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EXTERNAL ADJUSTMENT IN SMALL OPEN ECONOMIES -
SOME RECENT EXPERIENCE

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ABSTRACT

The paper deals with the adjustment problems that small open economies face in a financially integrated world. Particular attention is paid to the assignment of different policy instruments to the achievement of different policy targets. It is concluded that the possibilities to use monetary and fiscal policy instruments are highly dependent on the flexibility of wages and prices. It is, however, likely that monetary policy has to be increasingly geared towards the containment of inflation, while fiscal policy has to secure external balance. The possibilities to maintain employment is thus largely dependent on wage and price behaviour. The adjustment process of Australia, Denmark and Sweden is analyzed in order to shed some light on the role of the policy mix and to evaluate the importance of wage and price flexibility and the factors which influence the degree of flexibility.

Paper presented at the SUERF Colloquium on "The International Adjustment Process: New Perspectives, Recent Experience and Future Challenges for the Financial System" in Helsinki May 19-21, 1988.

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Introduction

The innovations in financial markets during the last few years have had a major impact on the economic policy environment in all countries. The innovations have constituted an international phenomenon; though most of them have been first introduced in the largest markets, they have quickly spread to the small countries. As a result, regulations of various kinds have become less and less effective, financial markets have developed quickly, and integration across borders has advanced at a rapid pace. This has imposed new limitations on national monetary policy. Many of the bigger countries have allowed their exchange rates to float in order to maintain the effectiveness of monetary policy.¹ However, in most of the small industrial economies the exchange rate has been fixed within the framework of monetary co-operation (EMS) or by pegging to single currencies or currency baskets. Hence, the external constraints on monetary policy have become increasingly apparent in these countries as monetary integration has proceeded. There is no doubt that this has also affected the division of labour between different policy instruments. But do these countries have any longer enough instruments to simultaneously maintain external and internal balance?

Helpful comments and suggestions by Juha Tarkka of the Bank of Finland are gratefully acknowledged. Any erroneous interpretations or conclusions are, however, solely the responsibility of the author.

1 According to the International Monetary Fund, 20 member countries maintained independently floating exchange rates at the beginning of 1987. Five of these countries belong to the OECD area, and of these three countries to the so-called big seven group within the OECD. See IMF, Exchange Arrangements and Exchange Restrictions, Annual report 1987.

In the following, the problems that small open economies face in adjustment to current account deficits are examined in some detail. First, recent discussions concerning the problem of assigning different policy instruments to solving different imbalances are referred to. After that the experience of three countries which have chosen rather different policy mixes to solve their external imbalances is analyzed.

The assignment problem

The Mundell-Fleming model was developed in the 1960's for the analysis of the relative effectiveness of monetary and fiscal policy². In the stylized versions the analysis assumed the existence of perfect capital mobility and static expectations. Hence the nominal interest rate was given from abroad. Furthermore, wages and prices were assumed to be rigid. Under these assumptions fiscal policy was shown to be more effective in securing internal balance under a fixed exchange rate regime, while monetary policy had a comparative advantage in the maintenance of external balance. The model predicted that, under a floating exchange rate regime, monetary policy would be highly efficient in controlling domestic demand, while fiscal policy would be impotent. It was also shown that, under a floating exchange rate regime, fiscal policy had a one-to-one impact on net exports (so-called exchange rate crowding out).

Recently, there has been renewed interest in the assignment problem, and the analysis has been elaborated in order to incorporate e.g. portfolio behaviour,

² For an exposition, see e.g. Swoboda and Dornbush (1973).

expectations as well as wage and price mechanisms.³ As a result of these new developments, there has perhaps arisen more scepticism as regards the existence of trade-offs which could be relied upon in the correction of external and internal disequilibria. As shown by Sachs (1980), exchange rate realignments will cease to be effective in influencing the external balance if wage-price links are strong enough (real wage rigidity). In these circumstances fiscal policy must be geared towards the maintenance of external balance, while monetary policy exerts a strong influence on inflation. This holds both under fixed and floating exchange rate regimes. If the interest rate (as compared with the rest of the world) reflects the expected rate of change in the currency's external value, the effectiveness of monetary policy as a demand management instrument is greatly reduced in a floating exchange rate regime as well (Genberg-Swoboda, 1987).

All this leads to some worrisome prospects as regards economic policy in general and the possibilities of economic policy in small open economies in particular. Given that the share of foreign trade tends to be bigger in small countries than in large economies, the risks that exchange rate changes spill over fairly quickly into domestic wage- and price developments will increase. In these circumstances, monetary policy will have a large impact on inflation because of its strong links to the exchange rate. But monetary policy will have only a minor or no impact at all on expenditure and the division of expenditure between domestic and foreign goods. If this were to be combined with downward stickiness in nominal wages, extremely uncomfortable situations might arise; an expansionary monetary policy and a related depreciation of the exchange rate are

³ A review of some of these aspects is given in Dornbusch (1987).

quickly caught up with, while a tightening of monetary policy and an appreciation cause an increase in the real wage and hence unemployment.

In these circumstances, fiscal policy would be the only effective instrument for demand management purposes and it would have to be assigned to securing external balance when that was considered an important policy target. There would in situations of severe external disequilibrium be no instrument available for securing internal balance, which would therefore be entirely dependent on wage and price flexibility.

However, at the same time there has been discussion about the influence of intertemporal budget constraints on the effectiveness of fiscal policy (see e.g. Frenkel and Razin, 1987). In the most extreme forms, it is argued that also fiscal policy will become ineffective as a demand management instrument because changes in public saving are offset by changes in private saving. Even if few subscribe to the most extreme views, there is, however, a possibility that the weight of this argument has increased with the development of financial markets; as the importance of credit rationing has been reduced, it has become easier for economic agents to decide on the time profile of spending.

In any case, there is another potential problem facing small economies. Small countries have, as a rule, to specialize in certain narrow export branches in order to achieve the necessary competitive edge. As a result, the opportunities to reallocate production between domestic and foreign markets are reduced. Restrictive fiscal policies improve the foreign balance by depressing demand and imports, but they do not help in switching production from the domestic market to the foreign market. Exports can be increased only after an adjustment of the domestic cost and price level, and the

necessary restrictive impact is, again, dependent on how fast domestic costs adjust to demand⁴.

A superficial look at developments during the 1980's indicates that there seems indeed to have been a stronger link between the current account balance and the fiscal balance in the big seven countries of the OECD than in the smaller countries (Diagram 1).

These deliberations point to the crucial role of wage and price flexibility for the maintainance of employment. The formation of inflationary expectations might not, however, be independent of the framework within which monetary policy operates, that is the exchange rate regime. In other words, there is a question as to whether the credibility of monetary policy is influenced by the exchange rate regime and whether credibility influences the flexibility of wages and prices. A floating exchange rate gives policy makers more room for manoeuvre. On the other hand, it also gives more room for expectations, and it might be difficult to inform and convince the markets about the target for monetary policy. If this causes uncertainty,

⁴ It is also often thought that small economies face a different demand curve in the international market than big economies. If small countries faced a more horizontal demand curve, they would have fewer chances to influence exports through relative cost reductions (barring long-term changes in capacity). However, this assumption is not supported by empirical evidence. E.g. the export price equations estimated by both the IMF and the OECD show that there is no systematic difference between large and small economies in the relative influence of domestic costs and competitors' prices on export prices (IMF (1984) and OECD (1987)). A study by Sukselainen (1986) shows that this might be due to the fact that even small countries have a strong influence on prices in markets for highly specialized goods, where their market share can be significant.

a risk premium might be built into both wages and interest rates which reduces the level of employment.

By contrast, pegging the exchange rates provides, assuming the target is trusted, an anchor to expectations and a norm for wage behaviour. That tends to reduce the costs related to maintaining a low rate of inflation. This is probably one of the major reasons why small countries have in most cases opted for some kind of a fixed exchange rate regime. However, countries can make adjustments to the peg at their own discretion in a fixed exchange rate regime as well. As recent history shows, countries which are pegging to baskets have in fact quite frequently resorted to depreciations. It is therefore often argued that the costs which arise because of a lack of confidence are further reduced if the country pegs its currency by participating in international currency co-operation.

By joining an international fixed exchange rate area like the EMS, the country could demonstrate a stronger commitment to a fixed exchange rate; a depreciation is no more a unilateral affair but requires the approval of all the participants in the currency area. Furthermore, short-term borrowing facilities and co-operative arrangements would be available in order to safeguard the financial base for intervention at times of market unrest. Hence, the risks of a depreciation are reduced, which should help reduce risk premia and impose more flexibility on the behaviour of the labour market. On the other hand, it must be noticed that realignments do take place within the co-operative arrangements as well, and this is bound to weaken the basis for this argument.

This raises several empirical questions. Are real wages sticky enough to make monetary policy (and exchange rate changes) impotent in influencing the external balance and/or domestic demand? How effective is fiscal policy,

and what is the relationship between fiscal and external balances? Does the exchange rate regime influence expectations and labour market flexibility, and does monetary co-operation increase confidence?

In order to shed some light on these questions, it might be useful to look at the experience of some countries with different policy mixes and adjustment patterns in the case of external imbalance. Accordingly, a brief review of the experience of Australia, Denmark and Sweden is given in the next section.⁵

Different adjustment patterns

All of these countries faced current account deficits amounting to 4-5 per cent of GDP in the early eighties, and it was considered a key policy task to reduce recourse to foreign savings. However, they chose different ways to achieve external balance, and during the latter half of the decade the record also seems to be quite different.

One of the basic differences in their policy approach is to be found in exchange rate policy. Denmark has pegged the exchange rate within different kinds of co-operative arrangements in the post-Bretton Woods period; in the early seventies Denmark participated in the so-called Snake arrangements, and since the late seventies it has been a member of the European Monetary System. Sweden also participated in the Snake arrangements for a few years, but has, since 1977, pegged to a basket of

⁵ Of course, a full understanding of the differences would need a much deeper analysis of history, structural problems and various policy details than is possible in this context.

currencies.⁶ In the period 1977 - 1982, Sweden devalued its currency on several occasions in order to safeguard the external balance. A clearly different approach is to be found on the other side of the globe. Australia⁷ pegged to a currency basket in the seventies and early eighties, but chose to allow its currency to float in 1983.

Denmark is the country which, as a result of the exchange rate regime, has relied most on internal adjustment of prices and wages. In practice, participation in the EMS has come to imply that the inflation performance of the strongest member, i.e. Germany, sets the target for Denmark also. This has been strongly spelled out by the Government during the last few years, and the need for domestic adjustment has been brought to the forefront. Admittedly the exchange rate target has slipped, and the Danish krone has weakened by somewhat more than 20 per cent against the D-mark during the eighties. But in relation to the ECU, the Danish krone has weakened by less than 10 per cent (and in fact has strengthened somewhat since 1981), and the effective exchange rate has, in nominal terms, been virtually stable.

Monetary policy has not had much room for manoeuvre in these circumstances; after a more or less complete deregulation of capital flows during the early eighties, monetary policy had to be geared towards the

⁶ The weights in the basket are determined on the basis of the share of different countries in Sweden's foreign trade. The weight of the US dollar is, however, doubled. See Sveriges Riksbank (1983).

⁷ Strictly speaking Australia is not a "small open economy" measured in terms of the share of foreign trade in GNP; the share of exports and imports is well below 20 per cent. But given its resource base, Australia is highly dependent on exports for the maintenance of growth and living standards.

maintenance of a stable exchange rate. The relative effectiveness of monetary policy as a demand management tool has been further reduced by the tax deductibility of interest payments in combination with relatively high marginal tax rates.

Hence, the adjustment of the current account has relied heavily on fiscal policy. Indeed, since 1983, fiscal policy has been tightened substantially, and the general government accounts posted a substantial surplus in 1986-87.

Determined efforts have at the same time been made to break the wage-price link. Traditionally, this link was strong in Denmark because of the widespread application of indexation. However, the Government suspended the indexation system in 1982, and it has not in fact been in force since then. Efforts have also been made to reduce the relative attractiveness of unemployment benefits in order to enhance flexibility in the labour market. The generous schemes were one important reason behind the rapid increase in the budget deficit at the turn of the decade. Hence, it was thought that a moderation of unemployment benefits would not only increase flexibility in the labour market but also strengthen the budget balance.

Sweden has also adhered to a fixed exchange rate policy. However, this has been more of a deliberate "adjustable peg"-type. As noted above, the krona was devalued against the basket on several occasions during the latter half of the seventies, and in autumn 1982 a large devaluation was undertaken with the explicit aim of promoting the external adjustment process; the so-called "third way" aimed at promoting a shift of resources to the foreign trade sector without a simultaneous rise in unemployment. As a result, the krona has weakened by some 30 per cent against the basket and by somewhat more

than 20 per cent in effective terms (OECD calculations) in the period 1980-1987. At the same time Sweden has maintained relatively strict control of capital movements. However, it is uncertain to what extent this has protected monetary policy from external influence, and it might be close to the truth to assume that monetary policy has had in practice to be geared towards the exchange rate target.⁸ As in Denmark, the effectiveness of monetary policy has been reduced by high marginal taxes and the deductability of interest payments.

Another main pillar in the adjustment strategy in Sweden was to bring down the budget deficit, which was seen as a prerequisite for the creation of the necessary room for the external sector as well as a reduction of inflationary pressures. Judging on the basis of the general government balance, fiscal policy has indeed been substantially tightened; during the period 1982-87 the balance has strengthened by some 10 per cent of GDP to a surplus of 4 per cent of GDP in 1987. Although Sweden has officially not intervened in the wage process, strong elements of indirect influences can be discerned; e.g. the authorities have on a couple of occasions resorted to temporary price freezes in the last few years.

Australia embarked on a different road as its unemployment and current account problems became more severe in the early eighties. The financial markets were deregulated and the exchange rate allowed to float as from the end of 1983. This was apparently done in order

⁸ Empirical estimates indicate that the sensitivity of capital flows to interest rates has been rather low in the eighties. (See e.g. Åkerholm - Tarkka (1987)). However, this result is also obtained if domestic interest rates are actively adjusted to check capital flows.

to increase the number of policy instruments and hence make it possible to simultaneously safeguard both external and internal stability.

The ambitious policy targets were clearly reflected in the policy mix. In 1983 fiscal policy was reorientated in a distinctly expansionary direction and it was hoped that the inflationary pressures could be contained through incomes policy measures. Incomes policy agreements with wide coverage were implemented, and monetary policy was used to "promote a non-inflationary environment". It seems, however, fair to conclude, that both monetary and fiscal policies were geared towards stimulating domestic demand. The budget deficit widened markedly in 1983 and has remained large since then. As a result, any improvement in the external balance had to come through the relative price changes brought about by the depreciation of the currency and the impact of the incomes policy agreements. In effective terms, the nominal exchange rate depreciated by 62 per cent between 1982 and 1987.

The outcome

The adjustment of the current account deficits seems to have been very different, however, as too have been the cost associated with reducing the deficits. In 1987, Sweden had reached almost balance on the current account, while the deficit in Denmark was somewhat more than 2 and in Australia more than 4 per cent of GDP.

As can be seen from Diagram 2, different indicators give a rather mixed picture as regards overall economic balance in 1982. Australia had the highest current account deficit and the fastest rate of inflation, but a virtually insignificant budget deficit. Denmark had the

highest rate of unemployment⁹ and the deepest budget deficit. Sweden was perhaps in a somewhat better position than the other two, even if allowance is made for the rather high proportion of "hidden" unemployment.¹⁰

In 1987, the picture is clear. Australia has experienced a marked deterioration in its relative performance and is now in the least favourable position on all fronts; and hence the costs seem to have been highest. However, it should be pointed out that, in absolute terms, the Australian position has weakened only as far as the budget deficit and the rate of unemployment are concerned. By contrast, Denmark and Sweden have gained on all fronts, and Sweden in particular seems to be in good overall balance. Sweden is only slightly worse off than Denmark in terms of inflation.¹¹ Overall, Denmark is situated somewhere between Australia and Sweden. How can one explain these striking differences? Some superficial considerations are presented below.

Sweden's relative success seems to hinge on at least one central factor. Nominal wages have reacted with a remarkably long lag to the large devaluations in the early eighties, and this has made possible the significant change in relative prices that was aimed at (Diagram 3). The catch-up process of domestic costs started only in 1984, and by 1987 the Swedish cost level

⁹ The Danish unemployment figures are based on Danish definitions and are not strictly comparable with the unemployment figures for the other two countries, which are in accordance with OECD standards.

¹⁰ According to the OECD, open plus hidden unemployment amounted to 6.3 per cent of the labour force in 1982. See OECD, Economic Surveys, Sweden, 1985.

¹¹ Even if allowance were made for the "hidden" unemployment in Sweden, the unemployment rate would not exceed the rates prevailing in Australia and Denmark.

had still not, in nominal terms, caught up with the countries to which Sweden pegs its currency. Measured in terms of relative unit labour costs in the same currency, the Swedish cost position strengthened by almost 10 per cent in the 1982-1987 period.¹²

The strong commitment to a fixed exchange rate and the relative stability of the nominal effective exchange rate have not stopped wage costs from rising in Denmark. On the contrary, relative nominal wage costs have displayed a constant upward trend, and the depreciations of the krone vis-à-vis the D-mark have only offset the difference between German and Danish cost developments. When allowance is made for the fact that the D-mark has strengthened significantly since 1985, the cost position has deteriorated during the last few years in particular. According to OECD calculations, the relative cost position vis-à-vis competitors worsened by more than 20 per cent in the 1982 - 1987 period.¹²

In Australia, the incomes policy arrangements do not seem to have been able to break the notorious upward drift in the relative cost position. In fact, relative costs seem to have developed well ahead of the exchange rate during the early part of the eighties, and only the sharp depreciation during the last few years has brought about an improvement. Since mid-1984 the relative cost position has improved substantially and is now well below the level in the early 1980s.¹²

Another striking difference is to be found in the relationship between the budget and external balances (Diagram 4). In Sweden there seems to have been a clearly positive correlation, while there is hardly any connection in Australia and even a negative relationship in Denmark. If this gives some indication about the

¹² See OECD, Economic Outlook, (1987)

effectiveness of fiscal policy in curbing external deficits, it is not very promising. However, although these relationships are interesting to note during the period in question, one should not take them too seriously. The different developments in foreign balances are bound to also reflect the very different developments of relative cost positions reported above.

Undoubtedly, too, the difference in the overall position is influenced by the large differences in the behaviour of terms of trade (Diagram 5). Both Sweden and Denmark have benefitted from an increase in the terms of trade during the eighties, while Australia has experienced a marked weakening in the post-1984 period. This weakening, which is of course not entirely unrelated to the simultaneous depreciation of the exchange rate, has not only imparted a negative influence on the current balance but probably also made it politically more difficult to tighten fiscal policy, as disposable incomes have been reduced by the development of foreign trade prices.

One cannot avoid the impression that the relative success of Sweden is largely due to the developments in costs. It is evident that expectations did not react immediately to the large devaluations, while there have been persistent inflationary expectations in the other two countries. The interest rate differential, which in Sweden was at about parity at the time of the 1982 devaluation, rose only slightly in nominal terms and actually fell in real terms (Diagram 6). Denmark, in particular, has suffered from stubborn inflationary expectations, which are clearly reflected in the interest rate differential vis-à-vis the target for the exchange rate peg, i.e. Germany. This difference was particularly large, both in nominal and real terms, in the early eighties. Thus the commitment to the fixed exchange rate target has not convinced markets, despite

Danish participation in the European Monetary System. It is only towards the mid-eighties that the interest rate differential has gradually diminished.

It seems that the credibility of the non-inflationary programs suffered in Australia as the exchange rate was allowed to float in 1983. As already noted, costs continued to soar, and the interest rate differential, rose sharply, even in real terms.

However, some interesting differences can be observed in the trends during the mid-1980's. While the Swedish labour market was slow to react to the devaluations, inflationary expectations, as judged by relative interest rates, have gradually picked up. As a matter of fact, the Swedish interest rate differential has been on a clearly upward trend in nominal terms since 1982 and in real terms since mid-1984. In nominal terms, long-term interest rates were, in 1987, some 3 per cent above the weighted interest rates in the countries that Sweden has pegged to. In real terms the difference was about the same.

By contrast, it would seem that inflationary expectations have slowly but gradually subsided in Denmark. While the interest rate differential is still positive, it no longer exceeds the Swedish interest rate differential. Also in Australia, for which the relevant interest rate differential is more difficult to identify, interest rates have stopped rising relative to trading partners. In real terms they may actually have been negative for a prolonged period in 1986-1987. Hence, there seems to have been a strong increase in inflationary expectations at the time of the decision to float. Even if expectations might have subsided later, there is still a substantial risk premium attached to the Australian dollar despite the marked depreciation during the last few years.

It is also useful to take a look at the development of fixed investment in order to get an idea of the long-term costs associated with the adjustment process. As can be seen from Diagram 7, Australia has traditionally had the highest share of non-residential investment in GDP (about 19 per cent), while Denmark has had a rate below 16 and Sweden below 17 per cent. The relative sizes were the same at the beginning of this decade. However, some interesting differences in trends are discernible during the eighties, and by 1987 all three countries had an investment rate at around 15 1/2 per cent. In Australia, the rate of investment has continuously been on a downward trend, while Denmark has experienced a marked recovery in the mid-eighties. In Sweden, the investment rate has fluctuated much less than in the other two countries.

Concluding remarks

While a period of five to seven years is much too short and examining the experience of only three countries provides too narrow a basis for any far-reaching conclusions, the superficial description presented above seems to invite some general remarks with respect to the questions raised above. First of all, it seems difficult to find general rules concerning economic behaviour or policy mixes which would be applicable in all countries at all times. Nevertheless, it would seem clear that an improvement in the external balance needs support from fiscal policy, as is shown by the lack of success in the case of Australia.

Second, it is evident that the flexibility of wages and prices is decisive to the overall outcome and the chances of maintaining employment in the adjustment process. This determines to what extent monetary policy can support domestic demand and whether monetary policy

has to be geared solely towards the inflation target. But the experiences of these three countries indicates that there are large differences as far as labour market behaviour is concerned.

Third, some limited support can be found for the view that the choice of exchange rate regime affects expectations and hence wage and price flexibility. A decision to float the currency does not necessarily make the adjustment process any easier and certainly not automatic. As is shown by the experience of Australia, it involves running the risk of losing an anchor, both for wage and price developments as well as for policy behaviour. It seems likely that the float delayed the tightening of policies in Australia and instead invited an attempt to deal with the unemployment problem through an expansionary fiscal policy and a rather loose monetary policy. Since wages and prices reacted rapidly, no real adjustment came about, and finally fiscal policies had to be tightened at a stage when also the currency was depreciating rapidly. As a result, the whole adjustment process was postponed, and it was therefore much more severe when it finally had to be initiated.

By contrast, fixed exchange rate policy seems to provide some anchor for expectations and it may help to put the brakes on fiscal expansion. But, fourth, it seems evident that a mere announcement of a fixed exchange rate policy does not help to achieve the necessary flexibility in wages and prices, even if it is supported by a commitment to international co-operation. As the example of Denmark illustrates, it takes a very prolonged period to suppress inflationary expectations once they have been built into the system. Both labour and financial markets seem to have been rather immune to the efforts taken by the Danish Government, and the risk

premia have been consistently high and thus have added to the costs of the deflationary process.

On the other hand, the example of Sweden shows that it may take a remarkably long time for expectations and costs to catch up with a "surprise" devaluation. There seems to be some evidence that the interest rate differentials have persistently exceeded the devaluations in Denmark in the seventies and eighties, while they undercompensated for the rate of depreciation in the case of the Swedish krona.¹³

This points to a fifth conclusion, namely the possibility that perceptions about the relative strength of currencies change only slowly, as does the credibility of policies in general. The interest rate differentials might reflect decades of experience with a relatively "weak" Danish and relatively "strong" Swedish currency. But the developments in the Swedish interest rate differential in the last few years indicate that the devaluations in the late seventies and early eighties are gradually being built into expectations. Some recent speculative waves against the krona (e.g. in 1985) also show that the basic thrust in the fixed exchange rate policy might have been undermined. This is bound to reduce the room for manoeuvre of monetary and exchange rate policies, since depreciations could in the future spill over into wage and price increases much more rapidly, and the "trick" of 1982 does not necessarily work again.

In general terms, it would seem that the room for manoeuvre in economic policies has become rather limited. Irrespective of the exchange rate regime,

¹³ See Åkerholm - Tarkka (1987), who show that there has also been an overcompensation in the case of the Finnish markka and an undercompensation in the case of the Norwegian krone.

monetary policy must to an increasing extent be geared towards the inflation target, while fiscal policy has to be used to correct external imbalances in situations of disequilibrium. If these policy constraints are not perceived in the labour market, even larger fluctuations in employment may be arising than has been the case hitherto. However, limited scope for policies is not necessarily a problem for only small economies. With faster information, expectations might react rapidly in big economies as well, and with the possible exemption of the US, it is doubtful whether the big economies have any more freedom in their policy formulation.

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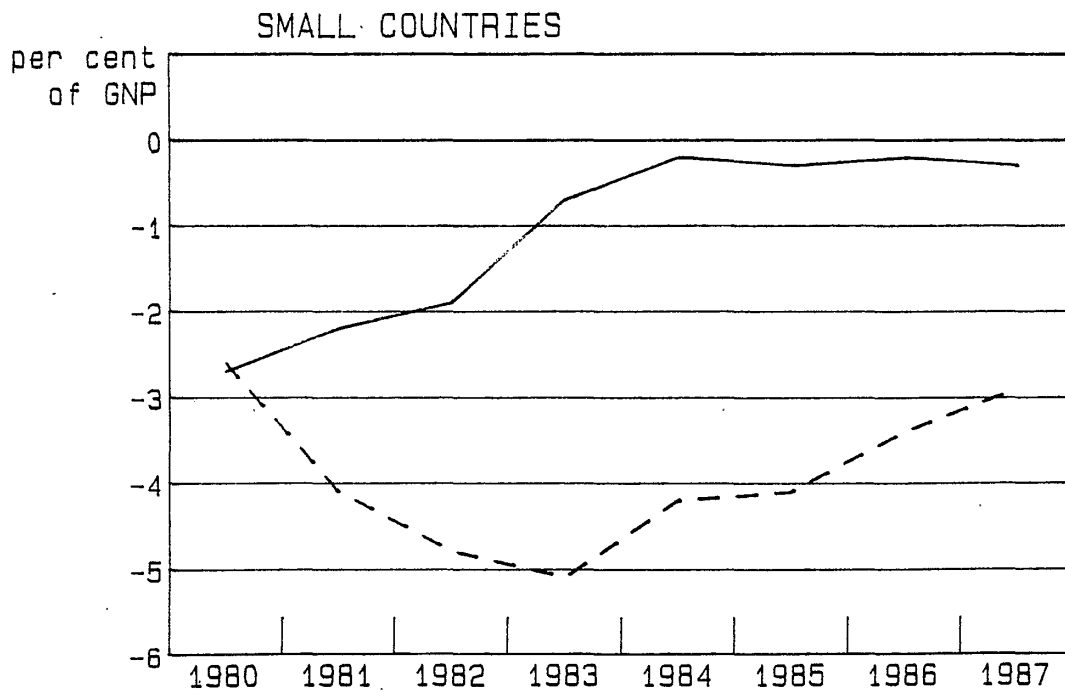
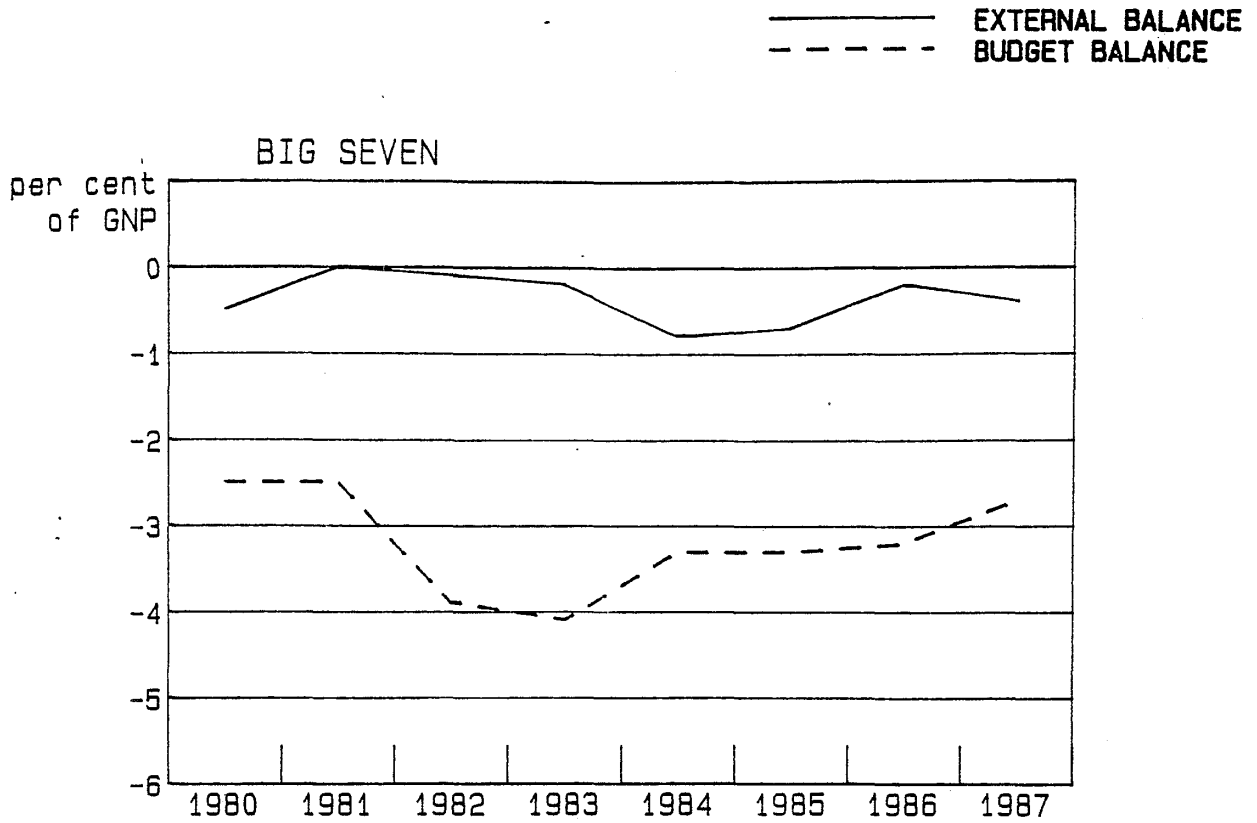
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Diagram 1 Fiscal and external balances in the
OECD countries 1980 - 1987



Sources: OECD, Economic Outlook, various issues.

Diagram 2

Overall economic performance

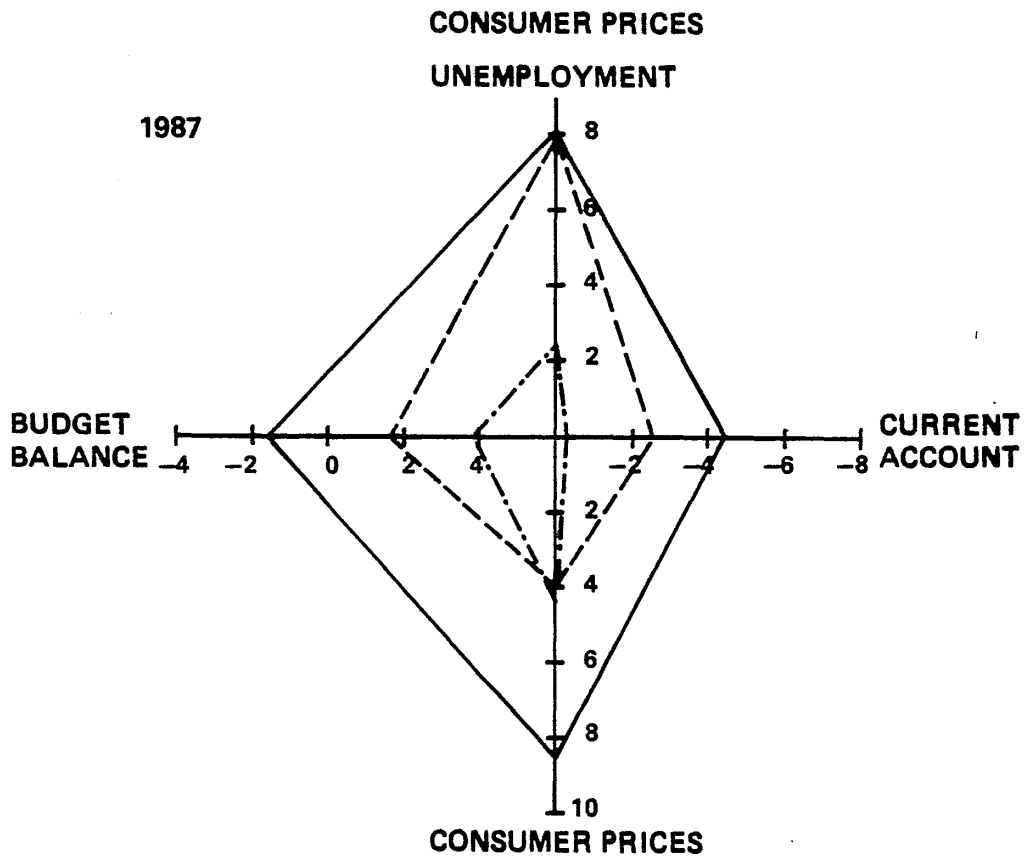
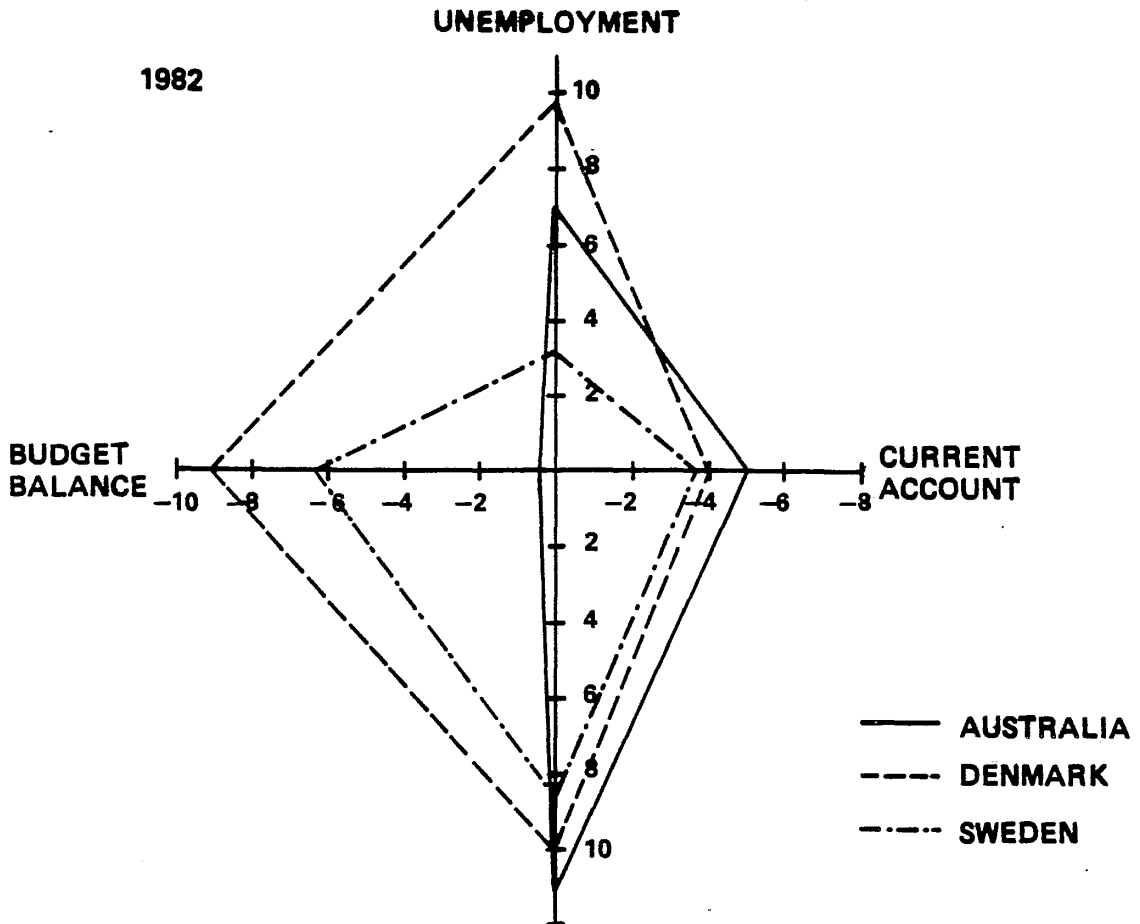
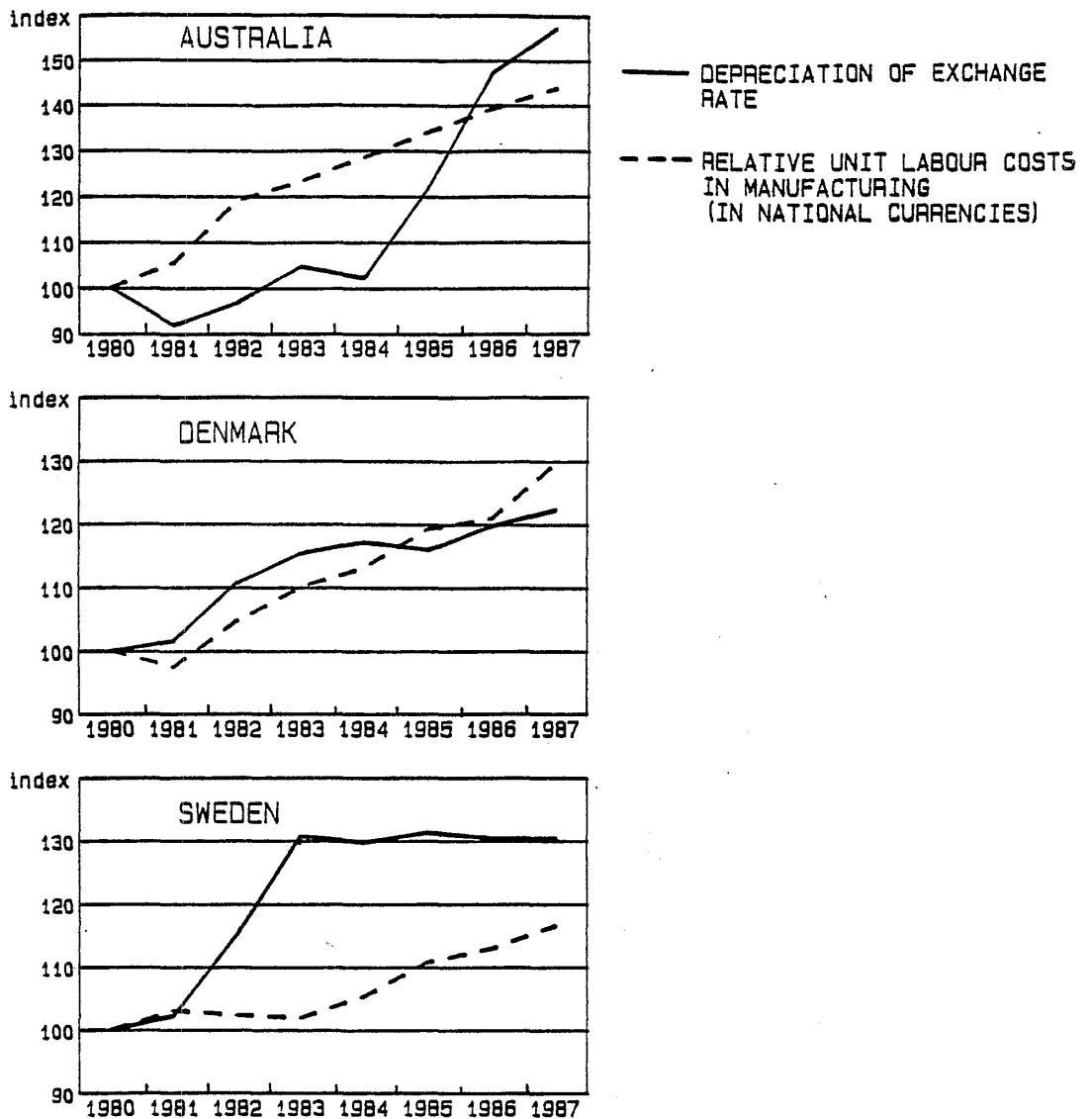


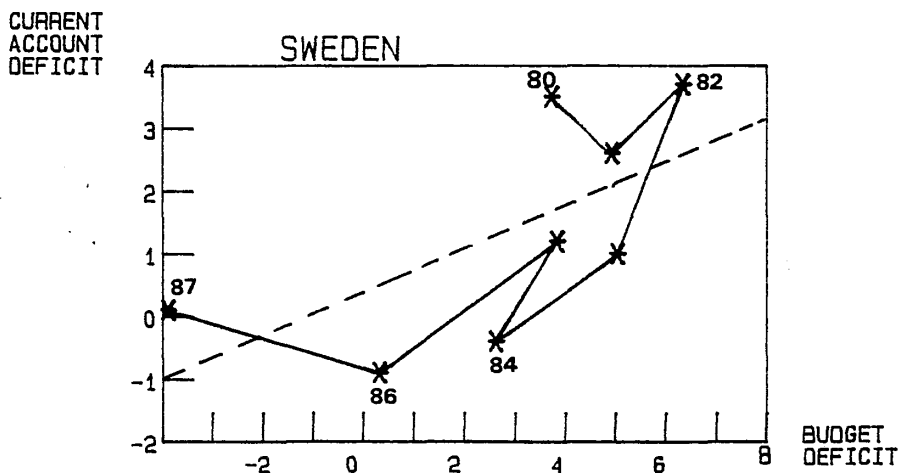
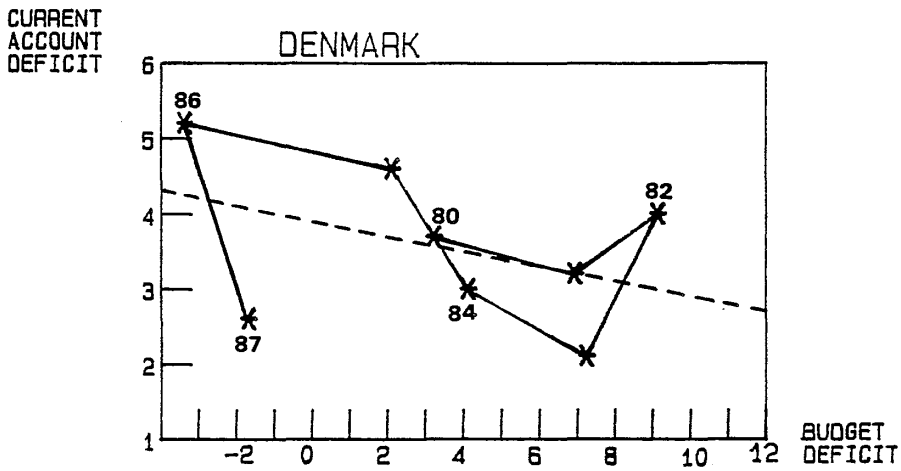
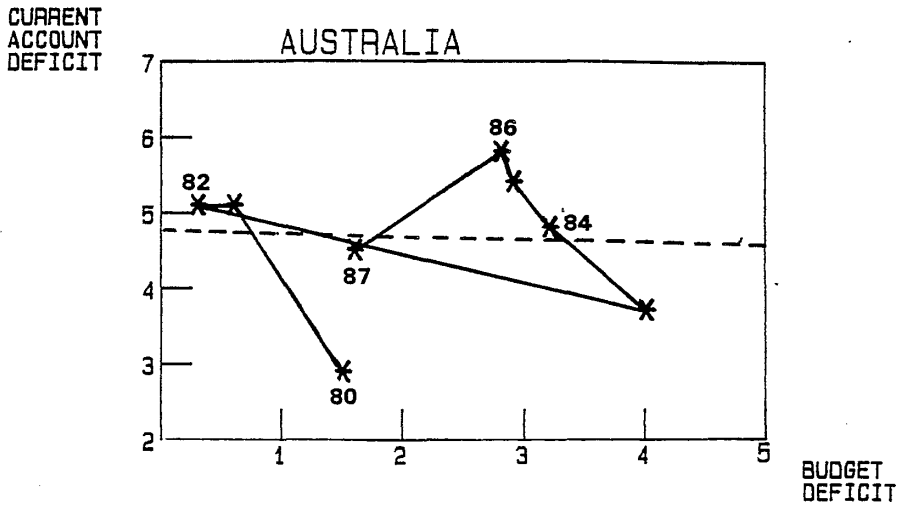
Diagram 3 Depreciation of the exchange rate and relative unit labour costs (1980 = 100)



Note: In the case of Australia, the depreciation indicates movements in the effective exchange rate (OECD calculations) and relative unit labour costs are calculated on the same basis. In the case of Denmark, developments are related to those in Germany. The Swedish figures are based on a comparison with the countries included in the Swedish currency basket.

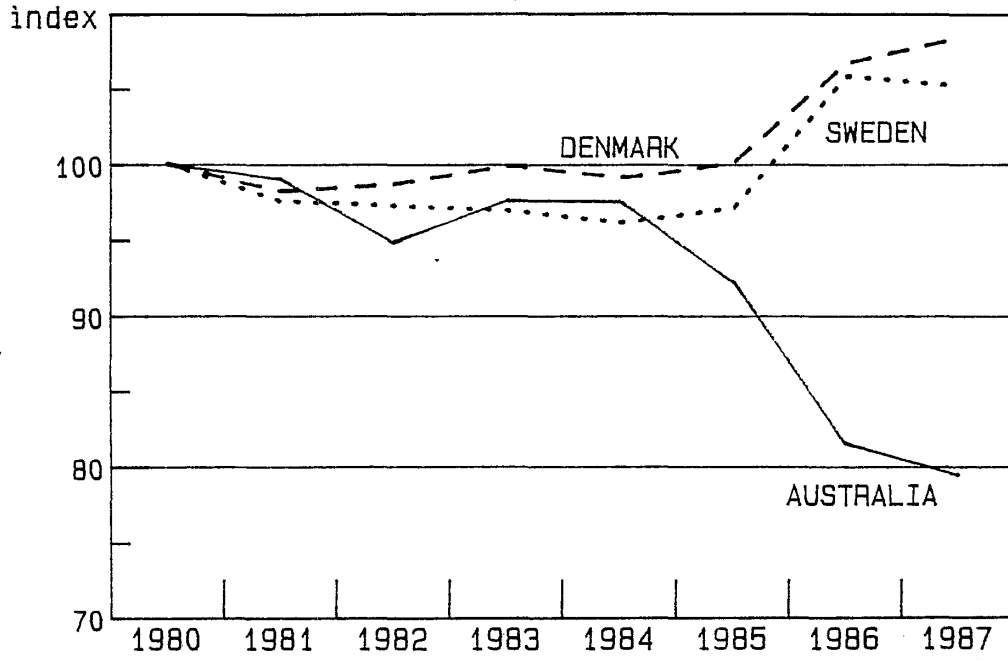
Sources: OECD, Economic Outlook, various issues, Sveriges Riksbank, 1983 and own calculations.

Diagram 4 Current account and budget balance (per cent of GDP)



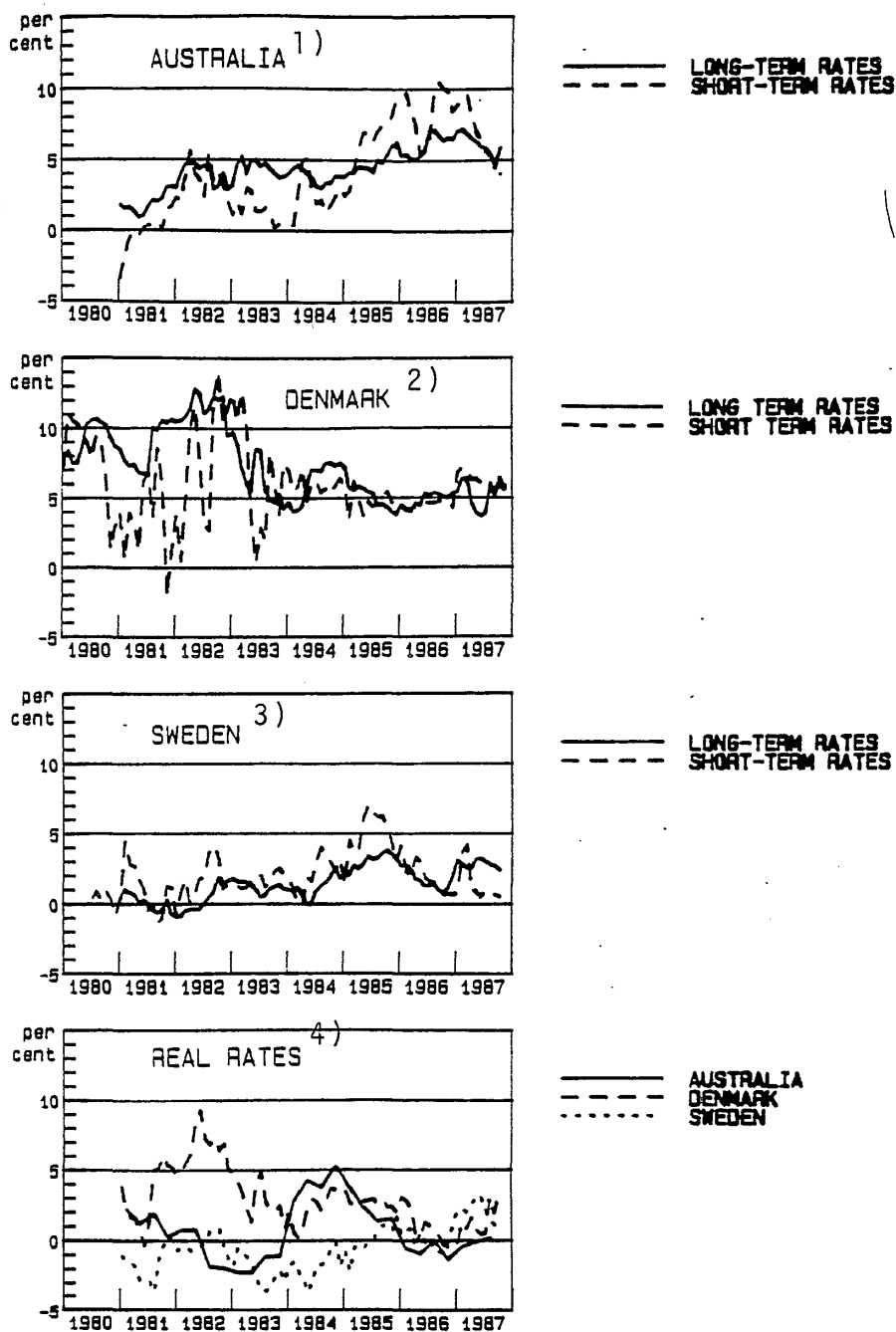
Source: OECD, Economic Outlook, various issues

Diagram 5 Terms of trade
1980 = 100



Source: OECD, Economic Outlook, various issues.

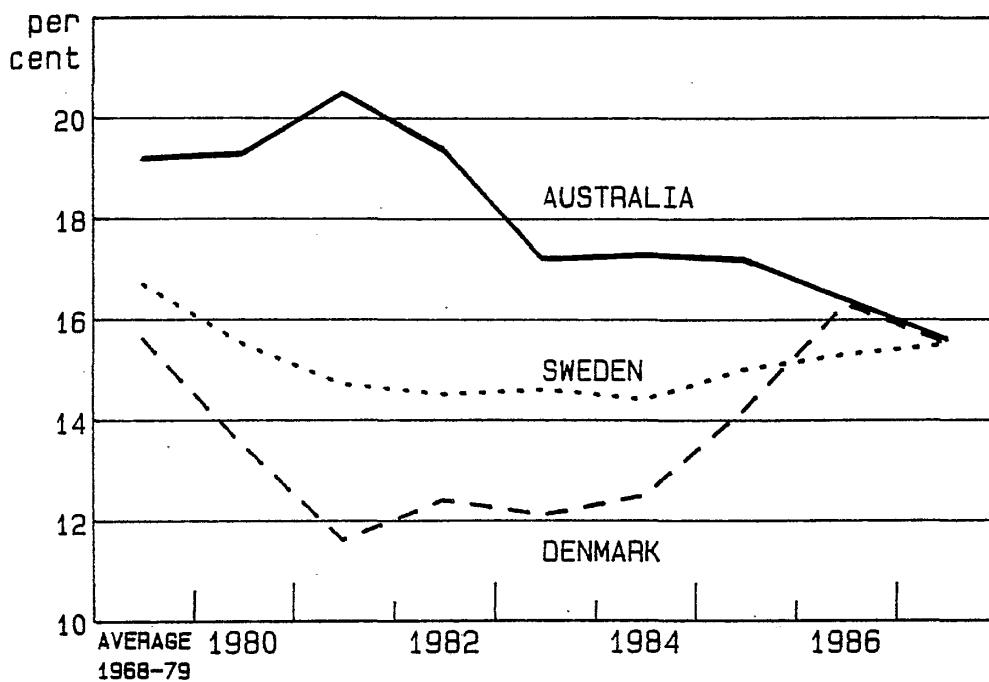
Diagram 6 Interest rate differentials



- 1) Australian interest rates less the weighted average in Australian's competitor countries (OECD weights)
- 2) Danish rates less German rates
- 3) Swedish rates less the weighted average for those countries represented in the Swedish currency basket
- 4) Nominal long-term rates deflated by consumer prices.

Sources: IMF, Financial Statistics, Herd (1987) and own calculations

Diagram 7 Non-residential investment
(as per cent of GDP)



Source: OECD, Economic Outlook, Historical statistics 1960-1985 and various issues.



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