably since the general EMS realignment of March 1983. The current account balance has improved from a deficit of F 79.3 billion (2.2 percent of GDP) in 1982 to a surplus of F 31 billion in 1985, and is projected to increase to F 60-65 billion (1.3 percent of GDP) in the current year, largely because of lower prices for imported energy. Autonomous long-term capital outflows declined by about F 30 billion between 1982 and 1985, while official reserves increased by an average of F 32 billion per year.

The substantial swing in the current account since 1982 has occurred despite weaknesses in France's external competitive position. The real depreciation of the franc that resulted from the March 1983 realignment and from the appreciation of the dollar against the franc and most other currencies between 1983 and early 1985 has not been accompanied by any gain in France's export market shares, while import penetration continued to increase at a rapid rate. The improvement in the current account therefore required a substantial measure of demand restraint, and a cyclical growth differential between France and her major trading partners that averaged 2.3 percent per year in 1983-85.

The decline in inflation in France to its present rate of about 3.4 percent in year-over-year terms has narrowed--but not eliminated--the gap in rates of inflation between France and Germany, which now stands at around 2.5 percentage points, and the cumulative inflation differential since March 1983 is 12 percentage points. By contrast, the cumulative differential for unit labor costs in manufacturing has been held down to about 6 percentage points, mainly because of lower real wage gains in France.

Overall, France's real effective exchange rate (on the basis of unit labor costs) appreciated by an estimated 8 percent in the year ending in March 1986, and was at that time 6 percent above its level just after the March 1983 realignment. This loss of competitiveness was mostly due to the recent decline in the U.S. dollar. By comparison, the cumulative gap in rates of consumer price inflation between France and her major trading partners amounted to about 5 percentage points between March 1983 and March 1986.

Since 1982-83, a main objective of macroeconomic policy in France has been the re-establishment of external balance. For this purpose, demand management has been based on a moderately restrictive fiscal stance and a normative incomes policy that has allowed virtually no growth in real personal incomes. Some tightening of the fiscal stance is expected for 1986, but the terms of trade gain resulting from lower oil prices will boost real incomes and final demand. Consumer price inflation is expected to decelerate from 4.7 percent at the end of 1985 to less than 3 percent by the end of 1986, and hourly wage increases may decline from their present annual rate of 5.5 percent to below 5 percent. Real GDP growth is projected to accelerate from about 1 percent in 1985 to about 2 percent in 1986, despite a negative contribution from the foreign sector.

Monetary policy, in terms of the setting of short-term interest rates, has been largely a function of external considerations. After the 1983 realignment, the improvement in capital flows allowed a progressive but cautious reduction in domestic interest rates which, however, have remained significantly larger than the German rates. The money supply, by contrast, persistently outstripped its target range, lately in direct consequence of the positive external contribution. The favorable balance of payments developments also permitted a partial dismantling of the various exchange controls introduced in the 1981-83 period.

4. Germany

Following three years of deficits averaging about 1 percent of GNP during 1979-81, the current account has recorded growing surpluses, owing mainly to a stronger showing on trade, but also to a strengthening on the services account. The current account surplus was 1 percent of GNP in 1984 and 2 percent in 1985. The improvement in the trade balance in 1984 and 1985 reflected strong merchandise export volume growth, 9 1/2 percent in 1984 and 6 1/2 percent in 1985, while import volume increased by only about 5 1/2 percent and 4 1/2 percent in these years, respectively. Both the relative cyclical position of Germany and improved competitiveness helped initiate an increase in non-oil export volume that exceeded Germany's export market growth by about 2 percentage points in both 1984 and 1985. In 1986, the current account surplus is expected to increase to almost 3 percent of GNP, owing largely to an improvement in the terms of trade, which is expected to be offset only partially by changes in real trade flows.

In 1983 and 1984, the current account surpluses were balanced by outflows of both short- and long-term capital. Net long term outflows were small in 1985, while short term outflows were large. Net official reserves had fallen through 1983 and 1984, and fell sharply again in the first quarter of 1985. Although they rose somewhat thereafter, by the end of 1985 they were still slightly below their level of a year earlier.

Despite a steady improvement in Germany's current account position, the deutsche mark depreciated markedly against the U.S. dollar from mid-1980 until the end of February 1985. From the second quarter of 1983, when the last major realignment in the EMS took place, to the first quarter of 1985, the deutsche mark depreciated by 23 1/2 percent against the U.S. dollar, 7 1/2 percent in nominal effective, and somewhat more in real effective terms. By the end of 1985, however, the nominal effective value of the deutsche mark had recovered from this fall and was above its level of early 1983. The appreciation of the deutsche mark, both against the U.S. dollar and in effective terms, continued in the first quarter of 1986. In 1984 and 1985, the Bundesbank intervened in the exchange market at times when the demand for dollars appeared to be exaggerated. There were two major episodes of intervention: in September 1984, following a period of sharp appreciation, and at the end of February and the beginning of March 1985, as the dollar reached its peak. The Bundesbank also participated in the concerted intervention following the G-5 meeting in September 1985. The deutsche mark stayed in the lower part of the EMS band from the realignment in the EMS in 1983 until July 1985, several months after the fall of the dollar in terms of the deutsche mark started. In July it moved slightly above the middle, and in December it moved close to the upper limit of the EMS band, where it remained through the first quarter of 1986.

The rate of growth of GNP in 1985, at 2.4 percent, was somewhat below that of the previous year. In 1986, a strengthening of growth to 3 1/2 percent or more is expected. While domestic demand rose only modestly and net foreign demand contributed 1 percentage point to GNP growth in both 1984 and 1985, the more rapid growth in 1986 is expected to depend entirely on a marked strengthening of domestic demand. Domestic expenditures in 1986 will be boosted by an improvement in the terms of trade, a reduction in personal income taxes, and larger wage settlements than in the recent past. Unemployment has remained slightly above 8 percent since 1983, but employment increased by 3/4 percent in

1985, the first increase since 1980. After peaking at over 6 percent in 1981, the inflation rate (as measured by the rise in consumer prices) fell to less than 2 1/2 percent in both 1984 and 1985, and the consumer price index is expected to be virtually stable in 1986, owing to the improvement in the terms of trade. Since the last major EMS realignment, wage inflation has remained low, partly in response to the relatively stable consumer prices, so that productivity increases have kept unit labor costs on a declining path. Higher wage growth in 1986 is expected to raise unit labor costs moderately.

Monetary policy has followed a stable course in the past two years. Central bank money growth was 4 1/2 percent in both 1984 and 1985; for 1986, a growth rate in the range of 3 1/2-5 1/2 percent has been targeted for central bank money. Fiscal policy has been guided by the medium-term objectives of reducing both the fiscal deficit and the share of the public sector in GNP. In line with this policy, the general government deficit has been lowered from a peak of 3 3/4 percent of GNP in 1981 to just over 1 percent in 1985, and the ratio of general government expenditure to GNP has been reduced from 49 3/4 percent in 1982 to 47 3/4 percent in 1985. The strict control of public expenditure has, moreover, facilitated a reduction of personal income taxes equivalent to 1/2 percent of GNP in 1986 without reversing the downward trend in the deficit.

5. Ireland

Economic policies in Ireland since the last general EMS realignment in early 1983 have continued to be aimed at reducing the large domestic and external imbalances and lowering the inflation rate to the average for the main trading partners. The progress made so far, however, has been uneven. The external current account deficit was reduced in relation to GNP from 10.7 percent in 1982 (and a peak of 14.7 percent in 1981) to 3.3 percent in 1985, despite large increases in interest payments on foreign debt and in profit remittances by foreign firms. The improvement in the external position reflected mainly rapid growth in industrial exports, which exceeded by a large margin the growth in export markets, and the subdued demand for imports associated with the weakness in domestic demand. The latter was brought about in part by the adjustment policies pursued since mid-1981 by the Irish authorities, which have focused on measures to reduce the large fiscal imbalances and to contain the growth in labor incomes. External public debt, however, rose further from about 56 percent of GNP in 1982 to over 67 percent by September 1985, owing in part to valuation changes, while the debt service ratio appears to have stabilized at about 18 percent.

Real GNP has grown at a modest pace (on average by about 0.5 percent per annum during 1982-85), while the unemployment rate has continued to rise, reaching 18 percent by the end of 1985. The annual rate of increase in consumer prices fell sharply from over 17 percent in 1982 to 5 percent by the end of 1985, mainly on account of a slowdown in import price increases and a significant moderation in domestic cost increases. The annual rate of growth in average hourly earnings in the manufacturing sector decelerated from 14.4 percent in 1982 to 6.5 percent in 1985.

On the policy front, the fiscal position improved markedly in 1983, but the pace of fiscal retrenchment has slackened considerably since 1984, reflecting in part the authorities' concern to arrest the deteriorating conditions in the labor market. The imbalances in the public accounts are still very large. In 1985, the current budget deficit exceeded 8 percent of GNP, while the Exchequer borrowing requirement (EBR) amounted to 13 percent. The budget for 1986 provides for a fall in the current budget deficit to 7.4 percent of GNP and the EBR to 11.8 percent. The reduction in the relative size of the EBR since 1982, coupled with the progress made in raising the share of domestic nonbank financing of the EBR, has allowed a significant slowdown in domestic credit expansion. Nevertheless, the rate of increase in broad money remains higher than in most other EMS countries.

Following the EMS realignment in March 1983, the Irish pound moved to the upper half of the EMS band where it remained, except for a brief period during June and July 1984, until the end of 1985. However, in the first quarter of 1986 it weakened relative to the other EMS currencies falling close to the bottom of the EMS band. According to staff estimates, the real (relative consumer prices) and nominal effective exchange rates of the Irish pound remained fairly stable between mid-1983 and mid-1985, but both rose by more than 6 percent in the second half of 1985. Relative unit labor costs in manufacturing also have been on a rising trend during the first three quarters of 1985, reversing some of the decline that had taken place during 1983 and 1984.

In common with most other currencies, the Irish pound has appreciated markedly vis-à-vis the U.S. dollar since early 1985; by March 1986 its exchange rate relative to the U.S. dollar was about 42 percent higher than in February 1985. The Irish pound also appreciated vis-à-vis the pound sterling between late 1983 and January 1985, but then fell back to broadly the late-1983 level (£Ir 1 = £0.80). The weakening of sterling since mid-December 1985 led to a sharp increase in the pound sterling/Irish pound exchange rate to about £Ir 1 = £0.90 in February and March 1986, a level close to that reached immediately before the EMS realignment in March 1983. Given the significance of the United Kingdom to the Irish economy (accounting for some 40 percent of Ireland's external trade), the appreciation of the Irish pound vis-à-vis sterling created some uncertainty as to its sustainability. This uncertainty, together with expectations of a general EMS realignment, appears to have contributed to sizable private capital outflows during December 1985 and early 1986. To stem these outflows and the associated pressure against the Irish pound, the Central Bank of Ireland raised, in two stages, the interest rate at which it provides short-term support to the money market by a total of 3.5 percentage points to 13.8 percent;

immediately after the realignment, however, this rate was lowered to 12.5 percent. During the first quarter of 1986, bank lending rates rose also by 5 percentage points to about 15.5 percent.

6. Italy

After a surplus equivalent to 0.2 percent of GDP in 1983, Italy's current account moved into deficit in 1984 and 1985 (0.8 percent and 1.1 percent of GDP, respectively). The deterioration of the external accounts was almost entirely accounted for by a worsening trade deficit, largely as a result of an expansion in Italy's domestic demand significantly above its trading partners' through 1984 and the first half of 1985. Export growth was actually well in excess of market growth in both 1984 and 1985, but there was a significant increase in import penetration. The terms of trade worsened moderately in 1984 (-1.5 percent) but recovered slightly in 1985 (0.4 percent).

Following a small decline in 1983, real GDP rose cumulatively by over 5 percent during 1984-85, largely as a result of higher consumption and especially investment spending. Despite the growth in output and employment, the unemployment rate continued to rise, from 9.9 percent in 1983 to 10.6 percent in 1985. Consumer price inflation fell by about 2 percentage points through 1984 to 9.2 percent, and by a further 1/2 percentage point in 1985, as wage costs moderated in 1984 and import prices decelerated markedly in 1985. The economy-wide system of wage indexation--the scala mobile--was further reformed at the end of 1985, reducing the coverage and the frequency of wage adjustments.

The public finances and especially the state sector deficit remain the most serious imbalance in the Italian economy. As a share of GDP, the deficit of the state sector fell by about 0.9 percentage point to 15.5 percent in 1984, but widened again to almost 16 percent in 1985. After several years of a rather restrictive stance up to 1983, monetary policy was eased somewhat in 1984 and 1985. Largely due to increased Central Bank financing of the Treasury, the growth of the monetary base accelerated in real terms from 2.1 percent in 1983 to 5.6 percent in 1985, despite the heavy destruction of base money through the balance of payments during 1985.

The lira was relatively strong within the EMS in 1984 as capital inflows, influenced by relatively high nominal interest rate differentials and stable exchange rate expectations, more than compensated for the current account deficit, leading to an accumulation of official reserves (excluding gold) of over SDR 2 billion. In the first quarter of 1985, the lira weakened markedly as expectations of a devaluation more than outweighed the interest rate differentials. By the end of March, it had reached the lower part of the EMS wide band, despite some significant losses in official reserves (SDR 2.4 billion). The lira remained weak in the second quarter, but the Bank of Italy actually accumulated reserves (SDR 1.9 billion). The realignment of July 22 was not preceded by heavy pressures on the exchange rate or on reserves. In the week following the realignment, the lira/dollar and the lira/DM exchange rates were about 2.5 percent below their pre-realignment levels. During the second half of the year, the exchange rate was kept within the upper half of the wide EMS band through heavy intervention, totaling over SDR 7 billion. The lira depreciated vis-à-vis the U.S. dollar by 16.7 percent in 1984, but recovered in 1985, appreciating by 13.3 percent in the course of the year. In effective (MERM weighted) terms, the lira depreciated by 6.6 percent on average in 1984 and by a further 5.7 percent in 1985. In real terms the effective rate moved narrowly in 1984 (a depreciation of around 1 percent if measured by relative unit labor costs in manufacturing and an appreciation of just over 0.5 percent if measured by relative wholesale prices) but depreciated during the first three quarters of 1985 (-3.2 percent and -3.6 percent, respectively).

A moderate tightening of financial policies is programmed for 1986. The state sector deficit is targeted to decline to 14.6 percent of GDP, in reflection of revenue-raising measures and expenditure cuts introduced with the budget law for 1986. A significant deceleration of the monetary aggregates is targeted for 1986 as a whole. Total domestic credit is projected to slow by over 4.5 percentage points to 13.2 percent through the year, and the target for M2 is 9 percent, almost 2 percentage points less than in 1985. Total financial assets held by the private sector are projected to grow by 14.6 percent, 3 percentage points less than in 1985. In mid-January, and in an attempt to stem the large official reserve losses sustained during the second half of 1985, monetary policy and exchange controls were tightened. Ceilings on bank credit, which had been abolished in mid-1983 after being in force for about ten years, were reintroduced for six months, and short-term interest rates on treasury bills were raised by about 1 percentage point--the three-month rate reached 14.3 percent in January--and the recently abolished requirement that export credits be partly financed with external credit was also reintroduced.

The pressures on the foreign exchange market and official reserves subsided following the implementation of these measures. After the recent EMS exchange rate realignment, the improved reserve position and the favorable outlook for the external accounts allowed the Italian authorities to lift the foreign exchange restrictions introduced in mid-January, and to take additional liberalization measures concerning capital movements. Thus, on April 12, the requirement that export credits be partly financed with external credit was abolished and the rules governing foreign portfolio investment and capital re-exports by nonresidents were made less strict. In 1986, nominal interest rates are expected to fall broadly in line with the projected deceleration in inflation, and the discount rate was lowered by 1 percentage point to 14 percent on March 21. Following the January peak, the three-month treasury bill rate fell in February and March, and at the latest auction it was around 13.5 percent.

Prospects are for a significant improvement in Italy's economic performance in 1986, mainly reflecting the favorable external environment. The growth rate of GDP is expected to remain around 2.3 percent, while the rate of inflation in consumer prices will probably decline by almost 4 percentage points to around 5 percent by year-end. The current account of the balance of payments is likely to shift into a surplus equivalent to about 0.4 percent of GDP. The main elements of risk, which could jeopardize further progress in 1987 if unchecked, remain the size of the public sector deficit, which limits the scope for a decline in interest rates and the likelihood of sizable contractual wage increases, especially at the plant level. The Italian authorities' decision to keep unchanged the central rate of the lira underlines their belief in the importance of maintaining a degree of external discipline on domestic cost developments.

7. Luxembourg

After exceptionally strong growth in 1984, GDP growth fell to 2 percent in 1985, owing to the slowdown in steel production. The rate of unemployment remained by far the lowest in the EEC, and inflation subsided in line with the average of partner countries. However, unit labor costs, which had declined in the two preceding years, increased again in 1985, in part as a result of the return to full wage indexation. The external balance weakened in 1985 because the slowing down of steel export growth was accompanied by a fairly strong recovery of import demand by both consumers and investors.

Fiscal policy remained on the cautious side in 1985. The authorities have emphasized the continued need for a restructuring of the economy in view of the trend decline of the steel sector. As a result, they have left the largest part of "solidarity" surtaxes in favor of restructuring in place and have preferred to accumulate reserves and repay debt over reducing substantially the high tax burden. For 1986, expenditure increases slightly above the long-term norm of nominal GDP growth and taxes are reduced by the equivalent of 1 percent of GDP. Nevertheless, a moderate budget surplus can again be expected in 1986. Monetary policy is circumscribed by the openness of the economy and by the monetary association arrangement under which the Belgian franc is legal tender in Luxembourg.

8. Netherlands

Owing to the success of the Dutch economy in capturing larger market shares because of improved competitiveness, and to a favorable cyclical differential in the early 1980s, the current account surplus of the balance of payments has widened substantially since 1981. A surplus of 4 percent of GNP was recorded in both 1984 and 1985, and was mainly generated in the trade account. Export volumes rose by 5 1/2 percent in 1984 and by 5 percent in 1985, with nonenergy export growth exceeding external market growth by about 1 percentage point. Import volumes grew slightly faster in both years, so that the widening of the trade surplus primarily reflected gains in terms of trade.

The pursuit of a stable exchange rate relationship with the deutsche mark, reflected in the maintenance of a slight positive interest rate differential vis-à-vis that currency, allowed the guilder to occupy a generally strong position in the EMS-band in recent years. By end-1984, the position of the guilder weakened within the EMS, along with that of the deutsche mark. The guilder further weakened, also relative to the deutsche mark, during the first quarter of 1985, but its position was subsequently strengthened. Following the devaluation of the Italian lira in July 1985, the guilder returned to the upper half of the EMS-band.

In view of the strengthening of the U.S. dollar, the effective rate of the guilder (MERM-based) depreciated by 3 percent in 1984. The depreciation came to a halt in the latter part of 1985 when the dollar rapidly weakened, and, for the year as a whole, the guilder appreciated by 0.4 percent. In real terms, given that the labor cost competitiveness of the Dutch manufacturing sector continued to improve, the effective exchange rate of the guilder depreciated by nearly 9 percent in 1984 and by a further 5 percent during the first three quarters of 1985.

Supported by expanding export markets, real GNP grew by 1.4 percent and 1.8 percent in 1983 and 1984, respectively. More recently, a significant impulse to GNP growth came from an upturn in domestic demand, allowing GNP to rise by 2.1 percent in 1985. During the initial stages of the recovery in activity, employment failed to expand, but a modest increase in labor demand materialized in 1985, contributing to a decline in unemployment to 15 percent of the dependent labor force by end-1985, compared with 18 percent in early 1984. Despite the upturn in activity and the strengthening of domestic demand, inflation continued to decelerate from around 6 percent in 1982 to 2.3 percent in 1985.

To cope with the structural imbalances in the public finances, the Government embarked on a program of deficit reduction after 1982, to be implemented through expenditure cuts rather than through revenue increases. After an initial setback in 1983, when the deficit of the central government and local authorities rose to 10.7 percent of net national income (NNI), the fiscal effort began bearing fruit, with the deficit narrowing to 9.3 percent of NNI in 1984 and to 7.3 percent in 1985.

The sharp decline in petroleum prices in the opening months of 1986 is projected to have a stimulatory impact on consumer demand. External demand, however, is expected to weaken somewhat and the surplus on the current account should narrow to the equivalent of 3.6 percent of GNP in 1986. While the loss in public revenues from natural gas production is expected to remain limited in 1986, the weakening of natural gas prices is likely to strain public finances in 1987, and could entail a renewed rise in the government deficit in that year if no additional budgetary measures are taken.

The rate of monetary expansion consistently outstripped the growth of NNI. This expansion had its counterpart in a large inflow of foreign assets in 1984, but, more recently, it reflected a strengthening of private sector credit demand. The shift in the sources of monetary growth raised some concern among the monetary authorities and led to a more restrictive monetary stance in early 1986, when the monetary authorities decided to limit domestic money creation to the same rate as the rise in NNI.